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Oil, Gas & Energy Law Intelligence

Survey of Recent Governmental Measures in Key Latin-American Countries (Argentina[1], Bolivia[2], and Ecuador[3]) and Comparison with the Venezuelan Case

by R. Chirinos,
D.G. Lamanna[1] and D.E. Arias[1], R. Guevara[2],
J.P. Zaldumbide-Serrano[3]

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Survey of Recent Governmental Measures in Key Latin-American Countries and Comparison with the Venezuelan Case

Ricardo Chirinos*

Bolstered by the sustained escalade of oil prices for the past few years in the international markets, the governments of certain Latin-American countries have taken dramatic measures aimed at significantly reducing the possibilities of private participation in oil projects, increasing the government take in the same and closing doors to the settlement of disputes through internationally recognized institutions such as the International Centre for Settlement of Investment Disputes ("ICSID").

Even though the impact varies depending on the case, it cannot be denied that, besides the high oil prices factor, the ideological, economic and political influence that Venezuela is increasingly exercising in the region has played an important role in certain decisions that other Latin-American governments have taken regarding their oil industries and, consequently, in the formation of the trends that seem to have been recently created in the region.

In the particular case of Venezuela, the so-called policy of "full oil sovereignty" promoted by the government of Hugo Chávez and aimed at "correcting inherited deviations and deactivating all symptoms of domination in the field of oil"[1], has served as basis for highly controversial measures that not only transformed the legal framework applicable to oil projects in this country, but also resulted in sudden and severely detrimental changes to the investment-friendly environment created with the process of *Apertura Petrolera* (or oil opening process) conducted during the 1990's.

* **RICARDO CHIRINOS**, LL.B. (*cum laude),* Universidad Católica Andrés Bello. He is currently an associate of the Oil and Gas Department of *Despacho de Abogados miembros de Macleod Dixon, S.C.* in Caracas, Venezuela. He can be reached at: ricardo.chirinos@macleoddixon.com

[1] Plena Soberanía Petrolera: Al Pueblo lo que es del Pueblo, Publication by the Ministry of Communication and Information, October, 2004, p. 4.

In the context of this special issue on Venezuela by OGEL / TDM, this brief contribution is aimed to provide an overview of the most relevant governmental measures that have been recently taken by the Venezuelan Government and which affect foreign and local companies participating in the different upstream and midstream projects conducted in this country, as well as to serve as an introduction to the kind contributions submitted by oil and gas experts from Argentina (Dario G. Lamanna and Darío E. Arias), Bolivia (Ramiro Guevara) and Ecuador (Jaime Zaldumbide S.), which comment on the governmental measures taken in those key countries.

I. Changes in the Venezuelan oil legal framework: The abrupt end of the *Apertura* era

As a matter of background, during the *Apertura* process 33 operating agreements and 12 association agreements were entered into between affiliates of the Venezuelan State-owned company, Petróleos de Venezuela, S.A. ("PDVSA"), and different foreign and local private companies. Concretely, the following structures were used:

(i) operating agreements for the reactivation of marginal fields;
(ii) strategic associations for the production of extra-heavy oil in the Orinoco Belt; and
(iii) associations under the so-called exploration at risk and profit sharing agreements.

Based on the high oil price scenario and a change of philosophy in the Venezuelan Government, a series of measures taken since the enactment of the Organic Hydrocarbons Law ("OHL")[2] in 2001, resulted in the cessation of all oil projects conceived under the *Apertura* era and their migration into a new

[2] Published in Official Gazette N° 37.323 of November 13, 2001. We note that even though the OHL was published on November 13, 2001, it actually entered into force and effect on January 1, 2002. The OHL was subsequently amended in 2006, this amendment was originally published in Official Gazette N° 38.443 of May 24, 2006 and later corrected and re-published in Official Gazette N° 38.493 of August 4, 2006.

structure of joint venture companies,[3] which has been regarded by the Venezuelan Government as the "true oil nationalization" of this country.[4]

Indeed, after the entry into force of the OHL in 2002, state control over oil activities was significantly increased and the performance of upstream and midstream activities (defined by the OHL as primary activities) by private participants was limited to State-controlled incorporated joint ventures having State-equity participation of more than 50% (commonly referred to as mixed companies).

Although the OHL cannot apply retroactively to affect prior agreements,[5] the Venezuelan government figured out a way to create an equivalent effect by challenging the legality of the operating agreements executed during the *Apertura* process and terminating the same agreements through a law enacted especially for that purpose. This was the case of the Law Regulating Private Participation in Primary Activities (commonly referred to as the "Regularization law"), which declared the content of such agreements as "incompatible" with the rules established by the "new nationalization regime" and, therefore, terminated such agreements and prohibited their further execution.[6]

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[3] Including also the incorporated joint venture project for the production of Orimulsion® commonly referred to as the Sinovensa Project.

[4] It is worth noting that the nationalization of the Venezuelan oil industry occurred back in 1975 with the issuance of the Organic Law that Reserved to the State the Industry and Trade of Hydrocarbons (the, "1975 Nationalization Law") which put an end the oil concessions awarded during the regime of the Hydrocarbons Law of March 13, 1943, amended in August 29, 1967. Nevertheless, the Venezuelan Government has made use of this term to refer to the process that has been conducted after the entry into force with the OHL for the assumption of control by the State (through mixed companies) in all existing projects and the termination of the agreements executed during the regime of the 1975 Nationalization Law.

[5] Read in relevant part, Article 24 of the Constitution of the Bolivarian Republic of Venezuela provides as follows: "No legislative provision shall have retroactive effect, except where it imposes a lesser penalty".

[6] Prior to the enactment of the Regularization Law, the so-called process of migration of the operating agreements began in April 2005 when the Venezuelan Government formally challenged the legality of such agreements for not being in conformity with the OHL regime and instructed PDVSA to convert the same into new mixed companies. Among other reasons given for asserting the illegality of the operating agreements, the Minister of Energy and Petroleum alleged that, by entering into such agreements, PDVSA handed to third parties oil exploration and production activities, which were reserved under the 1975 Nationalization Law to State-owned companies and association agreements and were not allowed to be conducted under operating agreements.

After termination of such operating agreements and the migration of most of such agreements into the new structure of mixed companies in accordance with the OHL, the Venezuelan Government proceeded to the migration -to the new mixed company structure- of the association agreements as well as the exploration at risk and profit sharing agreements executed between 1993 and 2001.

With respect to said agreements, two legal instruments were adopted, namely: (i) Decree-Law N° 5200 Concerning the Migration of the Association Agreements of the Orinoco Belt and of the Exploration at Risk and Profit Sharing Agreements into Mixed Companies (the "Migration Law")[7] and; (ii) the Law on the Effects of the Migration Process of the Association Agreements of the Orinoco Belt and of the Exploration at Risk and Profit Sharing Agreements into Mixed Companies (commonly referred to as the "Effects Law").[8]

Although in the majority of the cases the migrations to the new mixed company structure was conducted with the agreement of the relevant parties, the measures taken by the Venezuelan State against the parties that did not consented to the migration of their respective projects (or their corresponding share in the same) can be regarded as an expropriation of the contractual rights of the affected parties[9] conducted with complete disregard to the expropriation procedure established by the Law of Expropriation for Public Utility or Social Cause and the provisions of the Venezuelan Constitution,[10] the Law for the

[7] Published in Official Gazette N° 38.632 of February 26, 2007.

[8] Published in Official Gazette N° 38.785 of October 8, 2007.

[9] In this regard see Brewer-Carías, The Early and Unilateral Termination of Operating and Association Agreements which allowed participation of private capital in primary activities before 2002, through laws enacted in 2006 and 2007, Venezuelan Public Law Review No. 109, Caracas, 2007. Also see Eljuri and Tejera, The XXI Century Transformation of the Venezuelan Oil Industry, International Bar Association, Journal of Energy and Natural Resources, publication set for November 2008.

[10] Article 115 of the Venezuelan Constitution provides as follows: "The right of property is guaranteed. Every person has the right to the use, enjoyment, usufruct and disposal of his or her goods. Property shall be subject to such contributions, restrictions and obligations as may

Promotion and Protection of Investments,[11] and the different Bilateral Investment Treaties to which Venezuela is a party, all of which recognize the right of the affected parties to receive compensation.

It is worth noting that as a result of the forced termination of the operating agreements, the association agreements and the exploration at-risk and profit sharing agreements, so far three companies have filed for arbitration against Venezuela before ICSID, namely: Eni Dación B.V., ConocoPhillips Company and Mobil Corporation.[12]

In the particular case of ExxonMobil, it also introduced three requests for preliminary measures -based on the ICC arbitration it filed under its Association Agreement- one in a US Court, one in a Dutch Court and one in a British Court against PDVSA, where it requested a provisional asset freeze against PDVSA in New York, London, the Netherlands and the Netherlands Antilles. Recently, the British Court later suspended its injunction and ruled in favor of PDVSA.

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be established by law in the service of the public or general interest. Only for reasons of public benefit or social interest by final judgment, with timely payment of fair compensation, the expropriation of any kind of property may be declared" (emphasis added).

[11] Published in Official Gazette N° 5390 of October 22, 1999. Article 11 of this Law provides as follows: "No confiscations shall be decreed or carried out other than in the exceptional cases provided for in the Constitution; and, in the case of international investments and investors, under international law. Expropriations of investments, or application thereto of other measures whose effects are equivalent to an expropriation shall only be carried out for reasons of public benefit or social interest, following the procedure legally established for the purpose, in a way that is non-discriminatory and with prompt, fair and effective compensation.

The compensation is to be equivalent to the fair price of the expropriated investment immediately before the expropriation is announced by the legal mechanisms or made public, whichever is first. The indemnification, which is to include interest up to the date when payment is actually made calculated based on normal commercial criteria, is to be paid without delay.

Sole Paragraph. Indemnification payable for expropriations of international investments shall be paid in convertible currency and shall be freely transferable abroad" (emphasis added).

[12] ICSID, List of Pending Cases, available at: http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=ListPending (last visited March 29, 2008). According to the information published in ICSID's website, the case of *Eni Dación B.V. v. the Bolivarian Republic of Venezuela* (ICSID Case No. ARB/07/4) was registered on February 06, 2007, the case of *Mobil Corporation and others v. Bolivarian Republic of Venezuela* (ICSID Case No. ARB/07/27) was registered on October 10, 2007 and the case of *ConocoPhillips Company and others v. Bolivarian Republic of Venezuela* (ICSID Case No. ARB/07/30) was registered on December 13, 2007. None of the three tribunals have been constituted yet.

It cannot be denied that the effect of the governmental measures taken in Venezuela regarding the operating, association and exploration at-risk and profit sharing agreements reached other latitudes. Indeed, as explained with more detail in the Article covering Bolivia, similar measures followed in that country where the Government took over upstream projects and deprived foreign and local companies of their title over the hydrocarbons extracted, as well as forced the owners of downstream assets to sell those assets back to the State at very low prices.

Also, in Ecuador, after the Executive Branch and the Congress approved the enactment of a new law applying a windfall profit tax for sudden gains obtained by oil companies, the Government entered into negotiations with all parties to the participation contracts for the exploration and exploitation of hydrocarbons aimed, among other purposes, at recognizing greater State participation in the crude oil production of each block. The process is still ongoing and the result of such negotiations is yet to be seen.

II. High prices, more take

Besides the natural effect of increasing the State's revenue that results from the predominant role that the State now exercises in oil projects after the entry into force of the OHL, the high prices of oil in the international markets have led the Venezuelan Government to substantially increase royalty and tax rates as well as to create additional taxes and payments aimed at expanding the margin of government take in such projects.

Although it seems that, even with an increased government take, oil projects in Venezuela continue to be feasible and highly profitable for private investors,[13] it is worth comparing in general terms the current regime with the prior regime in order to see the magnitude of the changes made as well as the way in which

[13] This includes investors that continue to do business in Venezuela after their projects have been forced to adapt to the mixed company structure set forth in the OHL, as well as new investors from countries such as Russia, India, Belarus and Iran which have entered into the Venezuelan oil industry as part of a clear attempt by the Venezuelan Government to reduce the presence of US and European companies in the Venezuelan oil industry.

the Venezuelan Government has dealt with and taken advantage of the current high prices of oil.

1. Royalties

The Hydrocarbons Law of March 13, 1943, last amended in August 29, 1967 (the "Old Hydrocarbons Law") provided a standard royalty rate of 16 2/3%.[14] The OHL increased the royalty rate from 16 2/3% to 30%.[15]

Both the Old Hydrocarbons Law and the 2001 Organic Hydrocarbons Law,[16] subsequently amended on 2006,[17] ("OHL") allow the Government to agree on a reduced rate when the economic viability of the project is at stake and to revert such reduction if the economics of the projects improve in a way that allows for an increase in royalty. However, under the OHL, there is a limit to any reduction; namely: a minimum of 20% for mature or extra-extra-heavy crude fields. It is also important to note that granting instruments may establish special advantages for the Republic in the form of increased royalties.

2. Income Tax

Under the Income Tax Law of 1999,[18] the applicable income tax rate for extra-heavy oil projects was 67%. However, certain investment tax credits ("ITC") applied. These included an 8% ITC for investments in new assets and an additional 4% ITC on new investments for exploration, drilling and production facilities and related facilities, transport, storage to the port of embarkation or to the refining facility within the country, secondary recovery of hydrocarbons, use, conservation and storage of gas (including LNG), valuation of hydrocarbons and

[14] Old Hydrocarbons Law, Article 41.

[15] OHL, Article 44.

[16] Published in the Official Gazette N° 37.323 of November 13, 2001.

[17] Published in the Official Gazette N° 38.493 of August 4, 2006.

[18] Published in the Special Official Gazette N° 5.390 of October 22, 1999.

research activities. These ITCs could not exceed 2% of the taxpayer's taxable income and could be carried forward for three fiscal periods.

With the entry into force of the Income Tax Law of 2001[19] and to date, companies engaged in the exploration and exploitation of hydrocarbons and associated gas, as well as other related activities, became subject to a 50% income tax rate, while taxpayers under the agreements that govern the performance of vertically integrated projects for the exploitation, refining, transport, and distribution of extra-heavy crude oil, are subject to the standard 34% tax rate. In addition, with the partial amendment of the Income Tax Law of 2006,[20] several ITCs were revoked, including the 8% and 4% ITCs on new investments.[21]

3. Special Advantages

Under the regime of the Old Hydrocarbons Law, special advantages were established by agreement between the National Executive and the relevant concessionaire, and varied depending on each particular case. Now, under Article 33 of the OHL, mixed companies created for the performance of upstream and midstream activities may be subject to the payment of special advantages in favor of the Republic, the details of which must be informed by the National Executive (through the Ministry of People's Power for Energy and Petroleum) to the National Assembly, which may modify or approve such special advantages as proposed.

In recent projects approved by the National Assembly, special advantages payable by mixed companies consist of the following:

(i) 50% of the value of the hydrocarbons extracted by the mixed company from the assigned area and delivered to PDVSA Petróleo,

[19] Published in the Special Official Gazette N° 5.566 of December 28, 2001.

[20] Published in Official Gazette N° 38.529 of September 25, 2006.

[21] Gnaedinger, Venezuela Changing the Rules for Foreign Oil Companies, Tax Notes International, Volume 47, N° 7, August, 2007.

S.A. (or to any other company mentioned in Article 27 of the Organic Hydrocarbons Law appointed by PDVSA Petróleo, S.A.) during each calendar year (determined pursuant to the prices established for such hydrocarbons in the hydrocarbons purchase-sale contract which will be entered by the mixed company and PDVSA Petróleo, S.A., or its subsidiary); and

(ii) the sum of payments made by the mixed company to the Republic with regards to the activities developed by the mixed company during such calendar year, for royalties applicable to the extraction of hydrocarbons, income tax, contributions under the Organic Law on Science, Technology and Innovation, and any other tax calculated based on income (gross or net), and the investments made in endogenous development projects of one percent 1% of profits before taxes that is also required under the Accord of the National Assembly that approves the relevant project.[22]

4. Special Taxes

Article 48 of the OHL provides for different special taxes applicable to oil projects in Venezuela, which did not exist under the prior regime. Such special taxes are the following:

(i) Surface Tax: This tax is payable over granted area not currently under production. The tax is the equivalent of 100 Tax Units,[23] per year, per square kilometer or fraction thereof, and is subject to annual rate increases: a 2% rate increase per year during the first 5 years and a 5% rate increase per year thereafter, indefinitely.[24]

[22] Normally, the relevant Accord of the National Assembly provides that the amount of this special advantage is equal to zero when the sum of the payments mentioned in point (ii) is equal to or above the amount calculated pursuant to point (i).

[23] This amount is equivalent to approximately US$2,139 at the current value of the Tax Unit and at the official exchange rate of Bs.F.2.15/US1 (one Tax Unit is currently equivalent to approximately US$21.39 at the official exchange rate of Bs.F.2.15/US$1).

[24] It is unclear whether this tax may be applied to other areas used for project activities other than production, such as corridors for oil or gas pipelines. It is also important to note that this tax

(ii) Fuel Consumption Tax: This tax applies if hydrocarbon by-products or derivatives are produced and consumed as fuel in operations. The rate is 10% of the value of each cubic meter (m3) of hydrocarbon by-products or derivatives produced and consumed as fuel in operations, calculated on the sales price to the final consumer. When a product is not sold in the domestic market, the Ministry of People's Power for Energy and Petroleum will fix its price.

(iii) General Consumption Tax: This tax applies to projects that sell hydrocarbon by-products or derivatives in the domestic market. The rate varies between 30% and 50% of the price paid by the final consumer for each liter of a hydrocarbon by-product or derivatives sold in the domestic market (the rate will be fixed annually in the National Budget Law).

(iv) Extraction Tax: After its 2006 amendment, the OHL provides that entities carrying out the activities governed by its provisions shall pay 1/3 of the value of all liquid hydrocarbons extracted from any reservoir. However, taxpayers have the right to deduct the following concepts from the payment of this tax: (i) the amounts paid on account of royalty, including any additional royalty paid as special advantage for the relevant project; and (ii) the amounts paid on account of any special advantage to be paid yearly, but only with respect to tax periods occurring after the payment of such annual special advantage.[25]

(v) Export Registry Tax: entities carrying out the activities governed by the OHL shall pay 0.1% of the value of all hydrocarbons exported from any port located in the Venezuelan territory.

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is in addition to any payments for servitude rights that must be made to private or public land owners and it is not deductible for purposes of calculating royalty payments.

[25] Please note that the government may reduce the rate of this tax to a minimum of twenty percent (20%), without prejudice to its power to reinstate such tax to its original rate when it considers that the reasons that motivated the reduction no longer exist.

In addition to the above, it is worth noting that after similar measures being taken in Ecuador and Argentina, the Venezuelan National Assembly approved a new law imposing a new "special contribution over extraordinary prices of the international hydrocarbons market" (or, as is commonly referred to, windfall profits tax).[26] In principle, this special contribution applies only to PDVSA and to the mixed companies that replaced the four Orinoco Belt associations (which market their crude internationally) and the applicable rate would be: (i) 50% for revenues earned on the export of crude (including upgraded crude and byproducts) when in any given month the average price of Brent crude exceeds US$70; and (ii) if the average Brent benchmark is over US100$, 60% for the portion of revenue exceeding the US$100 per barrel mark.

III. Governmental Measures and Policies Regarding Arbitration

As part of the change of philosophy of the Venezuelan Government that resulted after Hugo Chávez came into power, numerous threats have been launched from different governmental sources about Venezuela's withdrawal from existing bilateral investment treaties ("BITs") and its denouncement of this type of instruments.

In addition, due to the current administration's policy regarding the "re-nationalization of the oil industry" and the recent changes imposed by the Government in the legal and contractual framework in the oil industry, there have been some rumors about potential denunciation of the ICSID Convention.[27]

This last threat was made clear during the Fifth Summit of the Bolivarian Alternative for the Americas (ALBA) held in Venezuela in April, 2007, where the Bolivian President, Evo Morales, proposed that member states (Venezuela,

[26] Law on Special Contributions over Extraordinary Prices of the International Hydrocarbons Market, published in Official Gazette N° 38.910 of April 15, 2008.

[27] Recently, within the context of comments regarding the recent ICSID arbitration filed by Mobil Corporation mentioned above, the Minister of People's Power for Energy and Petroleum declared to the media that the Government is considering the denunciation of the ICSID Convention.

Cuba, Bolivia, and Nicaragua) should "withdraw from the International Centre for Settlement of Investment Disputes (ICSID)". The proposal was supported by the Venezuelan President and the rest of the members of ALBA.

Although other countries have already taken tangible measures in this regard (*i.e.* Bolivia[28] and Ecuador[29]), the denunciation of the ICSID Convention has not materialized from the Venezuelan side and, therefore, Venezuela continues to be a party to the ICSID Convention. As to BITs, there have also been rumors of denunciation for some of them, but so far nothing has occurred.

Although the Government has not repealed or denounced other treaties or provisions, we are aware that all new contracts executed by the Government in relation to new projects and post-migration projects contain clauses of jurisdiction, which subject all disputes to the jurisdiction of the Courts of Venezuela. There is a slight mention of the possibility of settling disputes through arbitration if once the dispute arises the parties consent to submit such dispute to arbitration. In other words, there is no agreement for arbitration in such contracts but rather a mere mention of the need for a specific *compromis* in each dispute. Based in these new contracts as well as in recent legislation, there seems to be a trend in Venezuela to consider arbitration as an amicable mean of dispute resolution, as opposed to a binding method. In this regard, recent laws (including the OHL, the Organic Gaseous Hydrocarbons Law[30] and the Mining Law[31]) and contracts include mentions to amicable arbitration as trying to eliminate the binding character of arbitration.[32]

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[28] Bolivia formally withdrew from the ICSID Convention on May 2, 2007. On November 23, 2007, the 6-month survival period provided for in Article 71 of such Convention expired.

[29] Although Ecuador has not fully withdrawn from the ICSID Convention, the Ecuadorian Government sent an official communication a few months ago denouncing submission to ICSID in connection with disputes deriving from investments relating to the exploitation of natural resources.

[30] Published in Official Gazette N° 36.793 of September 23, 1999.
[31] Published in the Special Official Gazette N° 5.382 of September 28, 1999.

[32] For more a more comprehensive analysis of the recent measures concerning arbitration see Eljuri and Tejera, Update on the Venezuelan Oil Industry and Recent Developments in the Arbitration Arena, International Bar Association, Journal of Energy and Natural Resources, publication set for November 2008.

Whether Venezuela will in fact withdraw from the ICSID Convention (fully, as in the case of Bolivia, or partially, as in the case of Ecuador) or denounce any of its BITs currently in force are measures that cannot be anticipated with absolute certainty. If that were to happen, it is imperative that the Government be ready to provide other guarantees and assure that an independent forum exist for the settlement of disputes involving oil projects in this country.

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Oil, Gas & Energy Law Intelligence

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Bolivia

Ramiro Guevara
Partner
Guevara & Gutierrez S.C.

In terms of the scope and extent of the changes implemented no country in Latin America has undergone changes as dramatic and as consequential as Bolivia, particularly as relates to hydrocarbons and arbitration. And that is even considering Venezuela.

Following through on his campaign promises, President Morales has deprived all upstream companies (Bolivian and foreign) of their title over hydrocarbons extracted by those companies, and has managed to do so without paying a single dollar in compensation. In addition, he forced those companies to “migrate” into new contractual structures which, essentially, convert those companies into mere services providers.

On the downstream side of things, the Government maneuvered companies that owned downstream assets (i.e. refineries) into a corner until they had practically no choice but to “sell” them back to the State at an extremely discounted price.

In order to implement its program the current administration has brought back to life the almost extinct Government owned company: Yacimientos Petrolíferos Fiscales Bolivianos (YPFB). Through YPFB the Government now controls the whole industry, upstream to downstream, including commercialization, refining and industrialization.

Of course and as many suspected, as time went by ideology began to crash with reality. The reforms led to serious disruptions in the supply of fuels, gas and even gasoline. Exploration programs have been dramatically reduced and production is beginning to decline. Gas export commitments have not been met and seem unlikely to be met at least in the next two years. Political commitments on the part of “friendly” countries such Iran, Venezuela and Russia have, thus far, failed to materialize, as a result of which YPFB finds itself in dire need of funds to invest mostly in exploration activities. This, in turn, has led the Government to slowly and grudgingly turn back to the same private companies that were anathema a year ago to try to convince them to invest more aggressively again. In an almost tragic-comic sense, it is interesting to see how the Government is furiously backpedaling on the practical, down to earth, aspects of the hydrocarbons industry, while simultaneously pushing forward with a very extreme and ideological constitutional reform that runs in exactly the opposite sense. We will briefly explore some of those constitutional reforms in the last part of this paper.

As regards arbitration Mr. Morales has proven to be just as consistent with and just as true to his campaign promises as he was in the case of hydrocarbons. He promised that Bolivia would “no longer be subject to the unfair instruments of the empire” and thus instructed that Bolivia withdraw from ICSID. It did so on May 2nd. 2007. On November 23, 2007 the six month survival period provided in Art. 71 of the ICSID

convention expired. In the following part of this paper we will analyze some aspects and consequences of said withdrawal.

But Mr. Morales also promised a new Constitution. In keeping his word, he is currently embarked on trying to deliver on that promise. A Constitutional Assembly was elected, it met, it became impossibly bogged down and the Government decided that it was simply going to dispense with the constituents elected by the opposition. With only the constituents belonging to the Government it proceeded to approve, in unbelievably short sessions (approximately 14 hours first and slightly more than 20 hours a few days later), 411 articles and ten transitory provisions. Except for the Government itself (and apparently even within it) just about everybody else believes the draft Constitution is, at least, illegitimate if not downright illegal. The approved text should be put to a referendum sometime later this year. However, current political events seem to be pointing in the direction of some sort of compromise that could lead to a different text and, hopefully, to a less ideologically extreme draft.

WITHDRAWAL FROM ICSID CONVENTION

There is a popular saying now in Bolivia: “Somebody” else provides the words, we provide the action, and pay the consequences. In spite of all the rhetoric and propaganda Bolivia is the only country to have denounced the Convention.

A proper and complete analysis of the implications, consequences and interpretations of that decision would far exceed the limited scope of this paper, but a few basic thoughts are nevertheless attempted.

First, the starting point for any analysis is the existence and the text of BITs entered into and ratified by Bolivia.

This is so because of the text of Art. 72 of the Convention. This article is, in our opinion, the cornerstone of the analysis. Art. 72 states that notice by a Contracting State, pursuant to Art. 71 (i.e denunciation), shall not affect the rights or obligations (under the Convention) of that State or of any national of that State <u>arising out of consent to the jurisdiction of the Centre</u> (as defined in the Convention) given by one of them before such notice was received.

Thus, the first point of analysis must be what exactly is the jurisdiction of the Centre? And, more importantly, when is that jurisdiction perfected or acquired? The answer to those two questions must be sought mainly in the existing BITs because access to ICSID arbitration for investors is found almost exclusively in them.

Of course different BITs have different wordings, but their essence is extremely similar: both parties agree to submit the differences between an investor and one of the Parties to one or more methods of solving those differences and one of such methods is arbitration under the Convention.

Based on the above, three initial possible theories emerge. One is that the consent to ICSID jurisdiction was granted by both signatory States at the time they ratified the Convention and ratified each individual BIT. Jurisdiction is born because the States themselves grant it. Investors simply avail themselves of it procedurally.

The second one is the so called "offer theory" in which access to the Centre is deemed to be an offer of both signatory States to a BIT and jurisdiction is then perfected when each individual investor chooses to file a request before ICSID.

The third possible analysis is the "obligation/right" theory. This theory emerges from the text of Art. 72. According to this article it suffices that either the State or the investor accept ICSID jurisdiction, prior to denunciation, for the obligation of the State to accept arbitration under ICSID, even after the denunciation takes effect, to survive. Thus, if the State allowed for ICSID arbitration in a BIT, according to this theory, it unilaterally accepted that jurisdiction and is therefore bound by it, pursuant to Art. 72, because denunciation does not affect the right of the investor to avail itself of the Centre's jurisdiction, even after denunciation.

Of course many other questions arise, such as, for example: date of the investment, date of the controversy, date of the filing, etc. But the answers to all of those matters depend, to a large extent if not exclusively, on how the question asked above, is responded.

PROPOSED CONSTITUTIONAL TEXTS. BACK TO THE FUTURE?

After more than twenty years of dramatic change in Latin America, of huge privatization programs that left the State with a much smaller direct participation in the economy, a new wave is splitting the continent. Some countries carry on with the course set during the last two decades and some seem to be steering away from it. In all fairness it must be said that the change of tack owes most of its impulse to a spectacular failure on the part of the ruling elites in those countries. Much was promised when the privatization processes were launched, but many of the expected benefits simply failed to materialize quickly enough and, most importantly, they failed to reach those that needed them the most, the poor in those countries.

Thus, the election of several of the so called, "leftist" presidents in the region should have been a foregone conclusion long before it actually happened. And Mr. Morales' more than most given Bolivia's place as the poorest country in South America. Likewise and as a reflection of that poverty, it was almost natural that the change of tack should be dramatic, profound and radical. Unfortunately, the reforms undertaken by Mr. Morales lead more towards a return to the past, and a sloppy one at that, than to an enlightened twenty first century socialism.

The analysis of the reforms must begin with a description of the constitutional amendment process as it should have been, and as it in fact was.

By means of a special act of Congress (the Act) a Constitutional Assembly was convened (the Assembly). The members thereof were elected by means of a national election. The Act provided that the text of the amended Constitution was to be approved by two thirds of the votes of the members and later subject to a referendum. Finally, the act provided that the new text was to have been produced within 12 months of the date when the Assembly held its first official meeting.

In fact, at the end of the 12 month period, the Assembly had not been able to agree on anything of substance beyond the appointment of the Chairwoman. As a result of this impasse (which the government accused the opposition party of being responsible for and the opposition accused the government of being intransigent on the main issues under discussion), it was agreed that a new act of Congress was needed to extend the term. This second Act was rushed through Congress and the term was extended until December 14, 2007.

Unfortunately no breakthrough was achieved during the additional term and it was evident that it would expire without any amendment being approved. In light of this the Government decided to proceed with the approval of the amendments (which in fact constitute a completely new and different constitutional text) without the opposition parties. The amendments originally included, amongst other provisions, the unlimited re-election of the President and Vice-President of the Republic, a de facto albeit indirect, control of Congress and of the Judicial branch of Government by the President, as well as the impossibility, for private sector companies, to participate in the exploitation of natural resources.

At this point it is important to explain a historical, geographical and political fact that turned out to be pivotal in the events that ensued. Bolivia is the only country that has part of the branches of government in one city (Congress and the Executive branch in La Paz) that is not the official capital of Bolivia, and the others in the official capital (the Supreme Court and the Constitutional Court in Sucre). In addition to this, the Assembly convened, as mandated by the Act, in Sucre.

Taking advantage of the fact that a new Constitution was being drafted, a huge popular movement started in Sucre demanding that the new Constitution return all branches of government to Sucre. Of course a popular movement of equal dimension emerged in La Paz opposing that motion. The initial refusal, on the part of the Assembly, to contemplate the proposal ignited a series of increasingly more violent riots in Sucre. The riots were repressed by the police and later by the army resulting in four people dead.

By the time the second term was agreed and new proposals for the new constitutional text were being discussed, the riots in Sucre had exceeded the initial request related solely to the site of government issue and had become, to a great extent, a protest against the Assembly itself, against the Government and against its policies. More importantly, the riots had escalated into a major problem beyond the Government's ability to control effectively. When the Government announced its intention to proceed with the approval of the constitutional text with or without the

Assembly members belonging to the opposition, the riots increased in intensity and violence and it became evident that the personal safety of the members could not be guaranteed by the Government.

In light of these facts, the Government then decided to move the site of the Assembly to an army barracks some distance away from Sucre, surrounded by army personnel. During the sessions that then took place a new text was approved "in concept" *("en grande")* and within 16 hours. What this means is that, in theory, the text is read to the members, they then approve the concepts contained therein and leave the detailed reading and drafting for a later session. Since the media attended the session, everybody could see that the procedure consisted in the simple reading of section and article headings followed by the corresponding show of hands which, in this case, was obviously unanimous. In this way 411 articles were approved within 16 hours. Furthermore, the press was able to obtain some comments from some members who complained that the text had been handed to them a few minutes before the meeting started.

In light of the situation in Sucre, the Government rushed an additional act through Congress modifying the site of the Assembly, removing it to a city (Oruro) that had no claims under the new constitution and that is politically favorable to the Governmental party.

In Oruro the Assembly proceeded with the approval of the constitutional text "in detail", somehow managing the process of supposedly reading in full detail the 411 articles within a few hours. The text was then allegedly reviewed by a "Style and Drafting Commission" which, according to the information available to the public, introduced some rather substantial modifications to the text previously approved by the Assembly. That "final" text has been divulged and is now going to be subject to a referendum.

As a result of all of the above (in addition to other problems, objections and possible legal nullities not discussed here) the situation is as follows: a) the Government believes it has a constitutional text approved by the Assembly; b) it believes that the text can be put to a referendum; c) just about everybody else believes the approved text lacks legality as well as legitimacy; d) nobody really knows what the text that is finally going to be submitted to referendum looks like, including the government itself (because of the events and reasons to be explained herein below); e) there is a huge question mark as to how the government intends to introduce what could amount to very substantial changes, resulting from the political negotiations currently taking place, into the constitutional text (please bear in mind that, according to the Government the text has been approved by the Assembly and that the extension term, until December 14th., has already expired, so any additional meeting of the Assembly could be deemed to be illegal, etc.).

The second historical series of events that must be taken into account for this analysis precedes the events described above.

When the party currently in power was the main opposition party it forced the then governing party to approve a very substantial modification to the manner in which the departmental Prefects were appointed. Bolivia is divided in Departments (Bolivia is not a federal country). Each department has a Prefect which used to be appointed directly by the President. The reform forced through by the, then, opposition party consisted in the appointment of the Prefects by means of a direct election in each department. The political calculation behind the reform was that the, then, opposition party believed it could win most, if not all, such elections. Unfortunately for it, the election results were the exact opposite of what it expected. Six out of the nine Prefects directly elected turned out to belong to political parties which are now in opposition to the, now, governing party and a seventh one, while not belonging to the opposition, does not belong to, nor does he align himself with, the currently governing party. The political scenario that emerges from these events is easy to imagine. The Government is furiously trying to reduce the power and influence of the Prefects by several means, including finding ways to reduce the resources at their disposal. On their part, the Prefects are, just as furiously, trying to increase their power and influence by any means available and once again, a political miscalculation on the part of the party now in government has provided them with the ideal instrument.

As in the previous case, the party now in government, while in the opposition, forced a referendum on the, so called, “regional autonomy” concept. Once again, it did so based on an assumption that it could gain control of the, to be newly elected Prefects. The “regional autonomy” concept involves the granting of greater powers to each department, but it left, very much on purpose, the details of what those powers should exactly entail and include as vague as possible. Of course the referendum, on most regions, came overwhelmingly for such autonomy. But now the Government finds itself in a situation where the Prefects are asking that the “regional autonomy” be implemented and since the content thereof was so vague, they are now filling the void with their own particular ideas of what it should entail, including greater resources and much more.

Using “autonomy” as their rallying cry the Prefects have now drafted (each one of them separately) their own “autonomic statutes” and have collected very large numbers of signatures approving them, thus becoming a very serious and effective political force against the Government.

Faced with the possibility of escalating conflicts and violence the Government announced its intention to begin a dialogue with the Prefects in order to try to find common ground that would allow the Government to move ahead with its reforms while granting the Prefects a degree of autonomy and resources they feel they can live with. The proposal made by the President involved the inclusion, in the new constitution, of at least some of the concepts included in the “autonomic statutes”. Just how that could be achieved given the fact that the Assembly has terminated its mandate is anybody’s guess. Of course, in this regard it should be noted that the Government has managed to force all the members of the Constitutional Court to resign. What this means, in fact, is that there is no court of law that can review whether any act carried out by the Government is lawful or constitutional and thus, should the Government decide to

simply re-convene de Assembly or to just have the "Style and Drafting Commission" decide to include additional text in the constitution, there is no judicial means to challenge the legality of such actions. In any event, the meetings, in a foregone conclusion, ended in total failure. The latest initiative in this regard is the request, by the President, that the Catholic Church assume the role as mediator in this conflict. Meetings should begin within the following weeks but conditions for them to take place, stated by both, the Government as well as the opposition parties, run the risk of derailing them before they even begin.

Within the general political and factual context briefly described above we will now examine the Government's policies regarding hydrocarbons as such policies have been included in the proposed constitutional text.

Once elected the new Government immediately set upon implementing its stated objectives. It began by taking control of the hydrocarbons industry.

The proposed constitutional text repeats and in many ways re-states and ratifies the principle (already contained in the current Constitution) that all natural resources belong to the State and that the method, means and rights for their exploitation are to be decided exclusively by the State.

However, in many ways, the new proposed constitutional text introduces a series of confusing and even contradictory elements. Following are a few samples, out of many possible ones, found in the proposed new constitution:

1. Art. 359. "*Hydrocarbons, regardless of their state or form are the inalienable … property of the Bolivian people. … Only the State has the right to commercialize them. The totality of the income derived from their sale shall belong to the State.*" Fascinating statement from a logical and legal point of view. If all hydrocarbons (i.e. starting with those still underground and ending in those that fuel a cigarette lighter or even are found in a plastic bag) are inalienable, how can they be sold or disposed of in any way by anybody? Even when assuming the second sentence is a carve out of the first, the legal and logical problems derived from the strict compliance with the provision are just mind boggling, not to mention those of the third sentence.

2. Art. 362 authorizes YPFB to enter into services agreements with national and/or foreign companies so that those companies can, for example, perform exploration and exploitation activities on behalf of YPFB. The last sentence of article 362 reads: "*Said contracts may not, under any circumstances, result in losses for YPFB or the State."* A question immediately comes to mind: What happens when the services rendered as part of exploration activities result in the drilling of a dry well? YPFB would, presumably, still have to pay for those services, but such payment could be considered to be a loss; would that mean that such payment could be deemed to be unconstitutional?

3. But even if the two provisions cited above could be considered to be just the result of lack of drafting precision or even if it might be possible to glean their true spirit out of their awful structure, Art. 366 must be taken seriously. In this case the text is clearer: "*All foreign companies that carry out activities in the hydrocarbons productive chain … are subject to the sovereignty of the State, and shall depend upon the laws and authorities of the State. No foreign tribunal or jurisdiction shall be recognized, nor can they invoke any exceptional circumstance of international arbitration or make use of diplomatic channels for their claim.*" The intent is unmistakable: no foreign law, no foreign tribunals, no arbitration. And just in case there were any treaties that could be used to put that policy into question, the drafters of the proposed Constitution included two more articles to deal with that potential inconsistency.

4. Art. 410 provides that: "*Juridical norms shall be subject to the following order of precedence:*
   1. The Constitution.
   2. Laws and international treaties.

5. To further clarify matters, the Ninth Transitory Provisions states: "*International treaties entered into before this Constitution and that do not contradict its provisions, shall be maintained in the internal juridical structure and considered as laws. Within two years … the executive power shall denounce and if necessary shall negotiate again those international treaties that are contrary to this Constitution."*

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Elisabeth Eljuri
Macleod Dixon, S.C.

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Argentina's Hydrocarbons Export Regime
by D.G. Lamanna and D.E. Arias

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ARGENTINA'S HYDROCARBONS EXPORT REGIME

Dario G. Lamanna (*)
Dario E. Arias (+)

"What does wealth require of law to be produced and created? What Diogenes required of Alexander; ¡to stand out of its light!"
Juan Bautista Alberdi

Introduction

Recent relations between the Argentine government and the oil companies working there has included a group of measures that should be aimed at increasing the production needed to assure domestic supply. Those measure, however, have focused on stronger intervention in the economy than seen in the last decades. There is a certain incongruity between the two purposes, given that – on the one hand – the country needs to replace produced reserves and to take advantage of high international prices and – on the other - companies need legal certainty and respect for the rules of the game in order to program long-term investments. The government's actions and measures have not met their intended purposes and they contradict basic economic principles.

Background

As a result of the recent increase in international crude prices, the Argentine government adopted some time ago a policy of duties on oil exports for strictly tax purposes.

The idea is to control the evolution of internal prices and, in theory, to generate funds for the national treasury. The plan is to protect domestic consumers from the potential damages that may be caused to them, and to minimize the impact on the country's economic activity, the level of employment and the prices of domestic goods and services.

Although this measure impacts the profitability of the oil companies operating in Argentina, the national government believes that even after deducting the established export fees, the companies will still have enough profit for the normal course of business, and the conditions for future investments.

The new regulation increased oil export fees from 45% to almost 60%. Originally, through Presidential Decree No. 310 (13 Feb., 2002) and its amendments and additions, extended by National Law No. 26,217, and Presidential Decree No. 509 (May 5, 2007) and its amendments, the export fees were legally established.

Through Law 26,217[1], the Government enacted the 5-year extension of the 2002 oil export fee that had been implemented by Economic Emergency Law N° 25,561.

[1] Published in Official Gazette dated January 16, 2007. (The *Boletín Oficial* is the journal that publishes new Argentine laws).

In addition, through Resolution No. 394/2007 (Nov. 15, 2007) of the Ministry of Economy (Regime applicable to oil price for calculating hydrocarbon royalties of the Provinces), the export fees applicable to a group of hydrocarbons were modified; and reference and cut-off values were established for said products in order to assure the competitiveness of the national industry.[2]

This new rule repeals and annuls Resolution 532/2004 (Aug. 4, 2004), of the Ministry of Economy and Production and establishes new oil export fees of almost 60%.

It also establishes the new reference and cut-off values for hydrocarbons, which after this new resolution are as follows:

	US$/Bbl.	
	Cut-off Value	**Reference Value**
PETROLEUM-BASED OR BITUMINOUS MINERAL-BASED CRUDE OIL ***(aceites crudos de petróleo o de mineral bituminoso)***		
Petroleum	42	60.9
The others	42	60.9
PETROLEUM-BASED OR BITUMINOUS MINERAL-BASED OIL, EXCEPT FOR CRUDE OILS, PREPARATIONS NOT EXPRESSED OR INCLUDED ELSEWHERE, WITH A CONTENT OF PETROLEUM-BASED OR BITUMINOUS MINERAL BASED OILS HIGHER THAN OR EQUAL TO 70% BY WEIGHT, IN WHICH THESE OILS CONSTITUTE THE BASE ELEMENT; OIL WASTE (*desechos de aceite*)		
Light Oils (*aceites livianos*) and preparations		
Commercial hexane	74	108
Painters naphtha	62	90
Naphtha		
For Petrochemicals	39	56
The others	78	113
Kerosene		
For aviation	70	101
Other fuel oils (*aceites combustibles*)		
Fuel Oil	42	61
The others	22	32
Lubricating Oils (*aceites lubricantes*)		
Without additives	121	175
With additives	174	252

For the above-mentioned hydrocarbons, and if the international price is higher than or equal to the reference value, the export rate will be calculated by applying a formula

[2] As antecedents to the content of this provision, Laws 22,415 (Customs Code), 25,561 and 26,217, the Law of Ministries and its amendments, among others, are cited.

where the International Price minus the Cut-off Value will be divided by the Cut-off Value, and the result divided by a coefficient of 100. If the international price is lower than the reference value, a 45% fixed rate will be applied.

If the international price of oil is less than US$ 45.- per barrel, the percentages to be applied will be determined within a period of 90 days. The new rule defines international price as the price of hydrocarbons prevailing in reference markets considered to be such because of their common use and significance as an export alternative from the Republic of Argentina[3].

The official International Price will be set by the General Customs Department ("*AFIP*", in its Spanish acronym).

At the same time, the National Department of Refining and Commercialization ("*NDRC*") will fix the respective prices on a daily basis. The NDRC is part of the Assistant Secretary's Office for Fuels of the Secretary's Office for Energy of the Ministry of Federal Planning, Public Investment and Services.

For other derivatives, such as diisobutylene, white mineral oils (*aceites minerals blancos*), petrolatum, oil bitumen, sands, etc., for which no cut-off and reference value was fixed, the percentage of the export fee to be applied will be equal to the percentage resulting from crude oil (Cut-off Value US$ 42.00 – Reference Value US$ 60.90).

Finally, the new rule replaces Annex XV to Decree 509 of May 15, 2007, regarding the export fees for the tariff items of MERCOSUR Common Nomenclature.

This new regulation considers, among other things:

- the power of the Executive to establish the rate applicable to certain hydrocarbons for a term of five years,
- the decree establishing the export fees of specific hydrocarbons, the 25% increase in the crude oil (*aceite crudo*) export fee,
- the recent increase of the international oil price,
- the State's duty to capture the income from depletable natural resources, along with the need to maintain sufficient profit for the private sector to continue investing.

However, the measure has been criticized by analysts, entrepreneurs, and by the provinces (states) that produce hydrocarbons. By placing a duty on oil exports, the State takes a higher portion of the oil revenues than that received by Venezuela (the companies receive no more than US$ 42/bbl exported).

The prices of gas and liquid fuels had been much lower than international values and than those of neighboring countries. This began to change last year with constant increases in the values of naphtha and gasoil. But the result is predictable when artificially low prices are fixed: shortages. In fact, even though Argentina produces more natural gas than Bolivia, production does not meet the domestic market and the

[3] Article 3° of Resolution 394/2007 (Nov. 15, 2007) of the Ministry of Economy and Production

export commitments in winter. Shortfalls in liquid fuels have occurred in Patagonia and to the north of the country.

Contrary to what happened in the past, the subject measures have been adopted by the Assistant Secretary's Office for Domestic Trade, and not by the Secretary's Office for Energy, where said type of decisions were formerly made. The policy of the sector also seems to be in the hands of the Assistant Secretary for Trade and exceptional measures have also been taken in other sectors of the economy, such as suspension of meat exports by the application of a simple resolution.

Authorities of the producing provinces, at a meeting of the Federal Organization of Hydrocarbon Producing Provinces ("*OFEPHI*"), have made strong efforts to negotiate with the central government, in an attempt to suspend the increased duties or else to agree on a mechanism that minimizes the damage this increase means to the provinces.

An example of the results of said conversations has been the issue of Regulation of the Assistant Secretary's Office for Domestic Trade SSC 1/2008, which amends Resolution No. 394/2007 of the Ministry of Economy and Production.[4]

This regulation establishes (Art. 2°) that when the international price of crude exceeds US$ 95 per barrel for oil intended for domestic consumption, the possibility will be analyzed of compensating the corresponding provincial treasury; also, the producing provinces may charge the royalties in kind and the Ministry of Economy binds itself to "*exert the maximum efforts aimed at procuring the necessary agreements between them (*the provinces*) and the sector involved in order for the royalties received to be monetized*" (Art. 3º), by virtue of the minutes signed in November 2007 (which is part of the regulation).

We note that although the subject regulation could constitute the beginning of a solution for the provinces, the provision only establishes indirect solutions through an uncertain path that depends to a great extent on the will of the central government.

Other duties

The mining sector is also affected by export withholdings, in spite of the fact that this sector of the economy is under a fiscal stability regime.[5] All provinces approved the Law on Mining Investments, and the federal mining agreement was approved by Law 24,228. A standard 3% ceiling for royalties was accepted in this, and the rules of the game cannot be modified by the Nation by applying other encumbrances not capable of co-participation.

[4] http://www.infoleg.gov.ar/infolegInternet/anexos/135000-139999/136929/norma.htm

[5] Article 8 of Law on Mining Investments 24.196 prescribes: "*Mining undertakings included in this regime shall have fiscal stability for a period of thirty (30) years after the date of presentation of their feasibility study. Fiscal stability means that that the total tax burden, as determined at the time of the presentation, of the companies that develop mining activities in the framework of this investment regime, cannot be further affected as a consequence of increases in the tax contributions and duties, whatever the name of the same may be, in the national, provincial, and municipal ambit…*"

Some specialists believe, to promote productive activity and then favor measures that discourage it is contradictory. "*This favors a central government that increases tax revenues without control, and brings legal uncertainty to a sector that, on the contrary, should be protected*."[6]

In recent press statements, a northwest mining province governor stated that although he recognized that this encumbrance was not envisioned when the investments were made, mining companies should negotiate and pay the duties with "*even a sense of solidarity*" due to the increase in the world price of metals.

Other measures

In early 2008, because of the persistent shortage of fuels, and sustained prices (in 2007, they rose 35%, reaching US$ 1 per liter of gasoline), the central government, through the Assistant Secretary's Office for Domestic Trade again informed the companies that they should roll back the prices to October 31, 2007; and that the Secretary's Office for Energy would not grant the permits to export naphtha if domestic supply was not assured. The news (which rapidly reached the press and news agencies) not only concerned the refining companies, but the importing countries, such as Paraguay, where over 50% of the fuel consumed is bought from Argentina.

However, no resolution was issued and no provision was published in the Official Bulletin. The scheme will operate as follows: the Secretary's Office for Energy will receive the orders, send them to the Secretary of Coordination of the Ministry of Federal Planning. This body will in turn decide whether or not the shipment is authorized, after consultation with the Secretary of Trade and the consent of the Minister of Trade. The procedure is based on a subparagraph of the Law on Supply: it was used to close the borders to naphtha, using the argument that oil companies privileged exportation and were not duly meeting local demand. Analysts considered these to be verbal exercises intended to calm public opinion.

The effect of the "*de facto*" prohibition would not be the same for all companies. Repsol, for instance, assigns 90% of YPF's production to the Argentine domestic market, and the remaining 10% assigned for exportation, is a very low-quality naphtha. This situation is very different from that of other oil companies that operate in the country, where a prohibition against export would in practice force them to cease operations.

One week later, after reducing domestic naphtha and diesel prices, export restrictions were removed. This benefited the Spanish-Argentine company Repsol YPF, the Brazilian Petrobras, and the American Esso. These companies had agreed with the government to roll naphtha prices back to the values of the end of last October, which implies, in practice, a rebate of close to 15 percent.

The prohibition against export, however, remained in force for the English-Dutch company Shell, which did not participate in said agreement. The highest official of this company had told the press that "*the price reduction will result in higher demand, then, it is probable that the supply restrictions will be greater*". These statements aggravated

[6] Martínez, Víctor, "***Las Retenciones a las Exportaciones y la Minería*",** newspaper La Nación on-line (December 26, 2007).

the confrontation between the Argentine government and Shell. There was an immediate reaction: that afternoon, the general clerk of the government went to the company's building and demanded that the Shell president ratify or correct statements published in different media.

In the opinion of constitutional law experts, this represented a threatening, manipulative, and useless action[7]. In the opinion of other jurists, sending the general clerk of the government to make demands on a company constitutes a "clear abuse of power."[8]

According to official Argentine government sources, on the date when this work was prepared, the Ministry of Economy was working on a draft resolution to modify the oil duty system in effect.

The changes were aimed at modifying the reference price of raw gasoline and some other minor technical issue, but no matter of magnitude or with a great economic impact was included.

However, oil companies continue to claim that investments in the industry are not feasible with the present level of duties on exports.

Conclusions

We believe that it is important that both the central government and the provincial states understand the actual dimensions of hydrocarbon matters in order to be able to design long-term solutions in a coordinated manner that may assure energy reliability as an essential component of any durable economic policy.

Failing that, the approach to short-term solutions may only result in decreased reserves, discouragement of exploration investment, and dependency upon other countries.

Given the international prices of commodities, and the delicate fiscal and commercial equilibrium that the country insists on reaching, we cannot yield to the temptation of trying to regulate what is by nature exceptional and temporary. The measures aimed at encouraging investments, increasing production, and rationally exploiting the country's depletable natural resources require a sense of permanency, far-reaching targets, and enough flexibility mechanisms for adjustment to new realities (such as exorbitant international price increases), so that the extraordinary benefits that may be generated also have a positive impact on the producing regions and tax areas.

Finally, it is essential that respect for rights and the application of the republican values of transparency, legality, checks and balances, and liability of public servants be the frame of reference of any governmental measure. We want to once again quote Alberdi, whose words have now gained an unusual relevance: *The government has not been created to become rich, but to be the guardian and sentry of the rights of men, the first*

[7] "*A threatening and manipulative gesture*". This is the designation given by the Professor of Constitutional Law at the UBA, Gregorio Badeni, to the action taken by the Government in relation to Shell (La Nación on-line, January 25, 2008).

[8] Opinion of the criminal law expert Juan Pablo Vigliero (La Nación on-line, January 25, 2008).

of which is the right to work, that is, freedom to work and to engage in economic activities.... ownership is not actual wealth when it is not inviolable by the law and in practice"[9]. Only by recovering the values that inspired our Constitution can we reach sustained progress in peace and with justice.

(*) DARÍO G. LAMANNA, Argentine attorney, Master in Business Administration (MBA), Postgraduate studies in Oil and Gas Law (UBA). He obtained a degree in High Entrepreneurial Management (IDE) and in Directive Development (IAE). He is a member of the Association of International Petroleum Negotiators (AIPN) and the International Bar Association (IBA). He is a lecturer and author of various books and publications. He is International Business Manager for Teikoku Oil Co., Ltd. (Inpex Holdings Inc.) and Director of the Mixed Company Gas Guarico S.A. in Venezuela.

(+) DARÍO E. ARIAS, Argentine attorney, Master in Business Law, (Universidad Austral), LL.M. (Master) in Mineral Law & Policy (CEPMLP, University of Dundee), he is a consultant and lecturer and author of several articles and conference papers. Member of the AIPN and IBA. He worked as a legal advisor for Repsol YPF, Petrobras E&P and currently he is Lead Counsel for BG Bolivia Corporation (Sucursal Bolivia).

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[9] Alberdi, Juan B, "*Las Bases*" (Ed. Terramar, 1999) .

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Elisabeth Eljuri
Macleod Dixon, S.C.

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Windfall Profit Tax in Ecuadorian Petroleum Industry by J.P. Zaldumbide-Serrano

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PEREZ BUSTAMANTE & PONCE
ABOGADOS

WINDFALL PROFIT TAX
IN ECUADORIAN PETROLEUM INDUSTRY

Jaime Zaldumbide S.
Pérez, Bustamante & Ponce

During 2006, when the price of crude oil began its quick climb in the international markets, the Ecuadorian Government and the Ecuadorian Congress decided – in coordinated fashion – to process a bill whereby a "windfall" profit tax would be applied to income unexpectedly obtained by companies that had executed participation contracts for exploration and exploitation of hydrocarbons with the Ecuadorian State.

According to this contractual system, companies explore for and exploit oil in exchange for which they deliver a share of their production to the State. The companies pay for their investments, costs, expenses and taxes out of their own participation.

In addition to this type of contracts, there are others that have not been affected by the law, i.e.: Service contracts, the so-called "marginal fields" contracts, and "strategic alliances", the latter entered into with State-owned companies.

The bill was extensively debated and was approved by Congress after obviously unfruitful opposition from the affected companies (five consortia with a little over 10 contracts) and was subsequently ratified by the President of the Republic.

According to the following recitals, on April 25, 2006, the Ecuadorian Congress approved Law No. 42 whereby an amendment to Article 44 was introduced and a new article was added to the Law on Hydrocarbons:

> *"Whereas, Article 247 of the Constitution provides that resources found in the subsoil are the inalienable and imprescriptible property of the Ecuadorian State and, therefore, their exploitation must be carried out in terms of the national interests and pursuant to principles of reasonableness;*
>
> *Whereas, the third paragraph of the Political Constitution of the Republic reads as follows: 'In contracts executed with investors, the State may establish special protections and securities so that the agreements shall not be modified by laws or other norms of any kind that could affect their clauses';*
>
> *Whereas, in order to meet those principles, it is necessary to apply criteria of justice and equity in petroleum contracting processes so that those contracts shall be in keeping with principles of economic equilibrium and legal security for the parties;*
>
> *Whereas, the international oil sales prices in force on the date of execution of those contracts enormously differ from current prices and, therefore, the economic*

conditions of those contracts have been modified in favor of the contractors exclusively;

Whereas, the international price of a barrel of oil is an essential element to be taken into consideration to maintain the economic equilibrium of the Investor/State ratio and is even a factor beyond the parties' control, not depending upon the contractors' wise management;

Whereas, it is indispensable to include such principles of economic-financial equilibrium and legal security in the substantive aspects of the Law on Hydrocarbons that will make it possible to perform participation contracts executed by the Ecuadorian State on the basis of justice and equity for the parties."

The text of the new article added after Article 44 of the Law on Hydrocarbons was:

"*Article ___ - State participation in surplus sales prices of oil not agreed upon or not anticipated: Without prejudice to the volume of participation crude oil corresponding to them, when the average monthly FOB price of Ecuadorian crude oil exceeds the average monthly sales price in force on the date of contract execution expressed as constant values on the month of settlement, contractors under participation contracts with the Ecuadorian State for exploration and exploitation of hydrocarbons in force pursuant to this law shall recognize in favor of the Ecuadorian State* <u>*at least 50% participation*</u> *in the extraordinary income generated by reason of the price difference. For purposes of this article, extraordinary income is understood to be the described price difference multiplied by the number of barrels produced.*

The price of crude oil on the date of the contract used as a reference to calculate the difference shall be adjusted taking into consideration the Consumer Price Index of the United States of America published by the Central Bank of Ecuador." (Emphasis added)

As it can be appreciated from the recitals of the law as well as from the article added to the Law on Hydrocarbons, the legal reform failed to take into account two fundamental factors: First, the petroleum price index (PPI) that differs substantially from the consumer price index as well as the cost of petroleum services that, by reason of global demand, had shot up during the past years. Second, the new tax only took into account "income" in order to determine the distribution of extraordinary income, without deducting expenses incurred for extracting, transporting and marketing the crude. In other words, the law affects gross profits only, and not net profits as it would have been logical.

According to a specific provision of that law, the President of the Republic ought to have enacted regulations for application of the law which occurred when he issued Executive Decree No. 1672 dated July 13 of that same year. The Decree determined that the State's percentage on the extraordinary income would be 50% of the difference

between the price obtained by the exporter and the price in force on the date of contract execution (adjusted by inflation).

Despite protests from the companies, all of them observed the governmental decision, with the exception of City Oriente – a small producer (approximately 3,000 bbls/day) with U.S. capital – that filed a claim at the International Center for Settlement of Investment Disputes, and so far has not paid the price difference to the State.

The companies continued working in Ecuador under this new law. It is difficult to know if all – or some – of them actually restated their investment plans in Ecuador. However, this situation changed radically when on October 17 of that same year, and most surprisingly, President Rafael Correa (who had been inaugurated in January of 2007) replaced article 2 of Executive Decree 1672 with Executive Decree 662 and, thus, substantially increased the State participation in extraordinary income from 50% to 99%.

The new regulation caused a shock among the companies that almost immediately stopped their investment plans for additional exploration and drilling in 2008. The measure was so drastic that the 2007 budget for investments and expenses amounting to US$ 870,000,000 was reduced to merely US$ 50,000,000 for year 2008 – necessary for operating expenses exclusively.

Following the issuance of the above mentioned Decree 662, the companies held meetings with the Minister of Mines and Petroleum where each company presented the economic situation of its contract due to the effects of the 99% increased State participation in extraordinary income. The great majority of those contracts, particularly those where investments were still far from being amortized, would operate at a loss.

In late 2007, the Government offered to commence negotiations with the companies so that the contracts would again be economically viable and, therefore, to resume investments in order to prevent a rapid production decline.

While all these things were happening, the National Constituent Assembly – that replaced the National Congress and was beginning to perform legislative activities – issued the Tax Equity Law amending the Internal Tax Regime Law. The following chapter was included in the new law:

> *"CREATION OF TAX ON EXTRAORDINARY INCOME:*
>
> *Article 164 – Object of the tax: A tax on extraordinary income obtained by companies that have executed contracts with the State for exploration and exploitation of non-renewable resources is hereby created.*
>
> *Article 165 – Extraordinary income: For purposes of this tax, extraordinary income is income obtained by the contracting companies generated from sales at prices exceeding those agreed to or established in the respective contracts.*
>
> *Article 166 – Taxing agency: The taxing agency of this tax is the State. The tax*

shall be administered through the Internal Revenue Service.

Article 167 – Taxpayers: Taxpayers of the tax on extraordinary income are such companies that executed contracts with the State for exploration and exploitation of non-renewable resources.

Article 168 – Tax year: The tax year comprises the period from January 1 to December 31. If extraordinary income is generated after January 1, the tax year shall obligatorily be closed on December 31 of each year.

Article 169 – Taxable base: The taxable base includes all extraordinary income and constitutes the difference between the sales price and the basic price established in the contract, multiplied by the number of units sold to which the prices refer.

If the basic price of non-renewable resources has not been specified in the relevant contract, it shall be established by the President of the Republic by means of an executive decree and shall in no event be lower than the international price in force on the date of contract execution.

The basic price shall be adjusted in accordance with any variations of the Consumer Price Index in the United States of America as published by the Central Bank of Ecuador.

Article 170 – Tax rate: The tax rate is 70%.

Article 171 - Any amounts paid to the State for extraordinary income by reason of other regulations shall constitute a credit for this tax.

Article 172 – Payment of this tax constitutes a deductible expense for income tax settlement pursuant to the Internal Tax Regime Law."

The above amendments approved by the Constituent Assembly and ratified by the President of the Republic opened windows of hope to the oil companies that saw in this law the possibility of renegotiating their contracts with the State so that the new contracts would be subject to the new provisions of the Internal Tax Regime Law, and not to those of Law 42 that amended the Law on Hydrocarbons and, therefore, not to the feared 99%. Negotiations began in mid January.

On the date of this paper, all companies under participation contracts were negotiating with the State modifications to their old participation contracts so that they would recognize greater State participation in crude oil production from each block, and at the same time would allow them to resume exploration, development and production activities and would benefit the State with 70% of the extraordinary income to be generated between the "new basic price" of each contract and the actual sales price of the crude from those contracts.

The only non-negotiable condition imposed by the Ecuadorian Government in this contractual reforms process was a change of the contract clause on dispute resolution to one excluding ICSID as arbitration center to which – some months ago – the Government had already sent a communication denouncing submission to the Center of any disputes deriving from investments relating to exploitation of natural resources.

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AV. REPUBLICA DE EL SALVADOR 1082 Y NN.UU. P.O. BOX: 17-01-3188 – TELF(593 2)2254323 - FAX (593 2) 2258038
E-MAIL: pbp@pbplaw.com
Quito, Ecuador