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GLOBAL ARBITRATION IN THE ENERGY SECTOR

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HOT TOPIC

GLOBAL ARBITRATION IN THE ENERGY SECTOR

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Marco Tulio Venegas is a partner with 21 years of international experience, on both a professional and educational level. He is the youngest partner ever promoted by the firm. He has saved his clients billions of dollars and has protected and resolved several of the most complex and consequential litigation and arbitration matters for both multinational clients and governments around the world. His expertise includes two of the largest commercial arbitrations in Mexican history, worth more than $1.7bn, as well as the most important construction and infrastructure disputes ever with governmental entities.

CD: In your opinion, what is the current appetite for global arbitration among companies operating in the energy sector? Is it the primary method for resolving their disputes?

Pauly: Arbitration is, and will remain, the primary method of resolving disputes among companies operating in the energy sector. More often than not these disputes are high-stakes issues between companies incorporated in different countries and from different legal backgrounds, for which resorting to domestic litigation is not conceivable, if only because the existence of the dispute, the issues involved and the documents exchanged must remain confidential. In addition, an arbitral award is enforceable worldwide, which is a significant advantage compared to the costs and time required to enforce a foreign judgment before domestic courts.

Hems: In the upstream E&P sector, the current appetite for arbitration, or indeed litigation, is not great. There are a number of factors contributing to this. First and foremost, perhaps, there are fewer business opportunities out there than before the oil price crash and nobody wants to bite the hand that is currently feeding them. Furthermore, there are the consequences of consolidation in the industry. New entities, or the new owners of existing entities, do not necessarily want disputes on their books when their focus is on driving a new business model and strategy for stability and growth. We have certainly seen more arbitration than litigation in recent years and confidentiality in the process remains a key consideration for clients. However, we have also seen a growing sense of frustration over the flexibility in arbitration and the ability for the process to become protracted, compared to the rigour being instilled in English litigation by the Jackson reforms. Some parties are expressing doubts about the value of arbitration, given the time it is taking to get to a final outcome, and are starting to contemplate a preference for English litigation in their dispute resolution clauses, despite the potential disadvantages of publicity and enforcement issues.

Cole: Arbitration remains the final dispute resolution mechanism of choice for most companies operating in the energy sector. Only arbitration has the cross-border recognition and enforcement afforded by the New York Convention that is vital for energy companies doing business globally. The inherent unattractiveness of litigating in the state courts of a contracting party, as well as the difficulty, if not impossibility, of enforcing court judgments, especially outside of the issuing state, means that arbitration remains the preferred choice. Having the right to arbitrate, however, does not mean that it necessarily will be exercised. Many global energy companies recognise that arbitration is likely to

damage relations irreparably with its contracting party and therefore turn to arbitration only as a last resort.

Venegas: In Mexico there is a strong appetite for global arbitration in the energy sector. Local courts have proven that they are not ready to hear the type of highly-sophisticated disputes which have arisen in the sector. Moreover, under Mexican law, the legal framework is not clear as to proceedings to get the payment of damages arising from the termination or rescission of agreements involving public energy companies. For this reason, arbitration is deemed the best alternative available. Furthermore, a recent decree has set up a specific proceeding to enter into a potential settlement with public entities when a dispute arises. This proceeding has proven to be very cost and time effective in settling many disputes that could have led to costly arbitration proceedings.

CD: What are the key trends and developments to have impacted global arbitration in the energy sector over the past 12 to 18 months?

Hems: Costs are always a primary consideration for anyone using arbitration. A positive development is the greater range of options for, and accessibility of, litigation funding. Some recent cases addressing issues of recoverability of costs have also been helpful in growing confidence in the use of litigation funding – it is no longer seen as the place of last resort for parties in a parlous state, but a legitimate way of managing legal spend, particularly in situations where a dispute had not been forecast at the time of fixing budgets. A more worrying trend, though, has been a number of recent orders calling for standard disclosure in arbitration, including in one case where the parties had agreed between themselves that reliance disclosure was appropriate. This raises the question of whether tribunals really understand what is involved in managing the disclosure process and the volumes of data that are involved in a large dispute.

Cole: A process of renewal and upgrade has been taking place globally in respect of the laws and rules affecting arbitration. A number of countries have updated or renewed their arbitration laws. For example, Myanmar introduced its new arbitration law on 5 January 2016 and Qatar introduced its new arbitration law on 16 February 2017; both are based on modified forms of the familiar UNCITRAL model law. Saudi Arabia introduced its new implementing regulations to the Saudi arbitration law on 9 June 2017, five years after the country overhauled its arbitration law. Unfortunately, the UAE's new arbitration law has yet to materialise, after many years in the pipeline. Similarly, a number of arbitral institutions have amended their rules in recent times to stay abreast of developments in the market. These include the Singapore International Arbitration

Centre (SIAC) on 1 August 2016, the Stockholm Chamber of Commerce on 1 January 2017 and the ICC on 1 March 2017. The BCDR-AAA's new rules were introduced on 1 October 2017 and the Dubai International Arbitration Centre (DIAC) Rules 2017 are expected to be introduced shortly.

Venegas: Fortunately, the price of oil has risen slightly, which has stabilised the market. Although at the beginning of the process of reforming Mexico's energy sector, which opened the space up to private investment, there was some scepticism, and the flow of new players and investment was relatively low, in the past quarter the number of new projects undertaken has increased dramatically. In these new projects, conciliation and arbitration clauses have been included. Although it is too early to tell if these projects may lead to disputes, it is a fact that some of them will inevitably end in arbitration. Regardless of the potential future arbitrations, another trend that has emerged is the willingness to conciliate or settle the disputes arising from complex energy projects. Although the causes may be traced to the reduction of profits in the industry and the duration and cost of arbitration, and its potential enforcement before national courts, the fact is that more and more companies are seeing a benefit in resorting to other forms of alternative dispute resolution (ADR), rather than relying purely on arbitration proceedings.

Pauly: The increasing use of third-party funding is a key development that has impacted arbitration in the energy sector. Originally used by claimants to bolster their financial position, third-party funding is now frequently used to mitigate financial risk, resulting in a greater willingness to refer disputes to arbitration. However, the inclusion of third-party funders into arbitration proceedings raises issues relating to the allocation of costs, and the need to protect legal privilege requires the proper guidance of experienced counsel. This is particularly the case following the English judgment in *Essar v. Norscot* where the court found that the costs of third-party funding could be recovered by the successful party under the English Arbitration Act. While not binding

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> *Claire Pauly, Freshfields Bruckhaus Deringer*

on other jurisdictions, this decision reflects the increasing use and acceptance of third-party funding in arbitral proceedings. This trend is echoed in civil law jurisdictions, such as France where the Bar Association recently validated the use of third-party funding in legal proceedings.

CD: Could you outline the underlying causes of disputes being seen in the energy sector and the range of issues these generate, such as the impact on supply chains?

Cole: The energy industry is subject to the usual commercial pressures experienced in other industries. These are compounded by the current low oil price which has reduced margins resulting in cost saving efforts. Projects, whether new or existing, have been stopped or restructured to reduce capital expenditure and increase profits. This has resulted in challenges to entitlements from contracting parties, which, if not resolved amicably, become disputes. Likewise, constrictions on cash flows have delayed payments, with less scrupulous parties raising disputes in order to further delay payment until better financial circumstances arise. State intervention and changes to the legal regime can be a catalyst for disputed entitlement to compensation. As oil producing states have suffered reduced revenues, changes in laws have been made to protect or develop markets; these changes have affected many of those firms that operate in the sector.

Venegas: In my experience, the most common causes giving rise to a dispute are either accidents due to acts of god or negligence, or the trend adopted by some companies of late payment. The disruption in the supply chains caused by these types of events can be huge. Although, theoretically, subcontracts should be a mirror-image of the main contract in the relevant clauses related to insurance, indemnification and early termination, the fact is that in many cases this is not what happens. This lack of symmetry produces scenarios in which the claims and counterclaims arising between the owner, contractor and subcontractors become very difficult to resolve. Ultimately, in many cases, the subcontractors are the companies that suffer the most, because of their lack of leverage and their financial situation.

Pauly: Disputes in the energy sector commonly take the form of investment treaty disputes. Foreign investors are often guaranteed certain incentives under a bilateral investment treaty for investing in the host country's energy sector. However, in times of recession, host states may cut back or remove these incentives altogether, severely affecting the profitability of the foreign investment. Recently, a number of claimants have brought claims against Spain under the Energy Charter Treaty, alleging

that Spain's regulatory reforms to its tariffs regime amounted to an expropriation of their investments which denied them fair and equitable treatment. A significant number of disputes have also arisen in commercial cases when the price of the energy produced by a party and purchased by the other was indexed to a different source of energy, for example in long-term gas supply agreements, gas prices were indexed to oil prices. This situation causes discrepancies from prevailing market prices and requires a revision of the price provisions. In recent years, international law firms have been involved in a significant number of gas-pricing disputes in Europe. The next trend is for these disputes to be brought in other areas of the world, and in particular in Asia, following the liberalisation of the energy sector.

Hems: There will always be disputes that arise out of day-to-day operations, but in the current market, the need to protect cash flow, avoid doubtful capital outlay, reduce financing exposure and leave unprofitable jurisdictions have all been important drivers for decisions, which has ultimately led to disputes. Those decisions have included the exercise of rights to terminate contracts, sometimes on quite spurious grounds, to suspend work and to unwind joint ventures. We have also seen the use of audit rights in contracts as a means by which to investigate the circumstances that might lead to a right to terminate and we have seen companies trying to fend off those overtures which, in some cases, have led to questions over the rights to audit being submitted to arbitration.

CD: Have any recent, high-profile energy-related arbitration cases caught your attention? What lessons can the energy sector learn from the outcome of these cases?

Venegas: Recently, the Mexican Supreme Court of Justice ruled a dispute between the public Mexican utilities company and a private contractor that set the standard for future enforcement of arbitral awards. As part of this analysis, the Supreme Court adopted a restrictive approach about the concept of public policy in public contracts. Basically, the Supreme Court drew a clear line between the ultimate result that a contract may have on electricity rates, with potential impact for the consumer, and the contractual terms agreed, giving prevalence to the latter. The relevance of this case is that private foreign investors in Mexico may feel much more secure about the potential enforcement of awards arising from arbitration proceedings with public Mexican entities. Moreover, the topic of sovereign immunity, which has been implicitly present in all contracts with these entities, took a serious toll. The impact that this decision may have is huge. Public entities should be much more careful in the performance of their obligations and, moreover, in the content of their contracts, without

assuming that they are 'protected' by public policy considerations.

Pauly: The recent awards issued in three cases – *Charanne, Isolux* and *Eiser* – brought against Spain under the Energy Charter Treaty have raised considerable interest as they yielded mixed results. In all three cases, the tribunal rejected Spain's objection to jurisdiction, and the key issue on the merits turned on the application of the concept of 'fair and equitable treatment' and in particular its constituent 'legitimate expectations' element. The tribunals in *Charanne* and *Isolux* rejected – by majority decision – the investors' claims that arose from the 2010 reforms and the 2012-2014 reforms respectively. On the other hand, the tribunal in *Eiser* found for the investors who challenged the significant 2012-2014 reforms. These cases recognise that host states retain the right to alter the incentive landscape, and that the determining factor for a breach of the 'fair and equitable treatment' standard is the extent of the investor's reliance on the original regime. Thus, it is crucial that energy companies willing to invest in the renewable sector conduct thorough legal due diligence to fully appreciate the risks of operating under the host state's regulatory framework and to ensure that the incentives are in place for the full term of the investment.

Hems: The recent cases of *Symbion Power LLC v. Venco Imtiaz Construction Co* and *Teekay Tankers Ltd v. STX Offshore & Shipbuilding Co* Ltd are cogent reminders about the risks of losing confidentiality where there is a need to subsequently take the matter to court, and the need for parties to bear this in mind when setting out in arbitration. *Essar v. Norscot* was a significant judgment in terms of liability to pay costs in arbitration where the successful party was funded. This may well provide guidance about the future exercise of discretion on costs by arbitral tribunals, but also inform parties about the potential use in trying to flush out whether a counterparty to an arbitration is being funded. The other stand-out matter from the point of view of current 'hot topics' is *Star Polaris LLC v. HHIC-Phil Inc* and what that has added to the body of law

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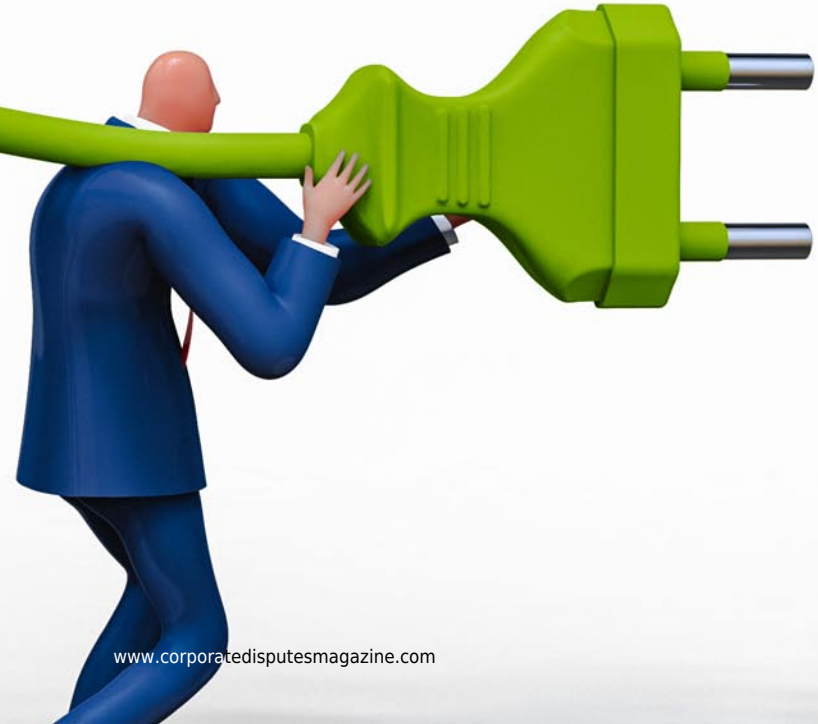
addressing the meaning of consequential losses, along with other litigation cases, such as *Transocean Drilling UK Ltd v. Providence Resources Plc.*

Cole: *Pearl Petroleum Company Limited and Others v. The Kurdistan Regional Government of Iraq* is of particular interest. Pearl secured a series of London seated LCIA arbitral awards of $2bn against the Kurdistan regional government (KRG), in relation to the development of gas fields in Iraq. The KRG was found liable to pay a minimum guaranteed price to Pearl because KRG's dispute with the federal government of Iraq meant that Pearl could not export gas produced by the gas fields. Pearl sought to enforce the arbitral awards in the courts of the Dubai International Financial Centre (DIFC), which KRG defended on grounds, among others, that KRG had sovereign immunity from action. KRG contended that only the UAE government could determine issues of sovereign immunity and not the DIFC courts. The KRG relied upon jurisprudence from the Hong Kong SAR which had found, in a case concerning the Democratic Republic of the Congo, that sovereign immunity was a matter of public policy and could not be determined by the courts. Cooke J referred to the contract between the consortium and the KRG, governed by English law, which provided that the KRG waives on its own behalf and that of The Kurdistan Region of Iraq any claim to immunity for itself and its assets. While holding that the UAE's recognition of other states was a matter of foreign policy which the DIFC Courts could not

rule on, KRG's waiver of immunity was a question of law and not public policy. KRG's submission to LCIA arbitration under supervision of the English High Court, together with the express terms of the contract, amounted to a waiver of any sovereign immunity that KRG may have had. The arbitral awards were enforced. Shortly afterwards, the parties settled their differences. This case goes to show the importance of having robust commercial terms, as well as the need for pragmatic enforcement of ensuing arbitral awards.

CD: What advice would you give to energy companies in terms of evaluating and preparing strategies when involved in arbitration proceedings? Are there any sector-specific nuances which they should consider?

Pauly: Arbitration can be considerably more complex than domestic litigation because it involves a wider range of procedural issues. For example, parties should carefully consider the seat of the arbitration as it determines the availability of the domestic court's assistance in making interim orders, which are often needed to preserve the status quo against fluctuating market prices, and the grounds on which the award may be annulled or at least not



recognised. Often, parties overlook the fact that arbitration proceedings are not confidential by default, under certain arbitration rules or domestic laws. Disputes in the energy sector often require strict confidentiality. Drafting a confidentiality agreement in the arbitration agreement often proves useful. The issue of language is also relevant, absent a decision as to the language of the arbitration, arbitral tribunals could rule that the arbitration should be bilingual, with parties incurring significant translation costs. Parties to high-stakes energy-related agreements should also consider carefully whether to include a document production phase in the proceedings. The number of documents in energy-related cases is often voluminous and the costs incurred during the document production phase are often a non-predictable item in the budget. In some cases, parties may wish to consider a waiver of this phase, so as to decrease costs and shorten the procedure.

Hems: Legal representatives must be able to devise a settlement strategy, which may well include arbitration as one of the means to achieve that, but as soon as a party's focus shifts to fighting for the sake of the argument then it will become harder to find a way out of the time and costs involved. Counterintuitively, perhaps, the key to this is early preparation. Early involvement of legal support as soon as issues arise can help shape how the issue is addressed, including proper control of communications, particularly emails, and the sort of language that is used, especially where internal investigations into causes need to be carried out.

"Good value is important to everyone, so engaging expert legal counsel who understand arbitration in the energy sector is vital."

Adrian Cole, King & Spalding

A full legal investigation at the outset of a dispute will front-load a degree of cost, but if it facilitates a proper, informed assessment of the merits then that is likely to be of far greater benefit to the instructing party in understanding what a range of acceptable outcomes are and how best to go about achieving a result within that range.

Cole: Energy companies should first ensure they have contracted on the best terms possible to avoid disputes arising in the first place. Where disputes have arisen, companies need to decide on the

importance of the case and the level of resourcing they wish to make. Good value is important to everyone, so engaging expert legal counsel who understand arbitration in the energy sector is vital. Time, cost and opportunity is wasted by using non-specialists. Legal counsel should be alert to all opportunities to settle on the best possible terms for the company. This may involve engaging in mediation or other forms of ADR or issuing Calderbank letters or other offers as to costs, which, if not accepted and are beaten at trial, may result in the rejecting party being penalised. Effective deployment of resources in the evidential stage of the case is vital if the strongest case possible is to be advanced. This involves the right people collating and managing documentary evidence and the careful selection and handling of factual and technical witness evidence.

Venegas: Energy companies should be aware that the time and money usually required for arbitration proceedings in the sector may become exhausting. Patience and consciousness of the difficulty inherent to this type of dispute is of the essence. Consequently, companies would be advised to have prepared for any eventuality that may occur during an arbitration, as well as the financial impact that it may have, not only on the company, but also for future projects. Other specific issues to consider include requiring nominating arbitrators who have a clear understanding of the industry, but also the relevant national law to which the contract may be subject. Unfortunately, in Latin America, a lot of arbitrations have been ruled by common law arbitrators who usually ignore the local laws which, in most cases, can impact the amount of recoverable damages, as well as the topics that can be subjected to arbitration. The ignorance of this specific topic has previously led to the setting aside of arbitral awards that may render the time and effort put into the arbitration useless.

CD: How would you describe the ease of enforcing awards following energy-related arbitration? What steps can parties take to improve their chances on this front?

Hems: Ideally, parties should take some time to consider the likely enforcement requirements at the point of contract, when the arbitration agreement is settled. The New York Convention is a good thing and, in principle, makes the process easier, but the practical reality is that there are still a lot of jurisdictions that will make life difficult, either because judges allow local interests to prevail over the Convention's provisions or because local legal provisions undermine what the Convention is intended to achieve. If a party can secure some form of protection through the terms of their contract, such as a parent company guarantee or on demand bank guarantee, then the enforcement picture improves considerably. Otherwise, a party may be

faced with the difficult prospect of applying for freezing injunctions, assuming it can identify a bank account or asset worth going after.

Venegas: In principle, enforcing awards in energy-related arbitration is the key to a successful dispute resolution strategy. To enforce them, it is very important to be aware of the assets and financial situation of the other party, on a global scale. Pursuant to the New York Convention, the enforcing of awards could be sought in any country in which the debtor may have assets. For this reason, having mapped potential assets to enforce an award, other than in the country which served as the seat of the arbitration, is a priority. Famous cases such as the *Commisa* case were finally settled because of the ability to enforce the award outside of the seat of the arbitration.

Cole: Many, if not most, arbitrations in the energy sector are 'international' in nature, and the cross-border recognition and enforceability of arbitral awards afforded by the New York Convention is likely to be important. The New York Convention, acceded to by 157 states, essentially limits challenges to the enforcement of arbitral awards to grounds of due process and public policy. Due process is fundamental to ensuring fairness and for the arbitral process to retain credibility. Thus, matters such as ensuring the arbitration agreement is valid and that notice of the proceedings have been given to the other party are essential requirements. Likewise, each party must be afforded the opportunity to present its case, provided the case is within the jurisdictional scope of a properly constituted tribunal. Thus, close compliance with the rules of the arbitration, whether institutional or ad hoc, is essential if a fair award, capable of enforcement, is to be obtained. Awards which contravene public policy or which otherwise contravene the laws of the state in which enforcement is sought are unlikely to be enforced.

Pauly: The ease of enforcing arbitral awards internationally, compared to court judgments, is seen as one of the key advantages of arbitration. Once a party has obtained a favourable award, it may enforce the award informally by applying commercial, diplomatic or reputational pressure to the unsuccessful party to comply with the award. In other cases, the winning party often relies on the international treaty for mutual enforcement of arbitral awards – the New York Convention of Enforcement of Arbitral Awards 1958. Under the New York Convention, over 150 countries have agreed to enforce arbitral awards from other signatories in their own jurisdiction as if they were local judgments, with very limited procedural grounds of review. Parties should always seek advice as to where the other side's assets are located to coordinate the enforcement under the Convention, so as to achieve swift compliance with the award.

It is often also a wise step for a party to apply for interim measures, pending the award, in order to prevent the respondent from dispersing its assets to countries that are not party to the Convention.

CD: What are your predictions on the outlook for arbitration in the energy sector?

Cole: International arbitration is constantly developing to ensure that it remains relevant and is of use to those that engage in it to resolve disputes. Tribunals and supervising courts must continue to resist the apparent growth of unprofessional and damaging 'guerrilla' tactics that parties sometimes engage in. Time and cost, like energy, are valuable commodities that should be preserved. Arbitration practitioners need to do all they can to ensure the expedient and cost effective determination of disputes. Provided good sense prevails, the outlook for arbitration in the energy sector remains good.

Venegas: In the coming years, arbitration will become even more relevant within the energy sector. Alternative energies and new technologies will give rise to new types of dispute that will reshape the already complex energy landscape. In addition, the growth of energy requirements that the global economy will require would only lead to more private-public associations that are likely to clash at some point. Considering these factors, as well as the experience and high specialisation required for this type of dispute, we foresee a scenario in which the use of arbitration will only expand, together with other ADR methods that may complement it, but that ultimately will not reduce its utilisation.

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Pauly: With the development of renewable energy projects around the world, the favourable domestic legislation adopted in this sector to attract investors and the subsequent removal of incentives offered to investors, the renewable energy sector is currently one of the most important areas of disputes in the energy sector. This trend is likely to continue in the near future with states developing favourable

legislation and offering incentives to investors, including in France. In addition, the near future might witness the development of international disputes over territory and maritime areas where energy resources are being explored or exploited.

Hems: One of our main expectations is that we will see a growth in 'mix and match' arbitration. Taking English law and London as examples, this would mean more non-English law disputes coming to London and more English law disputes with their seat in other jurisdictions. Hand-in-hand with that, we are also expecting to see other major international arbitration centres continuing to mature, probably, most obviously, Dubai and Singapore, but anticipate that other regional centres are also likely to see more business, particularly where NOCs are involved, such as in Mexico, Nigeria, Malaysia and Western Australia. From an English perspective, the depth of specialist expertise within the London-based arbitrator pool is a clear strength but it may not be enough to ensure London arbitration continues to thrive. Our hope is that London is able to keep up with the modern approach seen in many other places, which will particularly require a fresh look, as a matter of policy, at disclosure obligations and the handling of electronic data. Perhaps there is scope for an early, disclosure focused case management hearing to try to address these sorts of issues. So far as the markets we are operating in are concerned, we anticipate claims arising out of sectors of the market where there has been rapid expansion – such as LNG and FLNG. CD