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**Ecuador's Oil Industry Challenge: Nationalism vs. an Open Stance
towards Foreign Direct Investment**

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HOJA DE APROBACION DE TESIS

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Stance towards Foreign Direct Investment**

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Agradecimientos y Reconocimientos

Señor, tú que ya eres dueño de todo. Gracias por la bendición tan grande de darme una familia tan maravillosa. Por una educación y la oportunidad de crecer como ser humano y profesional. Siempre trabajaré por las causas nobles y verdaderas.

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ABSTRACT

Foreign Direct Investment (FDI) has been the single most determinant factor for the development of the Petroleum Industry in Ecuador. This industry has marked a before and after in terms of the country's economic growth because oil is a finite energy resource and a valued commodity in the international energy markets. Since the early 1970's oil exports have represented more than half of all exports and become a major contributor to Ecuador's Gross Domestic Product (GDP) and fiscal income. Because the oil business is risky and capital-intensive, host countries and International Oil Companies (IOC's) seek to enter into contracts that abide by international law standards and procedures in order to protect the rights and obligations of both parties. Bilateral Investment Treaties (BITS's) are very important because they serve as the general guideline and reference for incorporation of standard international law provisions, particularly those related to international arbitration for contractual dispute resolution. This research, correlates and explains, the effect that Ecuador's outspoken position on international arbitration proceedings and BIT's (independent variable), has had on FDI (dependent variable) by using statistical and descriptive data. While there are other variables that also have an incidence in the increase or decrease in FDI, the country's stance towards BIT's and arbitration is the most determinant factor driving FDI. Therefore, the country faces a major challenge to develop its full oil production potential: to maintain a stance against international investment treaties, agreements and arbitration which will mean continued reduction of FDI and stagnation of its principal export industry, or to adopt a favorable stance that will promote FDI. The data used in this research has been retrieved from the Central Bank of Ecuador, ARCH, from scholar articles, institutions, ministries, petroleum agencies and local and international news media.

RESUMEN

La Inversión Extranjera Directa (IED) ha sido el factor individual mas determinante para el desarrollo de la Industria Petrolera en Ecuador. Esta industria ha marcado un antes y un después en el crecimiento económico del país por cuanto el petróleo es un recurso finito y un "commodity" energético muy valorado en los mercados energéticos internacionales. Desde los 1970 las exportaciones petroleras han representado mas de la mitad de todas las exportaciones y ha sido un aportante significativo al PIB y a los ingresos fiscales. Por cuanto el negocio petrolero es de alto riesgo e intensivo en el uso de capital, los países anfitriones y las Compañías Petroleras Internacionales (IOC's) generalmente han buscado suscribir contratos que sigan la normativa y procedimientos internacionales a fin de proteger debidamente los derechos y obligaciones de las partes. Los Tratados Bilaterales de Inversiones TBI's, son muy importantes porque sirven como guía general y marco de referencia para la incorporación de provisiones legales, internacionales estándar, particularmente aquellas relacionadas con arbitraje internacional para la solución de disputas contractuales. Esta investigación correlaciona y explica, el efecto que la posición critica del Ecuador hacia los arbitrajes internacionales y TBI's (variable independiente) ha tenido en IED (variable dependiente), utilizando información estadística y descriptiva. Si bien hay otras variables que también inciden en afectar en mas o menos a la IED, la postura del Ecuador en contra de los arbitrajes y TBI's, es el factor mas determinante para la IED. Por ello, el país enfrenta un desafío mayor para desarrollar todo su potencial de producción de petróleo: Mantener una postura en contra de los TBI's y arbitrajes, lo que significara una significativa reducción de IED y, por tanto, estancamiento de su principal industria de exportación; o, adoptar una posición favorable que promueva la IED. La información utilizada en esta investigación ha sido recolectada del Banco Central del Ecuador, ARCH, artículos publicados de analistas expertos, ministerios, agencias de información de petróleo, así como los medios de noticias nacionales e internacionales.

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Introduction

Are Ecuador's prospects as recipient of Foreign Direct Investment in its Petroleum Industry affected by its Government's stance on International Arbitration? If so, what could be the magnitude of the impact in terms of investment?

This question is of utmost relevance because Foreign Direct Investment (FDI) has driven most of Ecuador's petroleum industry, which is the main source of Government revenues. Moreover, as this thesis will show, international arbitration has a direct impact on FDI. To understand the importance of this research question, it is first necessary to review how the petroleum industry has impacted the Ecuadorian economic development since the 1970's. Also, it will be essential to evaluate the effect that the lack of FDI has had in the development and growth of new petroleum production in the recent past. Then it will be important to analyze the reaction of international investment to the position that Ecuador has taken towards Bilateral Investment Treaties (BIT's) and international arbitration on FDI. It must be taken in account that the terms oil and petroleum will be used interchangeably throughout this research.

The hypothesis of this work states that the more open the country can be towards international arbitration, the larger the volumes of Foreign Direct Investment that can be expected in its oil industry. This hypothesis is stated on the basis that other factors affecting FDI do not have the significance of international arbitration for investment contract dispute resolution. This has been also stated in other literature article such as that written by Bernini (1997) who suggests that comparative studies have shown that nations that want to attract foreign investors have to be concerned with offering the adequate arbitration proceedings to

guarantee the investors security(para. 9). This is precisely the opposite of what Ecuador has done in the last 8 years, starting with Law 42 in April of 2005 during the Palacio administration (Official Registry No. 460, 5 of November, 2008), followed by subsequent reforms issued by the Correa administration, since 2007.¹

Other authors, for instance, Briones and Tagvoryan (2010) also argue that arbitration has been designed in order for investors to avoid unknown risks. They suggest that any country that wants to attract foreign investment must firmly establish trusted arbitration mechanisms: “(...) International arbitration provides uniform practice, a neutral forum, enforceable awards and final non appealable solutions (...)” (p.131). I agree with these views because I consider, that any country wishing to attract investment should embrace clear arbitration proceedings.

Hence, I will provide ample evidence to support my theory in the sense that FDI has been most important when Ecuador’s policies have favored international arbitration for its oil contracts, including adherence to Bilateral Investment Treaties (BIT’s). These treaties in general, serve to reinforce the applicability of existing country legislation to foreign investments, but they primarily serve to highlight the utmost significance of international arbitration. I will further support this notion with the existence of bilateral investment treaties with those nations where the companies are headquartered. These aspects configure my theoretical or independent variable, international arbitration. My theoretical or independent variable will be measured in terms of Ecuador government’s news statements rejecting and questioning international arbitration and BIT’s. Furthermore my dependent variable being Foreign Direct Investment will be measured by the net investment received by Ecuador from

¹Registry No, 460, November 5 of 2008. This is an Executive Decrete (1402) found under Informative Legal & Economic Synthesis (Informativo de Síntesis Legal Económico).

the International Oil Companies (IOC's). I will also review literature to evaluate the effect upon FDI of other variables (control variables), which certain authors consider important for FDI and international arbitration. These control variables are geological prospectivity, fiscal terms and political risk.² Briefly, the first one relates to the potential of finding oil in a region. The second one analyzes the business model that the host country offers to the investors. The last one looks into the stability of laws, regulations and fiscal terms over time.

To analyze the importance of the petroleum industry in Ecuador's economy, it is important to take into consideration some general information: In the 1960's the Ecuadorian economy was primarily based on agricultural production and export of basic commodities such as banana, cocoa, and coffee (World Bank, 1979, p. 140). Towards the end of that decade and as a result of Foreign Direct Investment (FDI), Ecuador was able to discover very significant reserves of oil in the Amazon Basin (Oriente) (1979, pp. 261-266).

Since then and until now petroleum production and exports have been the major source of exports income for the Ecuadorian economy, representing between thirty and forty percent of total fiscal revenue (Jimenez and Tromben, 2006, pp. 59-62). For example, author James Rochlin (2011), states that "Production capacity rose from 4,100 barrels of oil per day in 1971 to over 200,000 barrels of oil per day by 1973, the year in which Ecuador became a full member of OPEC" (p. 15). Additionally, one specific result shall prove that, other than taxes, revenues resulting from oil exports currently represent around 40% of the annual fiscal income (Central Bank of Ecuador, 2013).³ Furthermore, oil exports revenues represent the most

²These variables are considered through out this research, the control variables. Author Charles F. Conaway (1999) explains these are the three major considerations of an investor before entering into international petroleum contracts. This autor is review in the Literature section.

³Statistical Bulletin of the Central Bank of Ecuador, Foreign Direct Investment by Economic Activity. By diving the total oil FDI exports by the total of the GDP, more or less oil represents 40%.

significant income from the total of Ecuador's exports (Central Bank of Ecuador, 2013). According to the statistics published by the Central Bank of Ecuador, in 2011 for example, from a total of 22.3 billion dollars, oil exports represented 12 billion, which is more than 54 % of total Ecuadorian exports (Central Bank of Ecuador, 2013).⁴ Moreover, the U.S Department of State on its 2011 "Investment Climate Statement" states that in 2010, and as a result of the reforms to the Hydrocarbons Law, carried forward by the Correa administration, Ecuador's oil revenue is now received exclusively by the central government. This comes about from the change of the participation oil contracts to a service fee type arrangement, whereby 100% of the oil produced in the country belongs to the state (Hydrocarbons Law, 1978).

However during the last ten years oil production has remained stagnant around 500,000 barrels of oil per day ("Ecuador New Opportunities Arise", 2013, p.3). Nonetheless Ecuador has enjoyed the benefits of unprecedented oil exports income growth as a result of the dramatic increase in international oil prices, which have gone from around twenty dollars per barrel in 2000 to over one hundred dollars per barrel in 2013 (Central Bank of Ecuador).⁵

In a recent Bloomberg news article, author Ayesha Daya (2012) states the position of Ecuador's oil minister Wilson Pastor, clarifying that international oil prices appear to have stabilized around \$100 per barrel and that no further increases can be expected in the foreseeable future. Under these circumstances, and considering that, as a result of marginal FDI in the last 20 years, no major discoveries of oil have been made, the production of oil in Ecuador will start declining shortly, which means that fiscal income will also start to diminish (this of course assumes that the government will maintain its long publicized decision not to

⁴See: <http://www.bce.fin.ec> (2.5 Exportaciones Por Grupos De Productos (1927-2011)).

⁵Balanza Comercial (1)- Toneladas métricas y valor USD FOB (en miles).

produced commercial oil reserves from the Yasuni-ITT areas.) This decrease in income could be very large and even have catastrophic consequences for the Ecuadorian economy if there was also a significant drop in international oil prices in the next few years. Since Ecuador cannot control prices, it should, at least try to compensate with additional production and exports, for which FDI is essential.

Research has defined FDI as “a composite bundle of capital, know-how and technology” (Balasubramanyam, Salisu and Sapsford, 1999, p.28). According to Balasubramanyam et. al (1999), countries that import FDI assure, FDI’s main contribution to growth has been through technology, skill diffusion, and technology transfer. In addition, Taylor (2000) who quotes Rugman (1998) states, that “(...) One-half of all trade and one-fifth of worlds GDP are attributable to multinational corporations (...)” (p.635). He further states that previous research has found FDI to be more important to a country’s growth than domestic investment.

Considering that these components are essential to develop the still significant oil potential of Ecuador, according to the promotional Report “Ecuador New Opportunities Arise” by Forbes Magazine written by the end of 2012, only about 50% of the Oriente basin has been explored, it appears important to ask the question: How can Ecuador insure the availability of the very large amounts of risk capital investment and technology required to do more exploration, find new reserves and expand its oil exports potential?

In my research, I will not ignore other views such as contained in Report No. 31900-EC from the Development Economics Research Group (DECRG) from the World Bank, this report states that FDI has not necessarily proven to be the most effective mechanism for economic growth (p.159). The report suggests that it must be carefully aligned with the host

country domestic growth agenda (New Avenues For FDI and Sustainable Development, 2009, p.1). However, the alternative of exclusive state financing for the oil industry in Ecuador would mean risking Ecuador's limited fiscal resources, for which there are other more immediate and higher priority government needs in health, education and infrastructure development.

With respect to state intervention alone, it does not seem desirable, not only because of the large amounts of capital required, but also because of the very large risks associated with the petroleum industry. Regarding FDI, a very recent news article in newspaper *El Universo*(2013)by author Gabriela Calderon de Burgos from the CATO Institute in Washington D.C., argues that private investment is much more productive than public investment. She cites the findings of economists James D. Gwartney and Robert A. Lawson, whose research from a data base of 99 countries reveals that, between 1980 and 2000, one percent increase in private investment resulted in 2.6 times more economic growth than the same increase in public investment (para.5). Calderon's opinion can be supported by Reinhart and Khan (1990) empirical evidence, which suggested, based on a cross section sample of twenty-four developing countries that private investments have a larger direct effect on growth than public investment. These authors developed a simple growth model that showed how private and public investment produce different effects on the output growth. These authors share their findings stating:

In the equations where both private and public investment are included, we find that private investment contributes about 43 percent to average growth. The contribution of public investment is negative, as was expected since the estimated coefficient of public investment was negative in the regressions.
(Khan Reinhart and, 1990, p.12)

These findings showed the direct effects of both public and private investments in several countries, being Ecuador one of these countries.

In summary, I believe that FDI is still preferable over the use of Ecuador's state funds for financing oil industry development. To support my opinion, authors and Kalirajan Mottaleb (2010) cite Crespo and Fontoura, (2007), Romer (1993) and the World Bank (1999) when suggesting that: "It is widely recognized that foreign direct investment (FDI) provides economic benefits to the recipient countries by providing capital, foreign exchange, technology and by enhancing competition and access to foreign markets"(p.370). In addition these authors add that developing countries where their investment demand is higher than their proportion of savings, may be more suitable to invest and achieve faster economic growth " by importing capital from abroad in form of FDI" (p.370). State funding or financing the risky oil industry with internal or external debt is not desirable.

From the investor's perspective, Foreign Direct Investment also has to take into consideration other important factors such as how safe it is to invest in a host country. Ecuador for example, is a country that has suffered long-term economical instabilities (Boye, 2001) and therefore external investors might see Ecuador as a country, which might present risk regarding its security for investments. Literature suggests the importance of treaties in order to safeguard external investment.

Ackerman and Tobin (2005) introduce the importance of Bilateral Investment Treaties (BITs), a mechanism that provides rules that protect FDI reducing "the risk faced by investors" (p.9). This mechanism is essential since:

BITs generally provide for resolution of both country-country and investor-country disputes by an international body such as the World Bank Group's International Center for the Settlement of

International Disputes (ICSID) or other arbitration systems, such as those operated by the International Chamber of Commerce (ICC) (p. 8).

Since the petroleum industry is a risk capital business, BITS exist to guarantee the appropriate protections. On the other hand, Tobin and Ackerman (2005) cite Kahler (2000) when suggesting that some developing countries, believe signing BITs means losing sovereignty, refusing to sign Bilateral Investment Treaties.

A clear example of this reasoning is reported in newspaper *El Hoy* (2013) in the article headlined “Correa Rejects the Arbitration System”. This position reflects the president’s interpretation of the 2008 Montecristi Constitution (Art. 422) and his views rejecting international arbitration for the solution of legal disputes with foreign investors (in this case, Chevron and Occidental) on the grounds of sovereignty. However, a different stance has been adopted regarding arbitration provisions for credit facility contracts with the Chinese, where arbitration in the UK is accepted (“Petroleum for China until 2016”, 2012, para. 9).⁶

In addition, Bernini (1997) states that governments, which are still unwilling to renounce, often soon have controversies that arise with private investors, which act in detriment of the government economical growth. This arguments suggest that Correa’s position towards international arbitration will cause negative impact to foreign direct investment.

Also about this matter, in a 2010 issue, The Economist Magazine contributes with a review: “If it Aint Broke” stating: “Since Mr. Correa took office in January 2007, private oil production in the country has fallen from 255,700 barrels per day to 162,000—a gap worth \$2.3 billion a year, or 4% of GDP, at current prices”. This statement suggests Foreign Direct

⁶ Petroleum for China until 2016. This is a newspaper article used along this investigation .The title is translated by the author from Spanish to English.

Investment has weakened and that decisions made by the Ecuadorian government have scared risk investors away.

To properly discuss these issues, understanding Foreign Direct Investment (FDI) and how it differs from conventional lending and financing will be essential. I will also seek to establish the characteristics of FDI, the main industries where it is applied, the type of returns on investment that it seeks, as well as the risk reduction measures it looks for, of which rule of law, in general, and international arbitration specifically, are the main considerations (Carter, 2013, p.3).

After this introduction and as a reference for understanding FDI in the oil industry, I will review the literature from authors and scholars on the subject providing the general considerations an investor makes prior to evaluate whether to invest or not in an oil prospective region or country. One of the first authors consulted will be Charles F. Conaway a petroleum consultant who in his work “The Petroleum Industry” includes other considerations regarding the decision by an international oil company to invest in a country; these include geological prospectivity, fiscal terms and political risk (Conaway, 1999,p.65). Hence, regarding political risk for instance, another author, Professor Nathan Jensen (2008) from Washington University in St. Louis, MO, on his work “Political Risk, Democratic Institutions, and Foreign Direct Investment” states “ (...) arbitration is generally a last resort for firms since it can have repercussions by shaming the host government. Moreover, even after a firm wins an arbitration case, governments may simply ignore arbitration settlements (...)” (p. 6).In my work, I will develop my theory and then confirm it with data, that even if these other variables are significant, international arbitration under respectable jurisdiction provides the most comfort to international oil companies, considering FDI in a country.

As further evidence of the significance of FDI, I will support my theory by stating the impact of this type of risk investment in the sizeable development of the Colombian oil industry since, it opened up for investment in 2005 (US Dep. Of State, 2013). A very important contribution by the U.S Department of State is the fact that in 2005 Law 963 offered investors stability in its contracts (2013, para.7). Additionally, it will be important to review yet unresolved arbitration of contract disputes between Ecuador and International Oil Companies, such as the case of Occidental, that further in this research will be helpful to illustrate the ongoing situation in Ecuador. I will then estimate the impact it had in the future of FDI in Ecuador's oil sector. In this process I will pay attention to the work of international analysts and scholars with favorable and unfavorable views on the subject of arbitration and foreign direct investment.

I will specifically analyze the significance and implications of the role of China's state oil companies in Ecuador. Eduardo Garcia and Charlie Zou (2012) writers to Reuters News Agency explain in their online article "China's CNPC in talks with Ecuador over \$12,5 billion refinery" the importance and the relationship Ecuador has with China. This is just an example and later in the work it will be explained in detail why the Ecuador – China relationship is so important, and how this relates to my theory. This will also serve as a means to contrast these alternatives with conventional FDI. I will highlight the advantages and disadvantages in each case.

After literature has been reviewed, my research variables (independent, dependent, control) will be described and conceptualized in order to support my proposed theory. After explaining my theory, concepts, data and the methodology used will be explained. Finally in the last section of this work, I will draw my discussion and conclusions. Additionally my work

will expose the alternatives to FDI to satisfy the investment needs of Ecuador's oil industry in the future. For example, conventional lending from multilateral organizations such as the World Bank (WB), the Andean Development Cooperation, International Development Bank (IDB) as well as through government-to-government financing. It will be the aim of the research of this work to evidence that Ecuador can adopt a position regarding international arbitration, which is not in conflict with its Constitution and laws and yet, is attractive to foreign risk investors.

Literature Review

In this section of my work I will review literature to support my hypothesis, proving that the stance Ecuador has towards international arbitration, affects FDI's inflows. There are authors who present other variables (control variables) different from the one I state in my hypothesis, explaining how Foreign Direct Investment is affected; however, I will provide sufficient evidence to support my proposition in the sense that one of the most important independent variables affecting FDI, often neglected in the literature, is international arbitration.

As mentioned in the introduction, the President of Ecuador has repeatedly stated in *El Hoy* newspaper (February 21, 2013) news article headlined "Correa Rejects the Arbitration System" his government's position towards international arbitration, specifically referring to the cases of Chevron and Occidental, currently under litigation subject to ICISD jurisdiction (par. 1). The newspaper article reports the president "(...) criticized the arbitral award issued by the International Centre for Settlement of Investment Disputes (ICSID) ordering Ecuador to pay \$1770 millions plus interests, to Oxy, for terminating a contract in 2006 (...)" (2013, par.

11).⁷ Furthermore the newspaper reports President Correa stating that these processes are “true colonialism” (2013, par. 17) and evidence of the “abuse of imperialism”⁸ (2013, par. 17). To analyze these statements it is important to study Article 422 of the 2008 Montecristi Constitution supports these statements:

Treaties or international instruments where the Ecuadorian State yields its sovereign jurisdiction to international arbitration entities in disputes involving contracts or trade between the State and natural persons or legal entities cannot be entered into.

The treaties and international instruments that provide for the settlement of disputes between States and citizens in Latin America by regional arbitration entities or by jurisdictional organizations designated by the signatory countries are exempt from this prohibition (Constitution of Ecuador, 2008, p.187)

The first two paragraphs of Article 422, author Andrade Cadena (2009) suggests there is no clear definition in the Constitution of what “*sovereign jurisdiction*” means and that there are contradictions in this Article (p. 9). To understand his reasoning, I consider useful to refer to a news article from newspaper *El Comercio* (August 21, 2012), headlined “Petroleum for China through 2016”. This news article stated that PetroEcuador (the country’s national oil company) has five contracts in effect with PetroChina until 2016; the first contract stipulated international arbitration proceedings under jurisdiction of an Argentinian (a regional) court, whereas the other four contracts chose, as their venue, an International Court of Arbitration in London, which, obviously, do not fall under a regional court concept (par. 9). This illustrates, at least, how loosely Article 422 of the Constitution has been understood and applied in practice. In fact, one could even argue, strongly, that the government of Ecuador has evidenced a contradiction in the application of this constitutional precept.

⁷Translated by the Author from Spanish to English

⁸Translated by the Author from Spanish to English

Along these lines, Andrade Cadena (2009) states that Art. 422 “is based on a mistaken concept regarding jurisdiction of the state, as it would assume that the country’s ordinary courts are the natural and exclusive venue for resolution of international disputes” (p. 10)⁹. He further argues that this is not correct, as from a practical viewpoint international commercial disputes are rarely, if not exceptionally, submitted to resolution by ordinary courts. He then concludes that, since the state does not have a monopoly or exclusivity over the resolution of international conflicts, it would be incorrect to speak of yielding state jurisdiction or national sovereignty over something it does not have (2009, p. 10).

Furthermore Andrade Cadena states “the restriction of article 422 affects submitting contractual or commercial controversies of future treaties to international arbitration”(p.10). In this context, it would appear that the President’s public statements and his government actions are contradictory and project a confusing signal to potential foreign investors. For example, a report on the 2013 Spanish Investment Climate in Latin America, issued by the Business Institute, IE Business School of Madrid Spain, one of the main conclusions is that “Ecuador, along with Venezuela, Argentina and Bolivia, exhibit lack of rule of law” (par. 1). This was reported by *El Comercio* newspaper (march 21, 2013) in a news article by reporter Roxana Cazco, entitled “Ecuador, a country of great opportunities and high risk”. As Roxana Cazco writes in the article the study collected the perception of 38 Spanish companies regarding their investments in the region for the current year and projects a decrease of 26% for investments in Ecuador and 34% in Venezuela, in contrast with an increase of 58% in Peru and 76% in Colombia (par. 2). The newspaper article also quotes Consuelo Diaz, Risk Director of Cofides

⁹Translated by the Author from Spanish to English.

(a public/private organization that provides foreign project financing for Spanish corporations) saying that: “Ecuador is a country of great opportunities but too risky” (p. 3).

With respect to the Ecuadorian government view that considers international arbitration venues such as the ICSID, a tool for imperialist dominance, it is important to review the criteria of authors such as Delaume (1983) who state that the ICSID“(…) constitutes a self contained machinery functioning in total independence from domestic legal systems (…)”(p.784).With respect to the function of ICSID, another author, Gillman (2008), argues that the rejection by some Latin American countries of ICSID, is caused by “(…)the affirmative vision of creating a Latin American regional pole to counter the perceived dominance of the United States in the economic and political affairs of the Western Hemisphere(…)”(para. 3). This author also comments on a very important point, and that is that Ecuador has rejected ICSID because it argues that this center of dispute settlements, gives favoritism to the World Bank’s policies (par. 45). It also points out that through BIT’s and FTA’s (Free Trade Agreements) the risk of the investors is reduced (par. 7). It seems to me that Ecuador’s position goes along with that of some other countries in Latin America who are trying to develop a different model in which investor-state disputes are solved through regional courts and not anymore through international arbitration courts.In any case, it should be understood that investment always considers the possibility of a dispute, and if it were to happen, both the investor and the host country need to know how they are going to solve these investment disputes.

Authors Brunet and Lentini (2007) suggest in their work the influence of the“Calvo Doctrine”, “(…) a widely-adopted, anti-interventionist doctrine formulated in the nineteenth century(…)” (p. 592)as a factor in the posture adopted by several Latin American countries.

Nevertheless, economic difficulties in Latin America in the 1980's caused a new attitude towards foreign investment. Brunet and Lentini (2007) mention that the Washington Consensus resulted in legislation reforms to overcome the economic difficulties with foreign investment, offering *alternative dispute settlement* as one of these reforms (p. 595). The Calvo Doctrine was not what states needed anymore, rather new reforms and managing their economic and political affairs were necessary.

Cooper, Hawkins, Jacoby and Nielsen (2008) quote Keohane (1984), Moravcsik (1998), Abbot and Snidal (2000), liberal rationalists stating that:“(...) states delegate slices of sovereignty when international institutions help bring credibility to state commitments (...)”(p.502). In my personal opinion states might yield some jurisdiction for the only purpose of reaching conciliation avoiding further disputes that can cause economic harm to either the host country or to the investor. Nevertheless, the ICSID Convention stipulates under Article 26 the following:

Consent of the parties to arbitration under this Convention shall, unless otherwise stated, be deemed consent to such arbitration to the exclusion of any other remedy. A Contracting State may require the exhaustion of local administrative or judicial remedies as a condition of its consent to arbitration under this Convention (The Convention on The Settlement Of Investment Disputes Between States And Nationals Of Other States, 2006).

Regarding this article, it is clear that states are able to make their own decisions, even if this means yielding some jurisdiction regarding international disputes. However, I agree with Andrade Cadena (2009) and his view over how Ecuador lacks “exclusivity over the resolution of international conflicts” (p.10). From this idea it can be understood why

institutions such as ICSID where created, why they are necessary to some countries and how they still play such a significant role for Foreign Direct Investment. The Convention on The Settlement Of Investment Disputes Between States And Nationals Of Other States (2006) by which ICSID bases its norms, stipulate in its preamble ICSID objectives, being these: conciliation and arbitration (p. 11).

According to the Cepal Review of 2007 by Jose Antonio Ocampo, Latin America showed by 2007 the same economic stability it had shown in the 1970's. The author states that one of the determinants helping restore the economy has been the external factor of "strong commodity prices"(p.8). From the Cepal Review it can be understood that increments in raw material and commodity prices have improved Latin America's economic situation. But a new wave of governments have proposed a departure from the Washington Consensus, criticizing neoliberal views and the governments of countries that have shared those views (Egana & Micco, 2011).

Other Factors Affecting FDI

Regarding this work it is important to mention variables (control) that explain why Foreign Direct investment (dependent variable) is affected either positively or negatively.

Charles F. Conaway (1999) a petroleum consultant considers two sides, the host country's needs and the operation company's objectives. As the author suggests, the host country needs *financial capital*(p. 64) for its oil industry development. This capital is extremely intensive (huge amounts) and subject to very high risk due to oil exploration and production development(E&D) uncertainties. This capital is also needed for long periods of time because of how long it takes to find and develop oil production. Therefore, this type of

financial capital is normally not available within the host country and foreign investment is required.

Conaway (1999) also mentions that for the investor, several elements are critical for the success of its investment. These can be considered control variables: *Geological Potential, Fiscal Terms and Political Risk*(p.64).Regarding the first control variable he states “the contract area must offer an attractive probability of finding oil or gas in commercial quantities” (p. 65). Following Conaway’s idea, a country can generate more FDI if it is highly prospective, geologically speaking. Ecuador, is a country that found oil in the 1970’s and has proven to be highly prospective, even more so than its neighbors (Colombia and Peru).

Conaway (1999) mentions another important control variable, “fiscal terms”. As he states, since the petroleum industry is a business of much risk, “It’s essential that the company can freely take cash out of the country” (p. 65). From Conaway’s idea, it can be understood that foreign oil companies need to feel that their investing environment is safe, having rules that are clear and that allow them to repatriate their investment gains. This control variable is also important because if there are clearer fiscal terms in other neighboring countries, than it is likely that the oil company will invest in that country and not in the country where fiscal terms are unattractive.

Political Risk (Conaway, 1999) is another control variable that could affect FDI. The company wants to be sure that the host country will respect the terms of its contract over time (p. 65). This control variable is important because it reflects how the host country deals with its contractual commitments. It relates intimately to my independent variable but in the development of this work I will support the notion that the stance towards international

arbitration is the strongest variable controlling FDI. Another author Barry D. Solomon (1989) in his work states that:

The upstream activities of exploration, development, and production receive the majority of investment capital spent by US oil companies in foreign areas. Upstream petroleum operations are risky but potentially very lucrative. Many of the major oil companies have huge upstream operations in foreign areas; investment in oil E&D must be made where the oil reserves are located (p.39).

These ideas presented by Solomon (1989), in my opinion, adequately describe Ecuador's case and the potential capital investment that can be made in its petroleum industry. Solomon explains in his work that high profits resulting from low exploration and production costs generate more FDI (p. 41). The author mentions that "oil prices considered together with finding (exploration) and lifting costs (production), royalties and taxes have often been used by governments as policy instruments" (p.41) From these ideas the control variable that can be identified to affect FDI is the cost of doing business in different host countries. In conclusion FDI will tend to flow, where the cost of doing business is lower.

Concepts

My theory states that FDI has increased when Ecuador's policies have favored international arbitration for its oil contracts, including adherence to Bilateral Investment Treaties (BIT's). Conversely, when the government of Ecuador has made statements or taken actions against international arbitration proceedings, FDI has been significantly reduced.

Before operationalizing the dependent and independent variables, it is important to define concepts used along this research. Different author's perspectives will be helpful to define my personal understanding of these different concepts:

Sovereignty. -Ecuador's stance towards international arbitration is based on the idea that Ecuador has surrendered its sovereignty by accepting jurisdiction of ICSID, an autonomous international institution¹⁰. Janice E. Thomson (1995) states:

For liberal interdependence theorists sovereignty is defined in terms of the state's ability to control actors and activities within and across its borders. For realists the essence of sovereignty is the state's ability to make authoritative decisions- in the final instance, the decision to make war. (p. 213).

This quote expresses that there are different theories in the International Relations field that explain the meaning of sovereignty. As the author states, liberal interdependence theorists for example, consider sovereignty as the ability of the state to control actors' activities either internally or externally, whereas for realists it is the ability to make authoritative decisions (p. 213). It is important to include these different perspectives, since every state has different ideologies and interprets sovereignty differently. For realists sovereignty means something different than it does for liberal interdependence theorists. In my opinion, the same happens in the world of international relations; sovereignty is understood differently by different ideologies, and in practice they govern the behavior and decisions made by different states. For the purpose of this work, Ecuador government stance is one of a restrictive vision towards international arbitration as a means to protect its sovereignty. In my opinion a country acts with sovereignty when it makes independent decisions in the interests of the state, without interference or coercion from external factors and actors¹¹.

Another notion regarding this concept is added by Thomson stating, “ (...) sovereignty is best conceptualized in terms, not of state control, but of state authority (...)” (Thomson,

¹⁰ ICSID definition of the institution.

¹¹ Conclusion made by the author of the term sovereignty.

1995, p. 214). I agree with this author and her view; authority is part of the exercise of making important decisions for the state. The author also mentions how democracy and federalism have changed their notion of sovereignty over time, and their views regarding this concept. It can be understood that sovereignty is pivoting whether it is viewed from the ideological point of view or from the political tendency of each state. Another contribution to the meaning is that of Lapidoth (2001) stating:

A few examples of recent and current definitions and descriptions of sovereignty will show that a great variety of opinions still exist on this matter. Usually, a distinction is made between the internal and external aspect of sovereignty. The former means the highest, original –as opposed to derivative –power within a territorial jurisdiction; this power is not subject to the executive, legislative or judicial jurisdiction of a foreign state or any foreign law other than public international law. The external aspect of sovereignty underlines the independence and equality of states and the fact that they are direct and immediate subjects of international law. (p. 327).

From this perspective, the concept of sovereignty seems to have different meanings and appreciations in the International Relations arena. Furthermore Lapidoth (2001) in her work quotes, Swiss international expert Max Huber and his famous arbitral award saying “(...)Sovereignty in the relations between states signifies independence(...)” (p. 328). This idea is extremely important; my standpoint supports the idea that a country is sovereign when it makes its own decisions independently.

Regarding Thomson (1995), and Lapidoth (2001) different views, my personal definition of sovereignty relies on the concept that states exercise it when they have the capacity to make autonomous decisions in areas such as politics, economics, cultural affairs, and to comply with their rights and obligations under international law.¹² Since it is evident that there is not an absolute definition of the meaning of sovereignty, it should be understood as a concept whose meaning is continuously changing over time and interpreted differently by

¹² Conclusion made by the author, based on the literature of Thomson and Lapidoth.

different ideologies and political tendencies. In summary and as a contribution to this work, I would like to conclude that sovereignty means that the state is capable of making autonomous decisions that will benefit the state whether these decisions regard economic, political, cultural, military or international affairs. Additionally, I conclude that the state should not use the concept of sovereignty to justify disrespect of international law.¹³

Another important concept to define is *International Institutions*. Robert Keohane (1988) a liberal institutionalist, claims in his work, that “Institutions do not merely reflect the preferences and power of the units constituting them; the institutions themselves shape those preferences and that power. Institutions are therefore *constitutive* of actors as well as vice versa” (Keohane, 1988, p. 382). From this idea, it can be understood that institutions are a mechanism states use in order to achieve their goals and interests. In this research one of the international institutions studied is the ICSID, “an autonomous international institution established under the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (the ICSID or the Washington Convention) with over one hundred and forty member States” (ICSID, 2013, par.1). Through this institution is that the resolution of disputes over the interests of both the host country and the investor are obtained. My personal definition qualifies international institutions as an independent instrument of representation of the interests of states regarding specific matters. ICSID specializes in international arbitration over investment disputes. Finally my personal understanding on this concept it that international institutions constitute a mechanism to assist the member states so

¹³ Conclusion made by the Author

they can achieve their different interests; in the case of the ICSID, investment dispute resolution.

Foreign Direct Investment (FDI) is a very important concept in this research. Authors Jones and Wren (2006) define FDI as “the name given to the process where a firm from another country provides capital to an existing or newly created firm in another country” (p.260). From my own perspective Foreign Direct Investment represents the transfer of financial, commercial and technological resources by an international company to a host country to obtain mutual gains. In my opinion FDI also responds to large capital needs and assumes business risks that the host country cannot assume on its own. This is precisely the case of host countries and the oil companies that are willing to assume large capital risks in exploration and production of oil reserves in the host country. Furthermore host countries benefit from the expertise of oil companies, receive their know how, their technology, etc. Because of the large business risks that the investor takes, it seeks protection through clear contractual terms and reliable, independent resolution mechanisms in case of disputes over the contract.

Another concept is *Bilateral Investment Treaties (BIT's)* playing a very important role, as Vincentelli (2010), explains in his work “A BIT is an agreement entered into by two nations with the purpose of stimulating the investment and trade between both nations by offering a framework of protections available to investors” (p. 416). My personal understanding regarding this concept is that BITs help define, through a treaty, a general legal framework to protect the rights and obligations of the parts.

The concept of *International Arbitration* is also one of the most important concepts; Briones and Tagvoryan (2010) state, “For any country wanting to attract foreign investment, firmly established and trusted arbitration mechanisms are a must” (p. 131). In my opinion, foreign direct investors around the world, want to find countries that guarantee contractual terms that are clear and safe to enforce; if this is the case, then more investors will be interested in doing business in those countries.

One last concept, that has been utilized and studied along this research is how the *Petroleum/Oil Industry* plays a fundamental role in the economy of Ecuador. According to the Federal Trade Commission Bureau of Economics (2004):

The petroleum industry is institutionally complex, but can be divided into two basic levels: upstream and downstream. Upstream includes all activities necessary to extract oil from the earth: exploration, geological assessment of potential oil fields, and the drilling and operation of wells to produce a flow of crude oil. Downstream activities include transporting crude oil to refineries; refining crude oil into finished products; transporting finished products from refineries to storage terminals; and marketing by wholesalers and retailers (p.4).

From this quote, it is clear that the petroleum industry is a complex industry and for this reason host countries need the expertise of experienced oil companies; whereas oil companies look for the resources in these host countries. Charles F. Conaway (1999) views that “The petroleum industry, contrary to most peoples’ understanding, did not come about overnight, yet the industry did not take hundreds of years to evolve into what has become today either” (p. xi). I understand the petroleum/oil industry as a capital-intensive industry, which faces very large risks; it also represents very high profits for those that are successful. In the case of Ecuador, the successful development of its oil resources since the 1970’s has meant a dramatic growth on the country’s economy.

Theory

This section discusses the main theoretical argument of this research. However, before explaining this theory, it is important to have an understanding of its meaning. Andersen and Kragh (2010) argue, in their research, the different conceptions of theory, regarding their own perspective and considering definitions by other authors. They define the following:

(...) theory-building is defined as the process through which researchers seek to make sense of the observable world by conceptualizing, categorizing and ordering relationships among observed elements. This theory builds on Astley (1985) and Weick (1989), both of whom also focus on theory-building as a sense making process, where the interplay of observation and multi relational reflection through interpretation and authoring plays a central role for the generation of new theory (...) (p. 50).

In summary then, a theory can be built from the observations made over a specific subject and it can also order relationships among elements for developing new knowledge. In this research the hypothesis is introduced and it is derived from the notion that Ecuador is a country with great oil potential, and that this potential can be seized if the country makes proper decisions to attract FDI for its oil industry. From the research it is clearly understood that oil companies are accustomed to large investment capital risk with the expectation of large capital gains. Since countries like Ecuador, having oil resources potential, do not have large amounts of risk capital or, as I have already explained earlier in this work, can not afford to risk such large investments, therefore both the host country and the oil company should try to find a middle ground for a relationship that can complement each other's objectives. In this regard, even though oil companies are capable and willing to undertake significant geological risk in their search for oil, they expect to enter into investment contracts which are clear and stable and which, in the case of disputes, have an independent and reliable resolution forum.

This is generally an international arbitration center such as the one mentioned earlier in this research, ICSID.

On the basis of these considerations, my theory for this work establishes that FDI comes about as the result of the perception by the investor, of how the host country assures risk reduction for the investment to be made. This includes correlated issues such as clear contracting terms, stable legal framework, and political stability. However, the most significant signal to be processed by the potential investor is the host country stance towards investment dispute resolution. This stance is evidenced by the historical behavior of the host country in previous situations and by the position assumed and statements made by the host country political leaders.

The relationship between Ecuador and the oil companies holds economical benefit prospects for both sides. Since the early 1970's, this relationship has generally subscribed to Bilateral Investment Treaties (BIT's), which have provided a reference legal framework for the contracts entered into. The most important feature, common to BIT's has been a standard provision for International Arbitration settlement of contractual disputes between Ecuador and oil companies. This provision has also been adopted and continues to be adopted by many countries in the world seeking capital risk investment for their oil industry. For example, it is the case of Ecuador's neighbors, Colombia and Peru with whom Ecuador competes directly for new investment capital. If other investment variables are similar, each country's stance and track record towards contract conflicts resolution will make a significant difference on whether an International Oil Company (IOC) decides to invest and, even, on the volume of the investment to be made.

Following this reasoning, this research hypothesis states that: **The more the country opens up to international arbitration proceedings and BIT's, the higher are the level of FDI that can be expected, for its petroleum industry.**

An example that will help support this hypothesis is what has happened in Colombia since 2003. At that time, Colombia's production of oil had declined significantly for lack of continued investment. The Colombian government decided to reform its legislation and fiscal terms, to motivate new FDI. These reforms have generated a renewed interest by international oil companies to invest in Colombia, despite other negative considerations such as the existence of criminal organizations in the areas of oil operations activity. In the last seven years, since these reforms went into effect Colombia has attracted more FDI than ever before and despite its oil potential not being as important as Ecuador's, it now has doubled its 2003 production, and become a very desirable oil investment country. In the case of Ecuador, in 2003 it inaugurated the OCP pipeline giving it the capacity to double its production of oil; however very soon afterwards it entered into a series of conflicts with international oil companies in the country, including the OXY issue, thus scaring investment of companies already operating in the country and naturally those considering coming to Ecuador. The consequence of this is evident; Ecuador's oil production has remained stagnant (Hueper, 1999, para. 34), despite its large oil potential reserves. Oil companies know that their business development requires clear and stable fiscal terms, so no matter what other problems the country has, if this is the case investment will flow into the country, like it has happened in Colombia. On the other hand, no matter how large the oil potential is, if fiscal terms and legislation are unstable, and additionally, the country shows unfavorable stance towards

dispute resolution mechanism (international arbitration) the prospects of new investment are slim.

To confirm the hypothesis in this research data from the Central Bank of Ecuador has been collected, regarding FDI in the petroleum industry.¹⁴ Data shows investment to be significant during the periods of time when the country has maintained a friendly stance towards IOC's, evidenced by a favorable position towards Bilateral Investment Treaties and International Arbitration, giving oil companies a signal that it is safe to invest in Ecuador. Conversely, there is also data showing a negative effect on FDI, when Ecuador has imposed new contract conditions or behaved aggressively against international arbitration proceedings. It is important to understand that, because the host country controls the resources, it has a position of power in the contractual relationship it maintains with the IOC's. Therefore, when the IOC's perceive that the conditions under which their future investment will be treated are not going to be favorable, then they naturally react by protecting themselves, reducing the amount of investment that they had planned to make in the future. Even when a long term contract is renegotiated, by mutual agreement, if the IOC's feel that the new contract terms are the result of subtle pressures from the host country, they will again react reducing their future investments and, in some extreme cases, selling their operation and leaving the country.

Considering the recent past in Ecuador's oil industry, since the year 2000, two periods are evident regarding FDI. Between 2000 and 2005, when Ecuador projected a favorable image to foreign oil companies and as a result major investment projects, like the OCP pipeline* where built exclusively with FDI. Then, a subsequent period, between 2006 and 2011, when aggressive government actions against FDI took place, such as the termination of

¹⁴Data will be analyzed meticulously in the upcoming section of Data and Methods

the OXY (Occidental Exploration and Production) contract and the forced renegotiation of the participation to service contracts occurred. Reporting on one of the frequent changes made to the oil industry rules during this time, Carla Bass (2007), author of the journal in the Magazine Oilgram News, states that “In a surprise announcement late October 4, Correa signed a decree increasing state's take of private oil companies' extraordinary profits to 99% from 50%” (para.2). If someone reads this in the newspaper, it will most likely believe this is an assertive move made by the government, yet the author also includes the opinion of Patrick Esteruelas, a Latin America analyst with the Eurasia Group in Washington. Esteruelas argues in respect of this issue “I think it is an extremely aggressive move that will do very little to encourage private companies to ramp up investment and increase production, leaving Ecuador overly dependent on the inefficient Petroecuador to raise production” (par.7).

During the first period, characterized by a hands-off behavior by the government, FDI grew significantly, while in recent years it has been reduced to very small amounts and several IOC's have left the country. In addition to OXY, the media has informed that companies like PetroBras, Perenco, Burlington, EDC (Noble), have left the country. It has further been reported that some of these companies, Petrobras, Perenco and Burlington have either initiated, or are in the process of requesting, international arbitration for unsettled contractual issues with Ecuador.

One could even think of a third period of time when Ecuador has sent mixed signals to the international oil community regarding future investment. For example the Ministry of Natural and Non Renewable Resources, has launched in November of 2012, an international bid requesting FDI for exploration in the unexplored (high risk) Southeastern Oriente of Ecuador. Simultaneously evidence is found in the local newspapers of Ecuador, through the

negative statements of the Government of Ecuador towards international arbitration institutions and their proceedings.¹⁵

From the research made, these negative statements issued by the Government of Ecuador hold the argument that the country is losing sovereignty or yielding sovereignty, the moment the country adheres to international arbitration institutions and proceedings. This argument, however, loses strength when one can also see reported in the media that Ecuador has agreed to international arbitration proceedings for credit loans contracted with Chinese corporations.

In any case, even these contracts signed with the Chinese are evidence of the need for FDI in Ecuador. Therefore, my hypothesis is strengthened because Ecuador should adopt a consistent behavior, to attract FDI regardless from which country it comes. It seems to me that this should precisely be the attitude of Ecuador to avoid a situation in which we move from supposedly being the colony of one world power (United States) to become the colony of another (China).

In summary, this section seeks to demonstrate the importance of the alternative hypothesis for explaining the effect and correlation of the independent variable (international arbitration) on the dependent variable (Foreign Direct Investment). Also because it is clear that there is a fundamental and strong relationship between international arbitration and FDI, I have discarded the notion of a null hypothesis in this work.

¹⁵Idea from the author, taking reference from the opinions made by authors in the Literature Review.

Data and Methods

This section will present data related to the significance of oil in the Ecuadorian economy, as well as data necessary for measurement of all the variables considered in this work (dependent, independent, and other control variables).

The figures prepared by this author are based upon statistical data obtained from archives requested and obtained from the Central Bank of Ecuador (BCE), which is the official registry of the country's economic data. Each of the graphs utilizes numerical information from the BCE archives.

Significance of Oil in Ecuador's Economy. - This is shown in Figure 1 where oil income is graphed in relationship to GDP growth from the year 2000 through 2011. Oil represented a little over 5% of the country's GDP in year 2000; however by year 2011, oil contribution to GDP exceeded 13.5%.

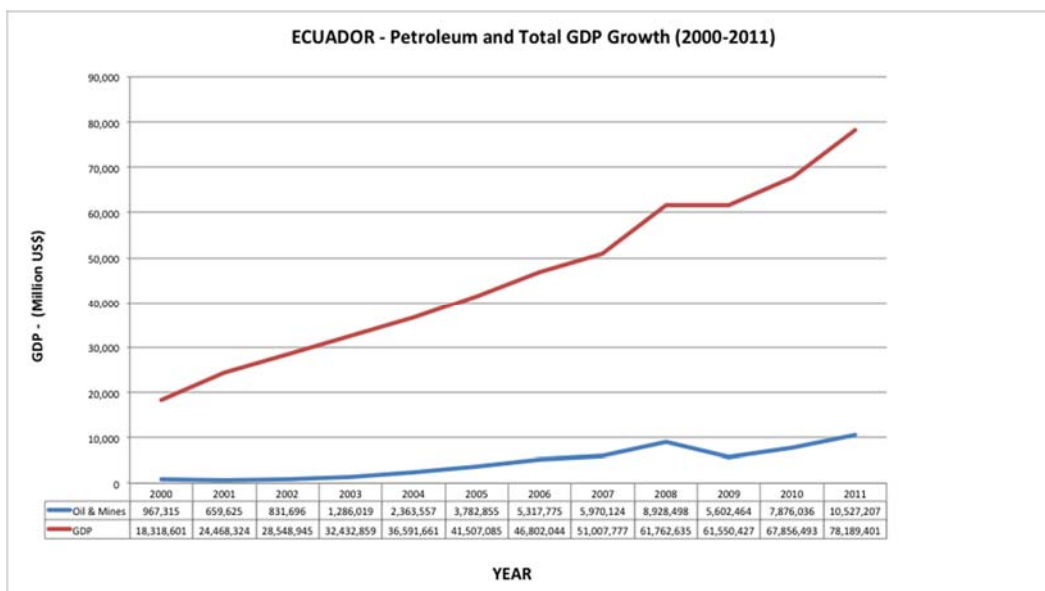


Figure 1: Central Bank of Ecuador- GDP by Industry (Oil and Mines)

To better understand the growing significance of oil in the Ecuadorian economy during this time, the following table has been prepared by the author to illustrate how the impact of oil exports came about. The total volume of exports grew approximately 1.6 times since the year 2000. However, export prices grew much faster, 4 times. Thus, the relative significance of oil in the Ecuadorian GDP was primarily a result of international oil prices increase. Also, one should note that between 2003 and 2004, the volume of exports increased by 1.3 times due to availability of the OCP pipeline, which was built by FDI of the international oil companies operating in Ecuador.

Total Oil Exports And Average FOB Export Prices		
<u>Year</u>	<u>Million Barrels</u>	<u>US\$/Barrel</u>
2000	86.6	25
2001	89.9	19
2002	76.7	22
2003	92.4	26
2004	129.4	32
2005	131.6	43
2006	137.4	53
2007	139.9	60
2008	144.2	81
2009	133.3	52
2010	136.3	71
2011	135.0	96
2012	141.2	98
Source: Central Bank of Ecuador- Hydrocarbons Statistics		

Table 1: Table created by the Author. Source: Central Bank of Ecuador.

Figure 2 complements Figure 1, by showing the relationship between oil income and total fiscal income for the central government of Ecuador. It illustrates the fact that oil has been a very significant portion of the total fiscal income for the last 23 years; for example in year 2011, oil exports income represented more than 48% of total fiscal income.

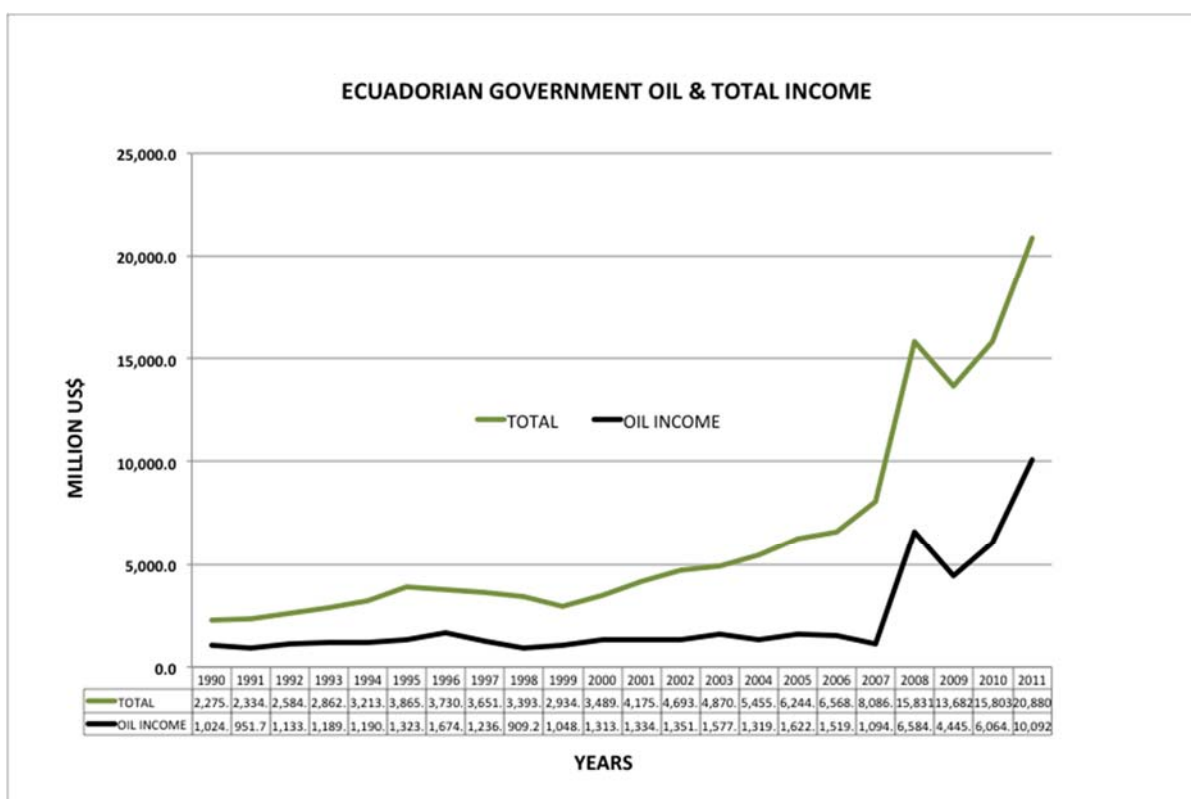


Figure 2: Central Bank of Ecuador : Central Government Operations (1990-2011) (1) Table.

Figures 3 and 4 show Ecuador petroleum exports with relationship to total exports both in absolute terms and as a percentage. Here again, the significance of oil exports income can be appreciated; for example figure 4 shows that, whereas before oil was discovered in the Oriente, it had negligible significance as an export product from Ecuador, by 1972 and 1973 when exports began, oil became the main export product. It represented as much as 73% of

total Ecuadorian exports in 1982 and, on average, it has been more than 50% of the total for the last 40 years.

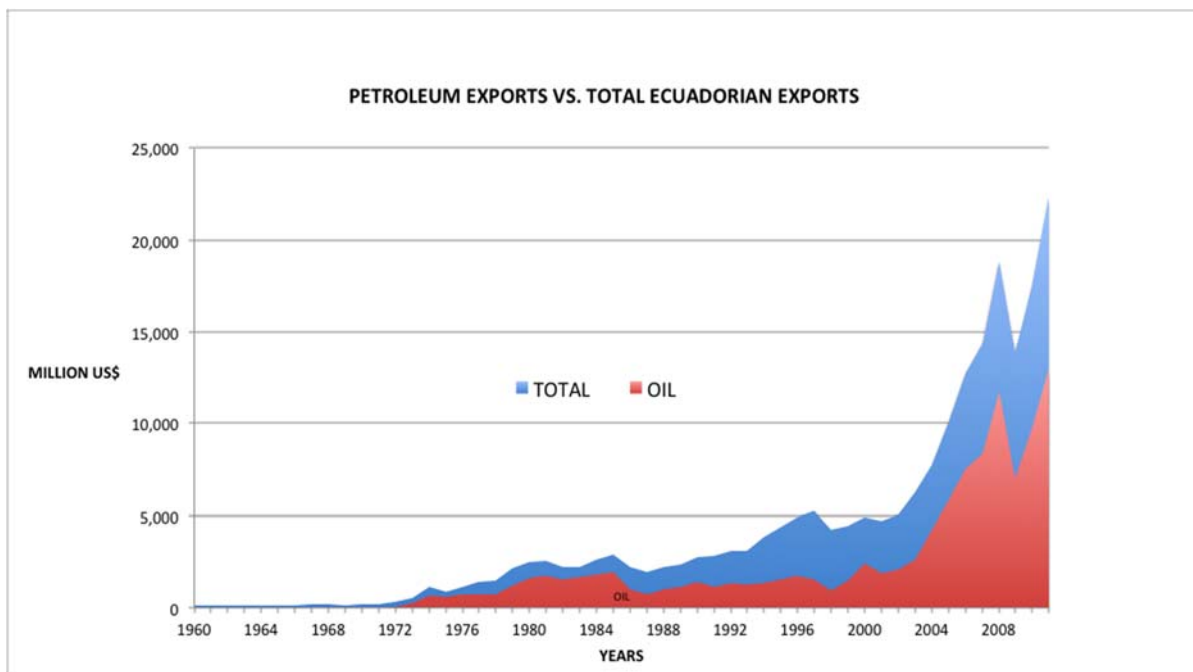


Figure 3: Graph made by the author. Source: Central Bank of Ecuador-Total Ecuadorian and Petroleum Exports.

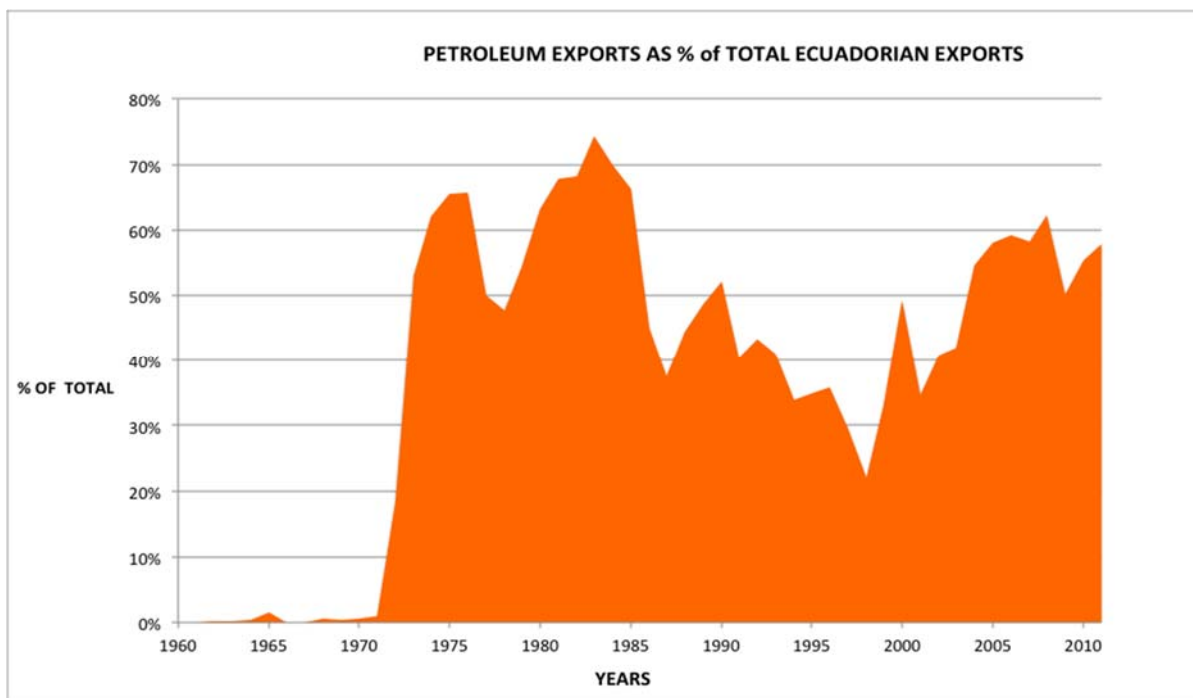


Figure 4: Graph made by the author. Source: Central Bank of Ecuador on oil exports

All of the figures above proof the relevance of oil in the Ecuadorian economy for the last forty years. The development of the oil industry, in turn, has been the consequence of FDI by the international oil companies that came to Ecuador starting in the 1960's and continued to invest through the end of the 20th century. If it were not for risk investments like those made by Texaco Gulf in the 1960's and 1970's, or by Occidental in the 1980's, fields like the Shushufindi and Sacha oil fields, or Eden-Yuturi would not have been discovered and developed. These fields are, to this date, the principal producers of oil in Ecuador.

Measurement of the Dependent Variable (FDI)

Figure 5 shows the relationship between total FDI and oil related FDI in Ecuador. The graph illustrates how in 2002 oil FDI represented almost US\$500 million from a total FDI of less than US\$800 million. It also shows how total FDI follows the trend of oil FDI as can be noted by the significant drop in oil FDI that took place after 2004, reaching negative levels in 2006 and 2007.

The negative values for FDI, during those periods, show that the net result of investment minus amortization of investment or profit taking, was negative; in other words, the total amount of new investment by the oil companies operating in Ecuador was smaller than the volume of profits expatriated during those years).

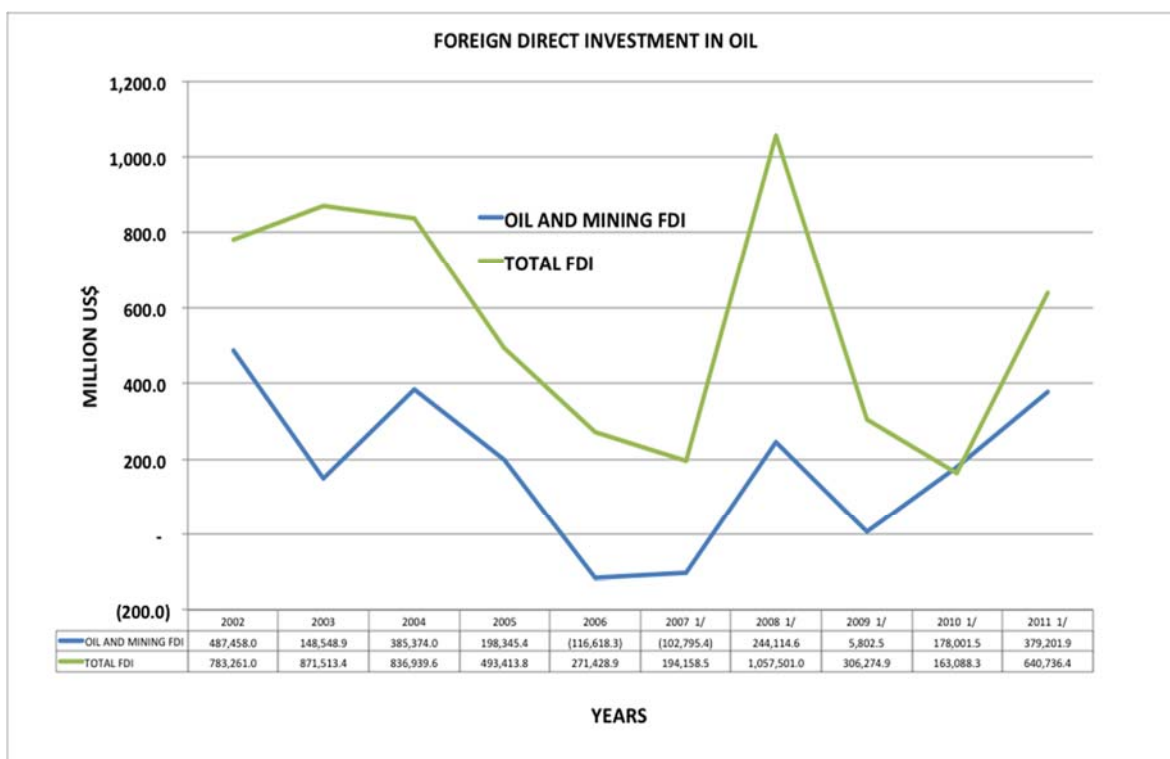


Figure 5: Graph made by the author. Source: Central Bank of Ecuador- Foreign Direct Investment in Oil (by economic activity, table , period 2002-2008).

As it was mentioned in the Theory, Figure 5 supports the observation that FDI can be measured by the volume of investment in US dollars taking place during a particular period of time. For example, it is clear from this figure that significant investment took place between 2002 and 2005, when a favorable climate existed for the oil companies; the data values show an aggregate investment of approximately US\$1,220 million during these years. By contrast, in the 6-year period starting in 2006 and through 2011, the aggregate investment amounted to only US\$ 587 million, that is less than half of the previous 4-year period. This significant decrease can be explained in terms of the aggressive stance Ecuador has taken towards IOC's and international arbitration proceedings since 2006.

Measurement of the Independent Variable

The stance towards international oil companies, as measured by Ecuador's position towards BIT's and international arbitration proceedings, the independent variable, will be measured in terms of the Ecuadorian government's conduct and public statements as indicators. Between 2002 and 2006, Ecuador had a fairly fluent business relationship with international oil companies operating in the country. However, this changed due to the decision taken by the government of Ecuador to expel Occidental Petroleum Corporation (OXY) in May of 2006, accusing the company of an unauthorized transfer of its contracts rights to a Canadian oil company. The resulting litigation under ICSID rules, probably constitutes the single most important case of Ecuador vs. a foreign investor dispute and the beginning of an era of recurrent conflict with international oil companies in general. The following table (see the Appendix A) summarizes how, beginning with the OXY case, since 2006, Ecuador is involved in a series of international arbitration disputes with a number of oil companies.

To measure the independent variable, it is important to note that between 2002 and 2006, there were no significant public statements or actions against BIT's and international arbitration proceedings. During this time FDI, the dependent variable, showed very significant levels, including the major investment made by international oil producing companies in the OCP pipeline. However, starting with the OXY case in 2006 and through 2011, a correlation can be established between the significant statistical decrease in oil FDI and the proliferation of political and government declarations criticizing oil companies, BIT's and international arbitration. This can be measured by recounting representative news accounts and

international news reports commenting on Ecuador's confrontational position towards foreign investment:

Diario La Hora, reports on the news article entitled "Palacio opposes arbitration proceedings with OXY" on September 9, 2006. President Palacio's statements against provisional measures taken by OXY before ICSID regarding Ecuador's decision to terminate its contract. He qualifies these measures as "absurd and not precedent" (para.1)¹⁶.

On January 7, 2007, *Diario La Hora*, reports on the news article entitled "Correa will not recognize arbitration with OXY". President Correa states that the former Attorney General of Ecuador, should have never accepted the arbitration proceedings under ICSID and that his government will not recognize any ruling of this arbitration forum.

On May 10, 2008, *Diario El Universo* under the title: "Correa Distrusts Arbitration by ICSID on the Ecuador-Occidental Dispute"¹⁷, reports the position the government of Ecuador holds in respect of international arbitration and the ICSID. The article describes the lack of confidence that the government of Ecuador feels towards an arbitration court such as this one related to the World Bank (para.2). Furthermore, the article reports President's Correa's argument, that under BIT's in effect, Ecuador has surrendered its sovereignty and calls for a new order in Latin America without international arbitration outside of the region.¹⁸

On July 2 of 2009, *Diario La Hora* reports under the title of "Ecuador terminates arbitration agreement with ICSID". President Correa issued a presidential decree denouncing and thereby terminating the arbitration agreement with ICSID, which had been ratified in 2001

¹⁶ Translated by the Author from Spanish to English

¹⁷ Title of the newspaper article translated by the Author (Spanish-English). Textual Citing

¹⁸ Paraphrased by the Author

by President Gustavo Noboa. Among other reasons mentioned, President Correa argues that ICSID and the World Bank have taken Latin America to a level of prostration, which cannot be tolerated.

Another source from *El Diario* a newspaper of November, 20, 2010 from Manabí, Ecuador, reported on an article statements made by President Correa about international arbitration (2010, para. 3). The news article describes his view favoring the creation of South American arbitration centers to take the place of tradition international arbitration venues (para. 3).¹⁹

On March 11 of 2011, *Diario El Hoy*, under the title “Correa requests UNASUR to speed up the creation of a regional arbitration center”, reports that the President urged UNASUR member countries to leave aside “mental atavisms”, in relation to the belief that investment controversies can only be resolved in arbitration centers in Washington, London or Paris²⁰.

As additional information, more recent news reports evidence that the government’s position against BIT’s and international arbitration holds firm. A news article in *Diario El Universo* on October 2012, entitled: “ Correa terms as a “new abuse” the ICSID Ruling against Ecuador in the OXY Case ” reported on what president Correa said about the award in favor of OXY imposed by the ICSID. He argued that the sanction imposed by ICSID “...is a consequence of yielding sovereignty to international arbitration courts, courts that always favor capitalism, companies, but never favor the State...”(para. 4)²¹. Furthermore, in its context, the article describes the negative statements made by Ecuador, arguing that there is no

¹⁹ Paraphrased by the Author

²⁰ Translated by the Author from Spanish to English

²¹ Translated by the Author (Spanish-English). Textual Citing

“symmetrical application” of the BIT provisions, and that for this reason Ecuador will be applying for the annulment of the arbitration award”(para. 10).

From an international perspective of Ecuador’s stance, Reuters reported on an article entitled “Ecuador-Oxy case to continue in World Bank court” (September,10, 2008), that “(...)Ecuadorean President Rafael Correa, a leftist economist who wants to boost state control over the economy and natural resources, has accused the bank's court of protecting the interests of private companies based in rich nations (...)” (para. 1). It is important to see, from this article how the international community perceives the Ecuador’s stance towards international arbitration.

The government online newspaper *el ciudadano* of February, 21, 2013 reports on article entitled “President Correa defended the Country’s Sovereignty in Accordance to International Law”. This article further discusses the stance of the government towards international arbitration forums. President Correa stated that one of the priorities in his government will be regional integration in response to what international arbitration courts have done to the sovereignty of their countries (para. 11).²²

These and many other position statements made by the Ecuadorian government provide measurement indicators of the independent variable of this work. Taken as a whole, these statements portray Ecuador’s stance towards international arbitration. From the author’s perspective it is only circumstantial that the majority of government statements have occurred during the administration of President Correa. The author has only sought to correlate the dependent and independent variables, without taking political position regarding President Rafael Correa’s strong stance on this matter. However, investors already in Ecuador and

²²Paraphrased and Translated by the Author

potential new investors considering Ecuador are naturally going to be concerned about the prospects of investment disputes resolution in courts which might be heavily influenced by regional political discourse, such as could be the case within UNASUR or ALBA jurisdictions.

Measurement of Other Control Variables

Other control variables, such as geological potential, fiscal terms and political stability, arise from the research done for this work and provide a deeper understanding on the subject of FDI in the oil industry. These control variables are other variables that could affect the dependent variable, FDI. However, as indicated in the last section, I consider the theoretical variable of this work as the most important variable, which has not received sufficient attention in FDI literature. Nevertheless, these control variables provide additional knowledge and are helpful in the understanding of how FDI in the oil industry operates. Also, including other variables in the model will help to decrease the possibility of finding a spurious relationship between Ecuador's stance on BIT's international arbitration and FDI.

As mentioned in the literature review, author Charles Conaway (1999), argues that there are three critical elements considered by the investor in the petroleum industry. These elements are also considered the other control variables in this investigation.

Conaway indicates that Geological Potential, Fiscal Terms and Political Risk (p. 65) could also explain a decrease or increase in FDI. In fact, it should be noted that the investor will always consider these variables at the very beginning of an investment decision process, because if there is no geological prospectivity, attractive fiscal terms and acceptable political stability, the question of whether the investment should be made would not even take place.

In other words, to arrive at the decision point of investing, these three elements should check to the investor's satisfaction first. In this research it is necessary to mention that if these control variables were to be measured, certain indicators should be used.

Geological Potential, is a basic consideration in the petroleum industry by investors. Charles F. Conaway (1999) argues that "Exploration geologists start out with the entire world as a target. They then go through a process of elimination to reduce the area of interest to manageable proportions" (p. 42). Generally speaking, prospectivity could be measured in terms of the probability of finding and producing oil in a region. Nevertheless the existence of the geological structure is not, by itself a guarantee that oil can be found in the structure formations, as in many cases oil has not accumulated in the structure. Different oil regions in the world exhibit different levels of prospectivity, measured in terms of how much oil production potential they have.

Geological potential is a control variable that could explain the increase or decrease in FDI. Additionally if this variable were to be measured it would be operationalized through an indicator. This indicator would be the amount of oil reserves or the oil in place found in a specific region.

Fatih Birol (2006) from the International Energy Agency states in his article "Policy Forum: The Future of Energy Markets" that "The oil and gas resources of the Middle East and North Africa (MENA) will be critical to meeting the world's growing appetite for energy. A large share of the world's remaining reserves lie in that region" (p. 190). As it can be understood, rich oilfields in the Arabian Peninsula in the Middle East and in North Africa hold immense volumes of oil. Therefore, it is important to understand that even though there are many countries that have oil potential and are exporters like Venezuela, Ecuador, Colombia,

there are still many other countries that have great capacity of developing its oil industry due to the oil in place or reserves potential.

Roy L. Nersesian (2010) talks about reserves, and argues, “Oil that is retrievable is called reserves. Reserves of an oil and gas field are not known with certainty until the last well is dry” (p. 207). The amount of reserves of oil could be the indicator of geological potential. Acquiring numbers and data on the amount of reserves through The Ecuadorian Ministry of Non-Renewable Natural Resources would significantly show the importance of geological potential.

This next control variable is another variable that could explain an increase or decrease in FDI. This variable could use as its indicator the “takes”. Johnston (1994) defines the following: “Fiscal comparisons center on government/contractor take. Contractor take is the percentage of profits going to the contractor or oil company. Government take is the remaining share” (p. 48). Therefore, the “take” would be the total percentage of the net income each part receives. This is at the end of the day, what matters to the investor, and what he uses to compare the relative attractiveness of his investment under various fiscal regimes. If for instance, he was to decide between two projects that show similar geological prospectivity, he would choose the one that offers a more attractive “take” or fiscal terms, because he would be receiving a better return for his investment. In Ecuador, since 2010, the Hydrocarbons Law (Article 16, para.2) establishes for the new service contracts, “...a reasonable profit in accordance to the incurred risk...” This is the “take” for the investor, which in all of the service contracts renegotiated with oil companies in Ecuador has had a maximum of 30% return on investment, after tax (Puma Marginal Field Contract).²³ If for instance, for a similar

²³ Contract- Campo Puma Oriente

investment, Colombia offered the possibility of a higher return on investment, then the investor would prefer Colombia on this account. To confirm the effect of this variable (fiscal terms) the “takes” would be the indicator. The model contracts issued by the host country would be the source of this indicator.

This variable does also have a direct impact in FDI. The indicator to measure this variable would be the frequency with which changes take place related to the laws, regulatory framework, contractual terms and tax regulations in Ecuador’s oil industry. Following this idea, Robert Olson (2010) argues in a newspaper article the following:

(...) oil companies (IOCs) are once again in the crosshairs of the Ecuadorian government, which is stepping up state control over the oil sector. Firms that held fast through the last round of brinkmanship which culminated in a new 99 % windfall-profits tax being imposed in 2007, are now being ordered to renegotiate their existing deals to turn them into fee-based services contracts (para.1).

In this regard, it is significant to mention the frequent changes that have taken place to the laws and tax structure governing oil exploration and production contracts. First in April 2006, Law 42 was passed which established that at least 50% of windfall- profits resulting from the increase in international oil prices (with respect to the oil price at the time contracts were signed) should be returned by the oil companies. In October, 2007 this percentage was increased to 99 % and a year later, reduced back to 70%. This was followed by a process of new changes to the Hydrocarbons Law and renegotiation of all participation oil contracts to service type contracts in 2011 (ICSID Case No. ARB/08/5 -Procedural Order No. 1- Burlington Claim against the government of Ecuador- Request for Provisional Measures, 2009, p. 5). Olson (2010) states that “ (...) The law itself specifies that the contractors will

receive a fee that covers the amortisation of investments, operating costs and an additional sum as a rate of return for the contractor (...)” (para.8).

Most companies did not see these changes in the terms as something positive, in fact, constant change in the oil contracts since the year 2006 generated instability, uncertainty and a consequent reduction in FDI, which can be evidenced by examining Figure 5 in this section. If the variable of political risk where to be measured, it would be measured through this indicator of time frequency of changes to contractual terms. Oil companies do not like instability, because they need certainty to plan their investments over the long period of time that it takes an oil exploration and development project to become a revenue making business.

To summarize, my dependent variable (FDI), and my independent variable (Ecuador’s stance towards BIT’s and International Arbitration) have been measured through both statistical and descriptive data. The dependent variable (FDI) was measured through the net investment received by Ecuador from the International Oil Companies (IOC’s). The independent variable was measured in terms of Ecuador government’s public statements rejecting and questioning international arbitration and BIT’s. Additionally, the control variables where investigated, mentioning that if these where to be measured certain indicators would be the mechanism to confirm these variables. Even though my independent variable is the most important explaining FDI, control variables give ample information and provide a greater understanding of this particular subject.

Discussion

Several cases will be discussed in this section. The first one to be analyzed will be the Occidental Petroleum Corporation (OXY)- Ecuador case. This case will explain in detail the origin of Ecuador's current behavior towards international oil companies and international arbitration. Furthermore the situation in Colombia and Peru will be compared and contrasted with the situation in Ecuador in order to evidence my hypothesis. Additionally the actual relation between Ecuador and China will be portrayed in order to describe the ongoing situation in Ecuador, the negative and positive influences of China in Ecuador and the future tie Ecuador has with this country.

Occidental Petroleum Corporation (OXY)- Ecuador

There are several cases regarding investment disputes between IOC's and Ecuador, however the OXY-Ecuador dispute arising from the unilateral termination of the OXY contract, by Ecuador in may, 2006 case is probably the one that best explains the origin of Ecuador's current aggressive behavior towards bilateral investment treaties and international arbitration.

The origins of this dispute can most likely be linked to a previous international dispute: Occidental Petroleum Corporation (OXY) had been providing oil services to Petroecuador, Ecuador's state oil company, through a participation contract, last modified in the year 1999 (p. 2). Susan D. Franck (2005) explains that throughout the existence of this contract "Petroecuador reimbursed OEPC for the VAT that OEPC paid on local acquisitions"(p. 675). However the State stopped reimbursing the oil company for VAT payments. As a result OXY

filed a legal action over Ecuador's non-compliance with the company and claimed back payments for US \$75 million. This lawsuit was presented in the following general terms before the United Nations Commission on International Trade Law (UNCITRAL) Arbitration Court in London, administered under Case No. UN 3467:

OEPC applied regularly to the Servicio de Rentas Internas (SRI) for the reimbursement of Value Added Tax ("VAT") paid by the Company on purchases required for its exploration and exploitation activities under the Contract and the ultimate exportation of the oil produced. Such reimbursement was also made on a regular basis.

Beginning in 2001, however, SRI, based on the opinion that VAT reimbursement was already accounted for in the participation formula under the Contract, issued "Resolutions" denying all further reimbursement applications by OEPC and other companies in the oil sector and requiring the return of the amounts previously reimbursed ("Denying Resolutions").

The arbitration court, finally ruled in favor of the OEPC claim. Following this legal action against Ecuador, increased friction between Ecuador and the oil company became evident. It would come as no surprise then that Ecuador started to meticulously review every single movement and action made by the oil company. Particularly non-compliance issues in the management of the OXY contract. These included OXY conduct related to Farm-out negotiations with Alberta Energy Corporation over the Block 15 contract.

Probably, as a result of this scrutiny, in May 2006, the Government of Ecuador decided that OXY had not complied with the provisions of the applicable regulations for the transfer of contract rights and unilaterally declared the immediate termination of the OXY contract. This action brought about the claim by OXY against the Government of Ecuador on the grounds of expropriation of their investment, in violation of the provisions of the BIT between Ecuador and the USA. ICSID Case No. ARB/06/11 explains in greater detail the events that followed the unilateral termination of the OXY contract by the Republic of Ecuador.;

OXY and Alberta Energy Corporation had entered a letter of intent for a Farm-out of 40% of OXY's interest in the Block 15 contract (ICSID Case No. ARB/06/11, p. 41). This is a very common transaction in the oil industry, whereby one company decides to invite another company or investor to take part in its business. Because oil is a capital intensive and risky business, this could be in consideration of reducing risk or to obtain fresh capital. Such was the case with OXY and the reason for the Farm-out. In the ICSID Case No. ARB/06/11 it is stated that "In order to finance the expansion of its operations in Ecuador, OEPC sought an arrangement that could provide the necessary funds, as well as diversity and reduce its exposure" (p. 41).

The Farm-out proposed that Alberta Energy Corporation would receive 40% of the economic interest of Block 15 (p. 41). The Farm-out triggered controversy since in order to transfer 40% of the economic interest, according to the Hydrocarbons Law (Article 79) the State had to grant prior permission. A meeting during the year 2000 caused more confusion, the award states the following:

As explained later in this award, one of the central issues in this proceeding is whether, during the meeting of 24 October 2000, Minister Terán in fact indicated that government approval (was or was not) required for the transfer of the economic interest to AEC under the Farmout. In this regard, the Tribunal notes that upon closing the Farmout on 31 October 2000, OEPC and AEC entered into a letter agreement mutually waiving satisfaction of any required government approvals for the first stage of the Farmout (ICSID Case No. ARB/06/11, p. 53).

Companies proceeded to carry forward with the Farm-out procedures and this was the beginning of a very long controversy. By the year 2004, the Attorney General of Ecuador concluded that OEPC and AEC had acted against the stipulations of Article 79 of the Hydrocarbons Law (p. 62). As a result, on May 15 2006 (p. 68) the *Caducidad* Decree, or the contract termination decree was issued. In the following days, government officials took over

OXY offices and operations, including documents and later as the award describes, “seizing” all of the wells, drills and equipment (p. 68).

As indicated previously, OXY then filed a lawsuit against Ecuador at the ICSID Arbitration Tribunal. In October 5, 2012 this tribunal issued its final award partially recognizing OXY’s claim in the amount of US 1700 Million Dollars plus accrued interest (Attorney General of the State, 2012, para. 1). Ecuador has responded by requesting annulment of this award, which is currently under ICSID consideration.

This case marks the behavior Ecuador has developed over these years against BIT’s and international arbitration. The ICSID experience fostered a negative sentiment towards the oil company and towards the ad hoc tribunals that were meant to settle investment disputes. This matter is open to discussion since there are many points of view on the arguments of either party. The intention of this work has been to analyze the case only from the perspective that it has been fundamental in determining Ecuador’s conduct and to acquire more knowledge and perspective of this complicated subject. This author takes no stance regarding the merits of the parties argumentations.

From the author’s personal understanding, there are certain actions by the State and by the oil company that could have been managed differently for a constructive outcome. This long term controversy should have already ended, without affecting the prospects of new and urgently needed FDI and driving to satisfactory conclusion other lesser oil investment disputes. Behavior from the State has sent mixed signals to investors and they are thinking twice before investing in a country where there has been evidence of weak and unstable normative rules.

Oil Industry in Colombia

A comparable review is made in this part of the discussion between Ecuador's oil industry and Colombia's oil industry situation, in order to illustrate the importance of my theory.

News information will be helpful in order to understand the different situations between Ecuador and Colombia. According to the Oil and Gas Information System (SIPG) of the Ministry of Mines and Energy of Colombia, oil production in 2005 had dropped to 526.000 barrels per day (Ministry of Energy and Mines of Colombia- SIPG)²⁴. According to the Central Bank of Ecuador, for 2005, average production was approximately 531.000 barrels per day (National Oil Production by Fields CBE-Petroproduccion/ Petroecuador). In the case of Colombia, however, local newspaper *El Espectador* of May 8, 2013, entitled "Petroleum production in March overcomes the one Million Barrels" reported that the Minister of Energy and Mines announced that by March of this year, production had reached 1.013.481 (bpd) from 947.000 (bpd) in 2012 (para.2). According to the National Hydrocarbons and Regulation Agency (ARCH), the production of oil in Ecuador has been 516.928 barrels of oil per day (bpd) as of May 5, 2013.²⁵ These data on oil production raises questions in this author's mind. As it is evident, Colombia's oil production now doubles that of Ecuador.

What has been the cause of such large increase in oil production in Colombia? On October 2, 2000, *The Financial Times* of London, reported by Wilson (2000) states that:

²⁴Refer to this link:

<http://www.sipg.gov.co/Sipg/Inicio/SectorHidrocarburos/EstadisticasdePetroleo/Produccionyconsumo/tabid/70/language/es-CO/Default.aspx>

²⁵ ARCH- National Hydrocarbons and Regulation Agency- Operation Day May, 5, 2013. .

Colombia has struggled over the past decade to attract fresh investment in its oil sector, prompting fears that the country would become a net oil importer by 2003, but it re-awakened interest this year by sweetening contract terms for investors (para. 4).

From this news report, it becomes clear that the one important reason that has promoted Colombia's oil industry towards success, are attractive fiscal and stable contract terms.

As an example of these, the U.S Energy Information Administration (2012) provided additional insight; Colombia has attracted more investors due to its “incentive for rising production” (para. 1).²⁶ Further, Armando Zamora Reyes (2005) from the National Hydrocarbons Agency presented on his work “A new era in the Colombian and gas industry”(pp.1-4), the basics of the Technical Exploration Agreement Contracts or (TEA's). The author explains that TEA's are awarded and are there to offer flexibility and opportunities to the investor (pp.1-4). The National Hydrocarbons and Regulation Agency (ANH) explains in their contracts section that the main focus of a TEA is to identify prospectivity, then the investor is able to proceed to exploratory activities and drillings before signing a contract.²⁷ Another explanation of the importance of TEA's is made by author James Bourne (2012), who states that: “The TEAs will allow successful bidders to study the acreage in depth before committing to a full concession contract” (para. 8). As it can be seen, all the terms revised and acted on by the Colombian government have favored FDI, creating a safe and attractive environment for investors all around the world.

On the other hand, the case of Ecuador has been different. During the same period of time, as has already been stated in this work, the country has been involved in constant

²⁶ Colombia-Background

²⁷ ANH-Colombia

changes to the oil contracts and disputes with oil companies. Author Xavier Andrade Cadena (2007) in his work “Introductory Note To Ecuador’s Notice Under ICSID Article 25(4)”, states that “All of Ecuador’s ICSID cases, with the exception of one, have concerned disputes related to non-renewable natural resources” (p. 5). He further explains the political and economical implications of the BIT’s denunciation:

Ecuador’s Art. 25(4) notice, in conjunction with its BIT denunciation and the fundamental changes in its contractual regime, reflects the government’s unwillingness of facing more ICSID arbitrations. In addition to the legal front, Ecuador is reportedly leading a political campaign, along with Bolivia and Argentina, for the creation of a new regional dispute settlement body to replace ICSID (p. 11).

What author Andrade Cadena explains in this previous quote, reflects the efforts some South American countries made back in 2007 by proposing the creation of a regional court or body replacing ICSID. Still, as of early 2013, efforts are still underway for the creation, under the Union of South American Nations (UNASUR) of a new regional court for leading arbitration proceedings. This matter is reported in newspaper *El Comercio* (2013) under the headline “Common Front from ALBA against international litigation”. Additionally this news article mentions what vice president Jorge Glass thought of the renegotiation of contracts. He said, “ Before, from 100 barrels 80 or even 85 were destined to the oil company and 20 to the Ecuadorian people. The renegotiation of contracts changed the participation contracts to service type fee contracts and this benefitted the country”.²⁸ This argument, however, needs to be placed in proper context; before renegotiation of the contracts, the oil company indeed received the higher production percentage, but it was responsible for all price risk, investment and operational costs, such that in terms of net economic benefits the government received more than the oil company.

²⁸Translated by the Author- Textual citation from spanish to english.

Changes in arbitration proceedings in Ecuador started to generate certain insecurities in investors. To support this idea, Andrade Cadena (2007) adds:

Foreign investment in Ecuador remains concentrated in the oil sector. The United States has been the major source of FDI in Ecuador. It remains to be seen whether the foreign investors, most of whom are from countries that have signed BITs with Ecuador, will waive their rights to ICSID and/or international arbitration in order to continue to operate in Ecuador. If they are unable to reach an agreement with the government, there is the risk that FDI may decrease or go elsewhere (2007, p. 12).

These changes in laws and proceedings have altered the investor's trust and caused them to move to other countries with friendlier contract terms, which has resulted in less investment in Ecuador. In comparison with Colombia, where there are clear safe terms, investors feel motivated and taken in consideration.

Peru

Another country neighboring Ecuador is worth mentioning. FDI in this country has also grown in recent years on the basis of safer terms regarding investment models. Perupetro a state oil company, sets a different scenario. In what corresponds to contract terms, Peru offers flexible work programs, international arbitration, entering into association with third parties, and free repatriation of funds from Peru (Perupetro, pp.4-5).²⁹ The contracts can be done by direct contract and by bidding rounds (p. 5). Peru is also a country where besides oil, the gas industry has had an important development. To evidence this argument, the International Financial Law Review (2012), states that Peru has developed a natural gas industry and has applied in their Hydrocarbons Law, safe terms eliminating restrictions so that investors can come to Peru (para. 3-4).³⁰

²⁹ Perupetro

³⁰Business opportunities in Peru's oil and gas industry (2012)

Personally, all of these facts lead me to believe that Ecuador is taking one step backwards by questioning international arbitration proceedings and BIT's. Peru and Colombia are developing new ways of attracting investors, and through bid rounds and proper contracting they are reaching higher levels of oil finding and production. These countries are enjoying higher levels of economic growth, giving fair and equitable treatment to oil companies and are not trapped in negative discourses towards international arbitration. In Colombia international arbitration is an accepted practice; in fact, institutional arbitration is the leading arbitration in Colombia, however the country takes part in international arbitration forums such as the ICSID (An Overview Of Arbitration In Colombia For U.S Companies, 2011, p. 5). It is evident that countries neighboring Ecuador are taking common steps to further FDI in their oil and gas industry. This should be the case of Ecuador who has all the elements for a robust growth of its oil industry but lacks a friendlier approach towards FDI, which is essential.

The Presence of China in Ecuador

“Given that China has a seemingly bottomless appetite for goods and services needed to fuel its growth, analysts examine the extent to which LAC can supply this rising demand” (Gallagher and Porzecanski, 2008, p. 187).³¹ Nirav Patel a Fellow at the Center for American Security (2009) argues in a similar way stating “Meanwhile, China has leveraged its economic strength for strategic gains by offering cash loans to fiscally weak, resource-rich countries for access to their resources” (p. 8). The authors discuss the way they perceive the great power of China. Even Reuters, the world's largest international news agency, provides articles with this

³¹ LAC (Latin American Countries)

vision. Such is the article from Eduardo Garcia and Brian Ellsworth entitled “Ecuador's Correa in re-election triumph, eyes investment for growth”³² (2013), where the presence of China in Ecuador is described. Rafael Correa won once again the elections of 2013, reassuring new policies that reject the ones from Washington, while embracing those from countries that the authors describe as “state driven economies” (para. 6). Through time Ecuador has demonstrated that it has new visions with other countries, visions that do not include the U.S as it used to.

The economic relationship that Ecuador shares now with China shows that the oil industry is taking a different direction.

Still, the continued success of Latin American socialism will depend on strong commodity prices that underpin generous social spending, and Correa needs to both improve Ecuador's stagnant oil production and spur a nascent mining industry (Garcia and Ellsworth, 2013, para.7).

In relation with this quote it is important to acknowledge that oil is a finite resource and the economic decisions that need to be made should lead to the assurance of production of this special commodity. Even though there is a constant economic exercise with China, Ecuador must not forget to make sense in their future decisions regarding oil. However, an article in the Chemical Engineer (2009) entitled “China to loan Ecuador \$1b for oil ” reports on what has been the situation since the year 2009. “China has agreed to loan Ecuador \$1b in cash in exchange for future supplies of oil “ (para.1). The money received by China has been destined for infrastructure and roads (para.1). Although China has provided strategic economic aid for the development of Ecuador’s economy, Ecuadorian oil is mortgaged to China until 2019. This means that not all 100 % of the oil is destined to the Ecuadorian state. To evidence this argument, newspaper *El Comercio* (2013), in a report entitled “ ‘Ecuador will give China

³² Title translated by the Author

460 million Barrels until 2019' ” by Alberto Araujo, explains the plan Ecuador has along with China. Fernando Villavicencio a legislative consultant in oil issues answers to an interview in this article. He recently wrote the book “Made in China”, and is currently involved in writing oil subjects. The author of the book also mentioned his writings started, when “ the administration of Rafael Correa decided to change the imperialistic and neoliberal nights for the alliance with China, Iran and Venezuela “. ³³ The article generates interesting debate about the participation of China in Ecuador since so much has changed since 2006. According to Fernando Villavicencio, anticipated oil has been given to China, with 460 million barrels committed to Petrochina until 2019. In this case, there is a direct contract negotiation with Petrochina, and the regular open bid procedure is not applied. Another newspaper article by Alberto Araujo was written in 2012. The newspaper article entitled “ 80% of national oil in China’s hands in 2012”, states that without a bidding procedure, 8 out of 10 oil barrels produced have gone directly to Chinese oil companies. Long-term contracts with China have consisted of anticipated oil exports in exchange for loans with disbursements of at least 1,000 million, plus interest rates between 6 % and 7,25% payable by Ecuador (para. 4). Additionally the article mentions that the loans so far provided by China have generated a debt of US\$ 4,000 million from three contracts (para.5). Because this large loans are guaranteed with oil production, Ecuador is compromising a large portion of its oil production or repayment of the loans.

³³Translated by the Author- Textual citation from Spanish to English.

Conclusions

The petroleum industry has been the most significant contributor to Ecuador's economic growth. The discovery and development of this high-demand, non-renewable resource has transformed the economy of Ecuador since the 1970's. Since then, oil is the single largest revenue export item and the principal non-tax source of fiscal income as has been shown in this work.

Foreign Direct Investment in the petroleum industry was fundamental and directly responsible for establishing oil reserves and production in the Oriente of Ecuador in the 1970's and continues to be essential to Ecuador's oil industry sustainment and development. This is supported by the fact that the Government of Ecuador is, at this time, actively promoting new risk investment in the South Oriente areas through the XI International Exploratory Bid Round conducted by the Secretariat of Hydrocarbons of the Ministry of Natural and Non-Renewable Resources.

Investment by international oil companies has also made up the largest portion of overall FDI in Ecuador and has occurred at very critical times for its oil industry development. For example, FDI by oil companies operating in Ecuador financed the OCP pipeline construction in 2003. Ecuador was then able to evacuate and export repressed oil production, which, was also the product of new FDI in exploration and development during the 1980's. This new production could not otherwise have been exported but thanks to the availability of the OCP Ecuador was able to obtain substantial new export revenues. Perhaps the most significant new development during the 1980's came as a result of OXY's investment to develop oil production in various fields in Block 15 which, presently, are major producers of oil and large sources of revenue for Ecuador.

Because of the large amounts of capital investment required, the long time needed to find and develop oil production and the high-risk nature of the oil industry, FDI is preferable over the use of fiscal savings, or fiscal debt. IOC's are used to and prepared to risk their investments in exploration and production of oil. They also have the know-how and specific technology is required. On the other hand, the country can utilize its own resources or savings for non-risk, high priority investments, such as health, education, or to build infrastructure, such as roads and public housing. Promoting FDI in the oil industry is essential and a smart decision because host countries can avoid large capital risks.

In an effort to optimize investment and reduce the risks associated with FDI, foreign investors and host countries around the world make an effort to enter into stable long term, legal agreements. These must clearly establish responsibilities for contract execution, investment amounts and schedules, terms of participation in the benefits and include all the appropriate provisions necessary to comply with their mutual contractual obligations according to the international oil industry practices. Among these legal considerations, typically derived from bilateral investment treaties, are adequate mechanisms for contractual disputes resolution.

The hypothesis of this work has been confirmed by establishing a relationship between FDI (dependent variable) to the stance that Ecuador has taken towards investment by international oil companies, international arbitration proceedings and BIT's (independent variable). During the times when Ecuador has had an open or favorable stance towards FDI the flow of capital resources to its oil industry has been much greater, as was the case during the period 2000-2005. Conversely, a significant decrease in foreign direct investment has related during periods when Ecuador's decisions regarding oil contracts have led to high

profile disputes with international oil companies, as was the case in may, 2006, when Ecuador took the unilateral decision to cancel the contract and expel OXY from the country.

Therefore, episodes like OXY's, along with the stance the government of Ecuador takes regarding international investment, such as the termination of several long standing Bilateral Investment Treaties that Ecuador had signed with many developed nations like the United States, Germany, France or the United Kingdom, as well as the negative criticism expressed by the President of Ecuador and other high government authorities, towards international arbitration proceedings at forums like the World Bank's ICSID, play a determinant role on FDI.

For the risk investors like the IOC's, host country independent and reliable mechanisms for investment disputes resolution are essential. They consider these mechanisms an essential component of rule of law, which provides both the host country and the international oil companies, the opportunity to settle contractual controversies in compliance with international law.

International arbitration proceedings and BIT's are designed to mitigate the legal contingencies of what is a risky business by its own nature. They not only protect the rights and obligations of both parties under the contract, but also serve to strengthen the partnership nature of their relationship to grow the oil production business. In the case of a controversy, IOC's seek international arbitration forums like ICSID or UNCITRAL as reliable venues for contractual disputes resolution.

All the knowledge acquired from this research work has helped support the proposed hypothesis stating that the more open stance a host country takes towards international arbitration, the larger the volume of FDI it can expect. Investors, like IOC's, are used to and,

thus, not afraid of the oil industry technical risks such as geological, drilling and operational risks; but they assign utmost importance to contractual issues and to internationally recognized mechanisms that will minimize problems derived from the contract execution.

FDI comes as a natural consequence if a host country has an open stance towards international investment, expressed through acceptance of international arbitration proceedings and BITS's. In order to illustrate this, in this research, the current situation of Ecuador's petroleum industry has been compared to the current situation in the neighboring countries of Colombia and Peru. Even though their geological potential is not as interesting as Ecuador's, their attractive investment policies and conflict resolution provisions have generated a positive image, which is attracting more IOC's to invest in oil exploration and production in these countries. Colombia, for instance, has a booming oil industry and now produces more than 1,000,000 barrels of oil per day when in 2005 its production was around 530,000 barrels per day. Ecuador, on the other hand has not been able to raise oil production from a similar level in 2005; in fact its production has actually declined, around 5% since that year to a current level of 517,000 barrels per day.

Ecuador should take advantage of the fact that its territory has high geological potential for hydrocarbons, much higher than other countries in South America, including Colombia and Peru. It should also recognize that oil presently sells at its highest international price because of increasing demand worldwide. The country leaders should, therefore, adopt a stance that is smart to attract increased volumes of FDI to develop these resources. The current levels of FDI in its oil industry are very small and inadequate. However, this coincides with Ecuador's involvement in a number of high profile legal disputes with major IOC's, like are the cases with OXY and Chevron. More importantly, this marginal level of FDI is a direct

reaction by investors to the government taking a very hostile stance towards BIT's and international arbitration forums related to these disputes. International perception of this stance does not favor Ecuador's prospects for new FDI.

Ecuador leaders should also recognize that the country is not alone in seeking FDI, it must compete with many other countries for risk investment by IOC's to sustain and further develop its oil industry potential. This author concludes that, while our competitors for FDI make very aggressive efforts to create a favorable host country image to promote FDI, it is unfortunate that Ecuador leaders have preferred to assign more weight to inconsistent populist rhetoric based upon abstract concepts like "sovereignty", "imperialism", or "neo-colonialism". These declarations, made by country leaders, hinder practical business decisions, are not understood by the international investment community and, at least, project a very confusing and negative signal to prospective international investors.

It is important to refer to the relationship between Ecuador and China whereby Ecuador receives large loans from China. These loans have an associated interest payment and are secured against oil production. This is different from FDI since the country assumes all the risks related to repayment of the loan. When the country receives FDI, it is the company that assumes all the investment risks and the host country does not have to be concerned with interest payments or securing the loan. In the case of these loans, China is in reality securing for itself the availability of oil resources at a discount because of the interest it charges.

From this research it is important to highlight, once again, that the stance Ecuador is taking towards international arbitration proceedings and BIT's has a determinant effect in the levels of expected FDI for its oil industry. The stance of the government of Ecuador towards

international arbitration proceedings and BITS's, has been shown to be the most important variable driving FDI.

During the measurement of the dependent variable information from the Central Bank of Ecuador was used. For the dependent variable the measurement was in terms of the net investment received by Ecuador from the International Oil Companies (IOC's). For the independent variable, measurement was in terms of Ecuador government's news statements rejecting and questioning international arbitration and BIT's. The control variables were important to confirm the hypothesis giving strength and a broader knowledge in this research of the other variables that cause a decrease or an increase in FDI. Additionally, the proposed measurement of the control variables and its indicators show the complexity of this subject, giving the future researcher a tool in knowing and exploring these other variables. Finally, one of the limitations this research had was the fact that the Central Bank of Ecuador and the Ministry of Natural, Non-Renewable Resources, could not provide statistical data on petroleum investments before the year 2000. FDI data was only available from the year 2000 onwards.

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Los casos que se ventilan en las cortes

Demandas arbitrales Internacionales que enfrenta el Estado

Compañía	Inicio del arbitraje	Monto (USD Millones)
Occidental (Oxy)	17 may. 2006	3370
Chevron II	21 dic. 2006	96
Burlington	21 abr. 2008	No definido
Perenco	30 abr. 2008	440*
Global Net	10 jun. 2009	32,5
Chevron III	23 sep. 2009	No definido
Tellus - Perú	31 ene. 2010	1,4
RSM Production	3 may. 2010	No definido
Copper Mesa	21 ene. 2011	69,7
Zamora Gold	11 jul. 2011	No definido
Murphy III	30 sep. 2011	No definido
Merck Sharp & Dohme	29 nov. 2011	No definido
Sinohydro	15 dic. 2012	No definido

Demandas entabladas por el Estado a nivel Internacional

Estado o demandado	Inicio del arbitraje	Monto (USD Millones)
Estado de Colombia	28 mar. 2008	No definido
William y Roberto Isafas Dassum	29 abr. 2009	No definido
Empresa China Zhe Jiang Hong Lin Shipping Project	13 jun. 2012	5
Terminales Internacionales de Ecuador	13 sep. 2012	No definido
Ayuntamiento de Madrid	14 feb. 2013	No definido

* Monto preliminar sujeto a ampliación

Fuente: Procuraduría / EL COMERCIO

