

## SERIES OF NOTES ON THE ENERGY CHARTER TREATY

### Note 5

12 March 2014

## “DENIAL OF BENEFITS” UNDER THE ENERGY CHARTER TREATY

### Article 17(1)

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## INTRODUCTION

1. This 5<sup>th</sup> note in the *Series of Notes on the Energy Charter Treaty* provides a brief analysis of two specific issues concerning Article 17<sup>1</sup> of the Energy Charter Treaty (“ECT”). The first is the meaning of the phrase “[e]ach Contracting Party reserves the right” as appears in the chapeau of Article 17. The second issue is the meaning of the phrase “third state” in the context of Article 17(1).

2. Article 17 of the ECT reads, in its pertinent part, as follows:

Each Contracting Party reserves the right to deny the advantages of this Part to:

(1) a legal entity if citizens or nationals of a third state own or control such entity and if that entity has no substantial business activities in the Area of the Contracting Party in which it is organized; or

(2) [...]

## THE MEANING OF “EACH CONTRACTING PARTY RESERVES THE RIGHT”

3. It is imperative to note that Article 17 embodies a *reserved right* to deny the advantages of Part III of the ECT to any investor or investment meeting the descriptions set out in paragraphs (1) or (2), respectively. However, that right must be exercised to be effective. In other words, “the

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<sup>1</sup> Article 17 is entitled “Non-application of Part III in Certain Circumstances”.

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*right*” which is reserved, must be exercised by way of positive action by a Contracting Party<sup>2</sup> wishing to benefit from it. Unless that right is exercised, the investor or investment will continue to enjoy the substantive protections in Part III of the ECT (Articles 10-16).

4. It follows that having *reserved* its rights under Article 17, each Contracting Party may or may not deny the advantages of Part III to an investor.
5. The textual interpretation of the chapeau of Article 17 above has been confirmed by both the *Plama* and the three *Yukos* tribunals. For example, the *Plama* tribunal in its Decision on Jurisdiction reasoned as follows:

In the Tribunal’s view, the existence of a “right” is distinct from the exercise of that right. For example, a party may have a contractual right to refer a claim to arbitration; but there can be no arbitration unless and until that right is exercised. In the same way, a Contracting Party has a right under Article 17(1) ECT to deny a covered investor the advantages under Part III; but it is not required to exercise that right; and it may never do so.<sup>3</sup>

6. What is clear from the above is that the Contracting Party intending to exercise its right under Article 17 must take a ‘positive action’ towards that end. The exercise of this right should be timely and exercised in a transparent manner.
7. Furthermore, it is clear from the provisions of Article 17(1) of the ECT that the option to deny the advantages of Part III of the ECT to certain legal entities which have made or claim to have made investments exists only where those entities meet the two sequential requirements, which, for the sake of clarity, can be listed as follows:
  - (i) that the legal entity in a Contracting Party be owned or controlled by nationals of a “*third state*”;
  - if the legal entity was owned or controlled by nationals of a “*third state*”, then the advantages of Part III *may* be denied to that entity **if and only if**, a second condition is also present: (ii) that the entity (owned or controlled by nationals of a “*third state*”) “*has no substantial business activities in the Area of the Contracting Party in which it is organized.*”
8. The three *Yukos* tribunals confirmed the inclusive nature of the two conditions that are necessary before a Contracting Party denies the advantages of Part III thus:

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<sup>2</sup> For the definition of a Contracting Party, see Article 1(2) of the ECT.

<sup>3</sup> *Plama Consortium Limited v. Republic of Bulgaria*, ICSID Case No. ARB/03/24, Decision on Jurisdiction of 08 February 2005, (2005) 20:1 ICSID Review 262, paragraph 155.

It is apparent from the wording of Article 17(1) that two additional cumulative substantive conditions must be met before the “denial-of-benefits” clause can be exercised in respect of any particular legal entity. First, such legal entity must be owned or controlled by citizens or nationals of a third State; second, the legal entity must have no substantial business activities in the place in which it is organized.<sup>4</sup>

9. To sum up, subject to a proper moment for exercising “*the right*”, Article 17(1) permits a host Contracting Party to deny the advantages of Part III of the ECT to an Investor<sup>5</sup> organised according to the laws of another Contracting Party, but owned or controlled by nationals of a “*third state*”, **only** if that entity does not have substantial business activities in the area of the Contracting Party in which it is organised. The absence of any one condition renders the *denial-of-advantages* clause inapplicable.
10. To the best of our knowledge there is nothing in the negotiating history of the ECT that suggests that the parties to the Treaty intended anything other than what the textual interpretation outlined above provides.

## THE MEANING OF “THIRD STATE” IN ARTICLE 17(1)

### Textual Analysis

11. The term “*third state*” does not include nationals of a Contracting Party to the ECT. It is our opinion that the term “*third state*” in Article 17(1) refers only to states that are not parties to the ECT. We hold this opinion for the following reasons.
12. Applying the rule of interpretation set out in Article 31 of the VCLT,<sup>6</sup> the two terms employed in Article 17, i.e. “*third state*” and “*Contracting Party*” must be construed in connection with the definition provided in Article 1(7) of the ECT.
13. Article 1(7) of the ECT recognises two kinds of Investors:
  - a. **with respect to a Contracting Party:**
    - i. a natural person having the citizenship or nationality of or who is permanently residing in that Contracting Party in accordance with its applicable laws;
    - ii. a company or other organization organized in accordance with the law applicable in that Contracting Party;

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<sup>4</sup> *Yukos Universal Limited (Isle of Man) v. The Russian Federation*, PCA Case No. AA 227, Interim Award on Jurisdiction and Admissibility of 30 November 2009, paragraph 460. See also, *Hulley Enterprises Limited (Cyprus) v. The Russian Federation*, PCA Case No. AA 226 and *Veteran Petroleum Limited (Cyprus) v. The Russian Federation*, PCA Case No. AA 228.

<sup>5</sup> For the definition of Investor, see Article 1(7) of the ECT. Also provided below, at paragraph 13.

<sup>6</sup> See Note 3 of this *Series*, dated 10 March 2014.

- b. **with respect to a “third state”**, a natural person, company or other organization which, fulfils, mutatis mutandis, the conditions specified in subparagraph (a) for a Contracting Party.<sup>7</sup>
14. It is suggested here that the above interpretation of the term “*third state*” is in line with its ordinary meaning. This is supported by what is said in the 1966 commentary of the *International Law Commission on the Vienna Convention*: “[t]his term [third state] is in common use to denote a State which is not a party to the treaty [...]”<sup>8</sup>
15. Therefore, any other interpretation amounts to assigning a “special meaning” to this term, and the party claiming such special meaning carries a burden of proving it, as required by Article 31(4) of the VCLT.
16. Based on the above brief textual interpretation of the term in the context of Article 17(1) and in the context of the investment provisions, and in light of the ECT’s object and purpose, it is the opinion of the authors of this note that the intent of the ECT’s parties was that the term “*third state*” means non-Contracting Parties to the ECT. We are also of the opinion that the textual interpretation summarised above is fully borne by the ECT’s *travaux préparatoires*, which we briefly consider next.

## Summary of Negotiating History

17. Early versions of Article 17 (formerly Article 19) from 1992 and 1993 used the term “*non-signatory country*” in place of the current term “*third state*”.<sup>9</sup> In late 1993, the drafters substituted the phrase “*a state that is not a Contracting Party*”.<sup>10</sup> In July 1994, the Legal Sub-Group recommended to the negotiators of the ECT, among other things, that the term “*third state*” continued to be defined in the definition of “Investor”, but that:
- [...] the term used in the text is “state that is not a Contracting Party”. (See Articles 10(1), 13(3), (7), 14(1), 16(5), 19(1), (2).) One or the other term had to be changed, and we favoured reinserting “third state” in the text.<sup>11</sup>
18. The Legal Sub-Group introduced its above recommendation concerning the substitution of the term “*third state*” alongside the term “*a state that is not a Contracting Party*” in Article 19, into a

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<sup>7</sup> Emphasis added.

<sup>8</sup> Draft Articles on the Law of Treaties with commentaries, *Yearbook of the International Law Commission*, 1966, vol. II, p. 190.

<sup>9</sup> See Annex 1.

<sup>10</sup> See, for example, CONF 96 document, dated 17 March 1994.

<sup>11</sup> Report of the Legal Sub-Group, dated 01 July 1994.

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draft text of the ECT which was subject to technical legal review;<sup>12</sup> thus indicating that the two terms were synonymous. The Legal Sub-Group's recommendation was adopted by the negotiating parties without any further discussions.

19. The three *Yukos* tribunals summed up succinctly the correct meaning of the term “*third state*” in the context of Article 17 as follow:

The Treaty [ECT] clearly distinguishes between a Contracting Party (and a signatory), on the one hand, and a third State, which is a non-Contracting Party, on the other. The Tribunal agrees with Claimant that, on their face, several provisions distinguish between a Contracting Party and third State (for example, Articles (1)(7), [sic] 10(3) and 10(7), and 17) and that there is no equation in the ECT between a Contracting Party and a third State. *This conclusion is further supported by the travaux préparatoires, which demonstrate that the term “third state” was substituted for the term “non-Contracting Party.”*<sup>13</sup>

20. Finally, it is noteworthy that the scope of Article 17 extends only to Part III of the ECT and not Article 26<sup>14</sup>, which falls in Part V. This was confirmed by both the *Plama* and the three *Yukos* tribunals. Thus, the three *Yukos* tribunals observed:

Whether or not Claimant is entitled to the advantages of Part III is a question not of jurisdiction but of the merits. Since Article 17 relates not to the ECT as a whole, or to Part V, but exclusively to Part III, its interpretation for that reason cannot determine whether the Tribunal has jurisdiction to entertain the claims of Claimant.<sup>15</sup>

21. Thus it seems that the current position is that Article 17 does not deprive a tribunal seized under Article 26 of the ECT from exercising jurisdiction.

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<sup>12</sup> See the Legal Sub-Group Report (as of close of business 08 July 1994).

<sup>13</sup> *Yukos* case, op. cit., paragraph 544. Emphasis added.

<sup>14</sup> Article 26 is entitled “Settlement of Disputes between an Investor and a Contracting Party”.

<sup>15</sup> *Yukos* case, op. cit., paragraph 441.

## ANNEX 1

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### ARTICLE 18

#### RELATION TO OTHER AGREEMENTS

Where two or more Contracting Parties have entered into a prior international agreement, or enter into a subsequent international agreement, whose terms in either case concern the subject matter of Part III or V of this Agreement, nothing in Part III or V of this Agreement shall be construed to supersede any incompatible provision of such terms of the other agreement, and nothing in such terms of the other agreement shall be construed to supersede any incompatible provision of Part III or V of this Agreement, where any such incompatible provision is more favourable to the investor or investment.

### ARTICLE 19

#### NON-APPLICATION OF PART III IN CERTAIN CIRCUMSTANCES

Each Contracting Party reserves the right to deny the advantages of this Part to a legal entity if citizens or nationals of a non-signatory country control such entity and if that entity has no substantial business activities in the Domain of the Contracting Party in which it is organised or the denying Contracting Party does not maintain diplomatic relationship with the non-signatory or adopts or maintains measures with respect to the non-signatory that prohibit transactions with the investor of that non-signatory or that would be violated or circumvented if the advantages in this Part [DL] were accorded to the investor of that non-signatory or to its investments.