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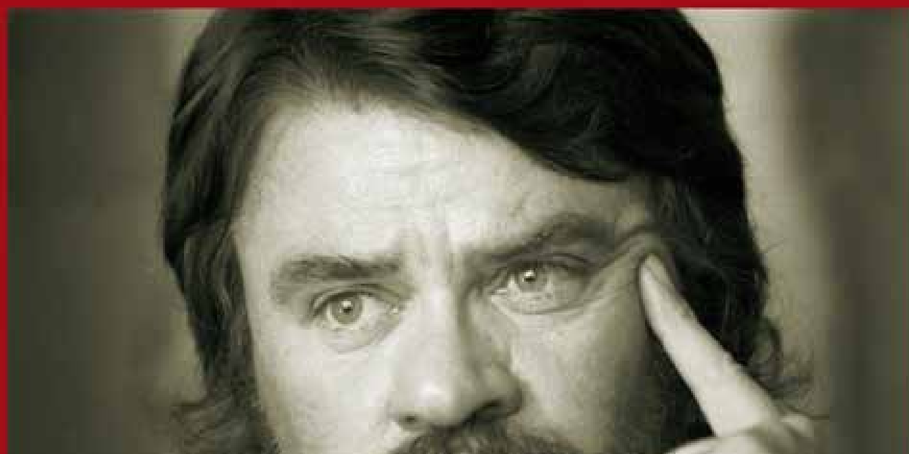

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PERU'S FOREIGN INVESTMENT FRAMEWORK PUT TO THE TEST: A REVIEW OF THE JURISDICTIONAL AWARD IN DUKE ENERGY INTERNATIONAL PERU INVESTMENTS Nº 1 LTD. VS. THE REPUBLIC OF PERU

*Arif Hyder Ali**
*Baiju S. Vasani***

As we put «pen to paper» —or perhaps better said in our digital world, «fingers to keyboard»— to honour our friend and mentor, it is with a deep sense of gratitude, wonderment and inspiration. Gratitude for all that he has taught us through his example; wonderment for the beauty and elegance of his intellect; and inspiration to follow in the footsteps of a man whose life has been devoted to the betterment of society and the rule of law.

We first met Fernando de Trazegnies in the context of our law firm's representation of Duke Energy International in its dispute against the Government of Peru, which is currently pending before a distinguished Arbitral Tribunal at the International Centre for the Settlement of Investment Disputes («ICSID»). We were seeking the guidance of a legal expert in order to educate the arbitrators about the legal framework for foreign investment in Peru, as well as the scope and effect of the *doctrina de los actos propios* and the principle of good faith under Peruvian law. The legal opinions presented by Fernando de Trazegnies on these subjects were key to our victory in the jurisdictional phase of the arbitration, and they were, in their substance and presentation, the reflection of what can only be described as «a beautiful mind».

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Given the context in which we first became collaborators and friends with Fernando, it struck us as appropriate that we should discuss the very areas of teaching that we received from him during the course of our work in *Duke Energy International Peru Investments 1 Ltd. v. The Republic of Peru*, ICSID Case Nª ARB/03/28[1]. The Tribunal's jurisdictional ruling in this arbitration constitutes the first international test case of Peru's legal stability system. That ruling also serves as important guidance as to the scope and effect of Peru's foreign investment framework. Fernando de Trazegnies' legal opinions would appear to have been central to the Tribunal's jurisdictional determination.

1. Peru's Foreign Investment Framework

Between 1988 and 1990, Peru suffered the worst economic crisis in its history. In the early 1990s, the new Government of Peru, under President Alberto Fujimori, embraced a market economy and implemented a far-reaching (but not always popular) economic reform package. With the encouragement of multilateral financial institutions, the Government undertook to open up the Peruvian economy, attract foreign investment, and create investor confidence regarding the country's commitment to economic and regulatory stability and the rule of law. All areas of the Peruvian economy were opened up to foreign investment, with particular emphasis on the privatization of State-owned entities[2].

In order to resuscitate the country's failing economy, the Peruvian Government also recognized the critical need to implement a new set of laws, complementary to its privatization program. Congress mandated the restructuring of the nation's economy and the growth of private investment pursuant to Law 25327. Under this law, the Government implemented a series of legal and regulatory measures characterized by far-reaching protections intended to provide foreign and national investors with a predictable and stable legal and business environment. The hallmarks of the new Peruvian investment framework were strong protections for individual property rights, broad non-discrimination protections, tax stability and the elimination of administrative «red tape».

The Political Constitution of the Republic of Peru («Peruvian Constitution») itself was amended in 1993 to reflect, in its terms, the country's newfound

[1] Duke Energy International Investments 1, Ltd. v. Republic of Peru, ICSID Case No. ARB/03/28, Decision on Jurisdiction, February 2006 [hereinafter «Duke v. Peru"], available at www.investmentclaims.com.

[2] UNCTAD (2000).

philosophy of economic liberalism, private sector initiative, capital importation and legal stability. For example, Article 58 of the Constitution states:

> Private initiative is free. It is exercised in a social market economy. Under this system, the State guides the country's development and acts primarily to promote employment, public health, education, security, public services, and the infrastructure[3].

In particular, with an eye towards promoting foreign investment, Article 63 of the Constitution was amended to read:

> Domestic and foreign investments are subject to the same conditions. The production of goods and services and foreign trade are free[4].

Included within the Government's reform package were, *inter alia*[5]: Legislative Decree 662 —*Ley de Fomento de la Inversión Extranjera* («Foreign Investment Law»)[6]; Legislative Decree 757— *Ley Marco para el Crecimiento de la Inversión Privada* («Private Investment Law»)[7]; and Supreme Decree 162-92 EF («Private Investment Regulations»).[8]

1.1 The Foreign Investment Law

The Foreign Investment Law, promulgated on August 29, 1991, was introduced with the objective of serving as «the cornerstone of a sound legal framework, that establishes clear rules and … security for the development of foreign investment in the country»[9].

The principal purpose behind this law is best summarized in its Preamble, which declares: «the Government's objective is to remove obstacles and restrictions to foreign investment in order to guarantee equal rights and obligations to

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[3] Peruvian Constitution, Article 58.

[4] Peruvian Constitution, Article 63.

[5] Other laws included in the liberalization package included Legislative Decree 708-Ley de Promoción de las Inversiones en el Sector Minero («Law of Promotion of Investments in the Mining Sector"); Legislative Decree 693-Ley de Promoción de las Inversiones en el Sector Eléctrico («Law of Promotion of Investments in the Electric Sector»); Legislative Decree 655-Ley de Promoción de las Inversiones en Hidrocarburos («Law of Promotion of Investments in Hydrocarbons"). The Law of Promotion of Investments in the Mining Sector entered into effect in November 1991, the Law of Promotion of Investments in the Electric Sector in December 1991, and the Law of Promotion of Investments in Hydrocarbons in November 1993.

[6] The Foreign Investment Law entered into effect in October 1991.

[7] The Private Investment Law entered into effect in December 1991.

[8] The Private Investment Regulations entered into effect in October 1992.

[9] PROINVERSION (2003).

foreign and domestic investors»[10]. The Preamble also sets forth the Government's recognition of the need to «provide legal stability to foreign investors by recognizing guarantees to assure them of the continuity of the existing rules»[11]. By virtue of the promulgation of the Foreign Investment Law, «*all laws* limiting or restricting *in any manner* foreign investments *in any economic activity*» were revoked as of the law's effective date[12].

Article 1 of the Foreign Investment Law describes the range of investments that are subject to protection, specifying that the State's guarantees attach to «foreign investments now or hereafter made in the country in all *economic activities* and under any corporate or contractual organizations permitted under national laws»[13]. Foreign investment protections are granted only to «investments coming from abroad made in any *income-producing activities*»[14].

The various «modalities» through which foreign investment can be made include capital contributions to a new or existing company established in Peru, or to acquire machinery, equipment or similar goods; investments in «national currency from resources authorized to be remitted abroad;» «the conversion of foreign private obligations into shares;» reinvestments; investments in goods physically located within Peru; technology transferred to Peru and investments or other contributions to intellectual property; investments to acquire publicly traded stock or other commercial paper; joint ventures and teaming arrangements; and «[a]ny other foreign investment modality contributing to the country's development»[15].

1.2 The Private Investment Law

The Private Investment Law reinforced the Government's newfound economic liberalism by ensuring freedom for private initiative and establishing that the Peruvian economy should be based on free competition and guaranteeing access for private investment to all sectors. The Government's economic reform objectives were reflected in the Preamble to the Private Investment Law:

> [...] it is advisable to enact a Framework Law to stipulate the required provisions seeking to foster the growth of private investment in all sectors of the economy

[10] Foreign Investment Law, Preamble.

[11] Foreign Investment Law, Preamble.

[12] Foreign Investment Law, Article 31.

[13] Foreign Investment Law, Preamble to Article 1 (emphasis added). See also Private Investment Regulations, Article 1.

[14] Id. (emphasis added).

[15] Id.

> […] it is imperative to eliminate all legal and administrative obstacles and distortions hampering the smooth development of all economic activities and restraining free private initiative, reducing the competitiveness of private companies which are a key element to a successful insertion into the international market […][16].

The Private Investment Law replaced the existing, highly restrictive economic structure in Peru in the early-1990s with a free-market structure designed to attract foreign and domestic direct investment. Like the Foreign Investment Law, this law guarantees rights and protections to all investors, both domestic and foreign, in the broadest of terms:

> The purpose of this Law is to guarantee free initiative and private investment, now or hereafter made, in all economic activities and under any business or contract form as authorized by the Constitution and the laws.
>
> This Law creates rights, guarantees and obligations applicable to all domestic or foreign individuals or legal entities investing in the country. This Law shall be binding upon all Central, Regional or Local Government entities, across all tiers[17].

Furthermore, the Government's far-reaching guarantees of stability for private investments, whether domestic or foreign, are self-evident in the various Titles of the Private Investment Law: «Legal Stability of the Economic Regime» (Title II)[18]; «Tax Stability for Investments» (Title III); «Administrative Stability for Investments» (Title IV); «Legal Stability for Investments» (Title V)[19]; and «Legal Stability for Environmental Protection» (Title VI). The Private Investment Law also gave effect to systemic administrative reforms, resulting in the elimination of significant amounts of bureaucratic «red tape» that previously had stunted the growth of private investment in the country[20]. Chapter II of Title IV, entitled «Removal of All Administrative Restrictions on Investments», serves as the best evidence of these dramatic reforms, and as a precise summary of the Government's objective of de-bureaucratization and deregulation.

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[16] Private Investment Law, Preamble.

[17] Private Investment Law, Article 1.

[18] In particular, see Private Investment Law, Article 3 («Free private initiative is understood to be the right that all individuals or legal entities have to engage in any economic activity they may elect, including the production or trade of goods and the supply of services, in accordance with the provisions set forth in the Constitution, the international treaties subscribed by Peru, and the Laws.").

[19] Title V, discussed below in more detail in the context of Legal Stability Agreements, complements the Foreign Investment Law by setting forth provisions governing legal stability agreements.

[20] Private Investment Regulations, Title IV.

In light of the complete overhaul of the existing administrative structure governing private investment in Peru, the Private Investment Law sought to and, in many respects, achieved the most favourable regulatory environment for private investment in Peru's modern economic history.

1.3 The Private Investment Regulations

Anchoring the legal framework designed by the Government to promote foreign investment were the Private Investment Regulations, which, by their own terms, are «required to guarantee the observance of the social market economy, free initiative and private investment, as well as those referred to the execution of Legal Stability Agreements»[21].

Further evidence of the Government's recognition that it was imperative to attract and protect foreign investment is reflected in the Regulations, which state:

> […] all discrimination against foreign investors included in domestic legislation is repealed as from the date on which [the Foreign Investment Law] became effective, except for those established for national security reasons. Therefore, *foreign investors will have full access to every economic activity carried out within the country, privatization processes included.*
>
> Similarly, all discrimination against foreign investors included in Article 1 of Legislative Decree 730 is repealed as from the date on which [the Private Investment Law] became effective. Therefore, the *treatment to be applied to foreign investors will be the same as the one applied to nationals*[22].

In addition to the abolition of discrimination against foreign investors previously provided for by Peruvian law, the Private Investment Regulations repealed several other laws that had the same discriminatory effect[23].

However, the right to non-discrimination is only one of several investor rights memorialized in the Private Investment Regulations. Specifically, Rule I of the Preliminary Title to the Private Investment Regulations sets forth numerous other protections guaranteed by the Peruvian State to all domestic and foreign investors and the companies in which they invest. This comprehensive «Bill of Investor Rights» includes the following protections: (i) the «[r]ight to private property;» (ii) the «right to engage in the economic activity of their preference;» (iii) the right to freely work or engage in business; (iv) the rights to foreign and domestic trade; (v) the right to freely allocate profits and dividends; (vi) the right

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[21] Private Investment Regulations, Preamble.

[22] Private Investment Regulations, First Supplementary Provision (emphasis added).

[23] Private Investment Regulations, Second Supplementary Provisions.

to receive the full amount of profits and dividends; (vii) the «right to acquire stocks, interest shares, or similar rights;» and (viii) the right to the most favourable exchange rate[24].

In addition, the Private Investment Regulations also set forth the various conditions investors must fulfil in order to avail of the benefits provided by legal stability agreements («LSAs»)[25]; the scope of the protections guaranteed to investors with regard to legal stability and tax stability[26]; the juridical nature of LSAs[27]; and the procedures for executing them. We discuss the Peruvian legal stability system in further detail below.

2. Peru's Tax Reforms in Support of Economic Liberalization

Yet another component of the Peruvian economic reform package was the restructuring of the Peruvian tax system, a fundamental aspect of which entailed allowing companies to merge or divide without taxable consequences. Thus, on January 1, 1994, Legislative Decree 782 («Decree 782») was passed, granting State-owned enterprises the right to reorganize without tax consequences[28]. Ten days after the Government issued Decree 782, on January 10, 1994, Congress granted tax free reorganization benefits to all companies through Law 26283 («Merger Revaluation Law»)[29]. Then, on September 19, 1994, Supreme Decree 120-94-EF («Supreme Decree 120») was issued with the purpose of providing implementing regulations for the Merger Revaluation Law.

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[24] Private Investment Regulations, Preliminary Title, Rule I.

[25] Private Investment Regulations, Title III, Chapter I.

[26] See id. at Title III, Chapters II and III.

[27] See id. at Title III, Chapter IV.

[28] Decree 782, Preamble. The Preamble to Decree 782 reads, as follows:

WHEREAS:

[…]

[B]y means of Legislative Decree 674, the process of promotion of private investment in State enterprises is regulated;

[A]rticle 10th of Legislative Decree 674 points out that State enterprises can merge, divide or reorganize when [COPRI] so decides;

It is necessary to exonerate from those tax obligations, acts and agreements made between the companies and the State under Legislative Decree 674.

[29] Merger Revaluation Law — «Exemption From All Taxes of Acts, Contracts, and Transfers of Assets Derived From Agreements of Merger or Division of All Types of Legal Entities», as amended by Law 26416, Law 26561 and Law 26733.

The best explanation of the scope and purpose of the Merger Revaluation Law and corresponding regulations lies in the sole substantive article of the Law:

> The formation, and other acts, contracts and transfer of equity, arising from merger or division agreements of any type of legal entity, whether mercantile, civil or cooperatives, shall be exempt from all taxes, including Income Tax and fees for registration in the Public Registries until December 31, 1994[30].

The Government promulgated this concise, single paragraph law in the broadest of terms precisely to allow companies to merge and revalue their assets free of all taxes within the context of dragging the country out of an economic crisis. In technical terms, the law allowed legal entities to use the market value of their assets as the cost basis when depreciating those assets for tax purposes, but only if such assets were subject to a merger or division.

The abovementioned tax laws and decrees played a key role in the Government's privatization program. Specifically, these laws were planned outgrowths of the policies and principles set out in the Private Investment Law.

Article 1 of the Supplementary Provisions of the Private Investment Law dictates that «the exceptional measures which must be adopted in the country's own interest to *reorganize companies*» (emphasis added) shall be governed by the principles set forth therein[31]. The Merger Revaluation Law, which had the «same objectives» as those of the Private Investment Law[32], was one of the «exceptional measures» taken by the Peruvian Government to «eliminat[e] legal and administrative obstacles or distortions that hinder economic activities»[33]. As such, it constituted an integral part of the economic reform package implemented by the Peruvian Government to promote private investment.

The foregoing observation is supported by the drafting history of the Merger Revaluation Law, which is replete with references to encouraging private investment[34]. The Law had its origins in the draft of Bill 1051, the Preamble of which stated as follows:

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[30] Merger Revaluation Law, Article 1. The only other article of this law, Article 2, simply states that the law is effective upon publication in the official gazette.

[31] Private Investment Law, Supplementary Provisions, Article 1.

[32] Bill Proposing Extension of Decree Law 25877 and Including in the Scope of Decree Law 25601, the Division of Companies, dated October, 29, 1993, with Copy No. 1051/93.

[33] Bill Proposing Extension of Term to Exonerate from Taxes the Juridical Acts Derived From the Merger or Division of Juridical Persons, dated December 9, 1994, With Copy No. 2127/97 — CCD.

[34] In addition to promoting private investment, the Government passed the Merger Revaluation Law to give Peruvian companies, and the Peruvian economy in general, a much-needed boost. See, e.g., Debate Ledger —Law 26283— First Regular Session of the Legislature of 1993, 44th Session, dated December 21, 1993 («[M]erger, and division as well, can be elements for the strengthening

> In order to promote private investment and eliminate the legal and administrative obstacles and distortions that thwart economic activities and in order to grant companies legal stability and certainty and, consequently, stability to the investments that they make, through Legislative Decree 757, the Framework Law for growth of Private Investment was issued; and whereas
>
> For the same purpose, Decree-Law 25601, which exempts from all taxes acts, contracts and capital transfers arising out of agreements for mergers of legal entities was issued; and whereas
>
> Through Decree-Law 25877, application of Decree-Law 25601 has been extended until December 31, 1993; and whereas
>
> However, company divisions have not been included in the scope of either Decree-Law 25601 or Decree-Law 25877; and whereas
>
> The existing conditions that justified the issuance of the laws in question have not changed to date. It is necessary, for one thing, to extend the term of Decree-Law 25601 until December 31, 1994 and, in addition, to include company divisions in the benefits of said laws. It is felt that in modern commercial doctrine, company reorganizations include both company mergers and divisions[35].

Furthermore, in recommending the approval of Bills 1051 and 1100-93-CCD —the bills that ultimately gave rise to the Merger Revaluation Law— the Economics Commission of the Democratic Constituent Congress declared the following:

> The promotion of private investment entails eliminating legal and administrative obstacles and distortions, seeking the stability of companies and the investments that they make.
>
> Exemption from all taxes must include the reorganization of companies, which means their merger or division.
>
> For such reasons, [the] Economics Commission recommends to the Democratic Constituent Congress the APPROVAL of Bills No. 1051 and 1100-93-CCD […][36].

These and similar considerations were echoed every time the Government approved the extension of the term of the Merger Revaluation Law each successive

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of companies themselves and for helping them at a time of a serious recession crisis … and this even guarantees the permanence of work sources»); Opinion of the Economic Commission, dated November 1997 («The proposed extension [of the Merger Revaluation Law] would allow consolidating the process of Economic Reactivation because […] [g]reater economic and financial solvency of the [c]ompanies will be achieved […]»).

[35] Bill 1051/93, dated October 29, 1993, (emphasis added).

[36] Bills 1051 and 1100-93-CCD: Extension of Exemption Term for Company Mergers, dated December 16, 1993.

year between 1995 and 1998. Thus, for example, the Congressional debate ledger of December 15, 1995 regarding extension of the term of the Merger Revaluation Law reads:

> All of these companies that are in the process of merging have the following benefits: First, there is a process of revaluation of assets of the companies at market value, originating that the capital is linked to reality; [second,] a greater capital and financial stability of the companies; [third,] it will allow a greater rationality through a reduction in administrative expenses; [fourth,] it *allows for greater efficiency and encourages corporate investments* and, as a consequence thereof due to the production there will be a greater collection of taxes[37].

Lastly, the Congressional debate ledger of December 27, 1996 contains almost identical language:

> The importance of the waivers regulated by [the Merger Revaluation Law] must be pointed out, since it has been allowing the consolidation of the process of economic reactivation, revaluing the assets of the companies at market values, giving rise to the capital being linked to reality, therefore obtaining greater capital and financial solvency of the companies. Likewise, the extension will allow a greater rationality and a reduction in administrative expenses, achieving greater efficiency and, above all, it will encourage corporate investments[38].

In short, the Peruvian Government issued the Merger Revaluation Law specifically to further the objectives underlying its program of promoting private investment.

3. The Peruvian Legal Stability System

3.1 Effects of the Granting of an LSA

As noted above, the rights granted to foreign investors under Peruvian law are stand-alone protections guaranteed by the Peruvian state to all foreign investors and do not require a special agreement in order to be effective. As an added protection, the Government of Peru may contractually guarantee the stability of certain of these rights and protections, both express and implied, by executing

[37] 20th B Session (Morning) of the Legislature of 1995, dated December 15, 1995, at p. 2 (emphasis added).

[38] 24th A Session, First Ordinary Legislature of 1996, dated December 27, 1996, at p. 2. See also Opinion of the Economic Commission, dated November 1997 («The proposed extension [of the Merger Revaluation Law] would allow consolidating the process of Economic Reactivation because, [inter alia] […] that will allow greater efficiency and will encourage corporate investments»).

LSAs[39], which the Peruvian State has declared «are internationally recognized as instruments which promote investments»[40].

LSAs are essentially «investment incentives»[41] in that they serve as «additional measures on the whole, and not substitutes» to the basic rights and protections available to all investors in Peru[42]. LSAs do not displace the basic rights established by the Peruvian investment promotion laws and Peruvian law generally, but reinforce them.

The Foreign Investment Law and the Private Investment Law authorize the execution of LSAs, which typically incorporate by reference relevant provisions of these laws. LSAs «give contractual assurances for ten years [...] of protection from any change in certain key policies».[43] As noted in the Preamble to the Private Investment Regulations, the purpose of these agreements is «to enable investors to plan their investments in the long-term»[44] LSAs, therefore, cement the key protections within the Peruvian investment promotion laws for a period of ten years by ensuring that the State will not introduce changes in its practices or its fiscal, legislative and administrative framework that might adversely affect the economic return on the underlying investment originally forecast by the investor.

The protections provided through a foreign investor LSA are effective immediately upon its execution and continue in effect for the term of the LSA, subject to the requirement that the investment described in the LSA take place within the period of time stipulated in the LSA (typically no longer than 2 years). If the investment is not made within the required time limits, the rights and other guarantees stabilized under that LSA, as well as under all related LSAs (*e.g.*, the local investment-receiving company's LSA) are deemed immediately terminated, requiring the reimbursement by the investor of all benefits obtained while the LSA was in force[45].

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[39] See UNCTAD (2000: 20). Almost all foreign companies that have acquired Peruvian state-owned assets have executed Legal Stability Agreements with the Government. A recent study shows that more than 600 Legal Stability Agreements were executed between 1992 and 2003, 29 percent of which involved privatized companies. The same study indicates that Legal Stability Agreements represent at least US$14 billion in investment commitments in Peru and at least US$9.9 billion has been collected by Peru's treasury in connection with investments made pursuant to such agreements.

[40] Private Investment Regulations, Preamble.

[41] For a discussion on other investment incentives under Peruvian law, see UNCTAD (2000: 24-29).

[42] UNCTAD (2000: 24). See also Foreign Investment Law, Article 17; Private Investment Law, Article 45; Private Investment Regulations, Article 21.

[43] UNCTAD (2000: 20).

[44] Private Investment Regulations, Preamble.

[45] Foreign Investment Law, Article 11 («The stability regime shall become effective on the date on which the agreement is executed and shall provide, under responsibility, the express resolutory

In the case of the foreign investor LSA, the agreement is entered into between the investor and PROINVERSION (formerly CONITE), for and on behalf of the Peruvian State. In the case of the recipient company LSA, the agreement is executed between that company and PROINVERSION (formerly CONITE) and the corresponding ministry for the industry sector, for and on behalf of the Peruvian State. Which vehicle is used by the foreign investor to serve as the Peruvian State's counter-party to the LSA will depend on a host of factors, primarily the foreign investor's corporate and international tax planning structure, or local incorporation requirements imposed by municipal law.

LSAs can only be granted in connection with new investment in Peru and in an income producing activity that contributes to the country's development (*i.e.*, an «active» investment)[46]. Pursuant to Article 13 of the Foreign Investment Law, an LSA can only be granted on the basis of the filing of an application by the investor with the Peruvian authorities[47]. The application must contain specific information relevant to the investment on the territory of Peru. This information includes the name, legal status, domicile and nationality of the investor, details regarding the investor's legal representative, the amount of the investment, the target of the investment, and a description of the project in which the investment is being made.

The guarantees and rights protecting an investment, and which are implemented through the execution of an LSA are described in Article 19 of

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condition that in case of failure to deliver the contributions, or if these are reduced or transferred to third parties, said agreement will be invalidated and subject to the relevant penalties and payment to the Tax Administration of any taxes not paid due to the stability regime»). See also Private Investment Regulations, Article 28 (listing the causes for automatic termination of an LSA).

[46] Foreign Investment Law, Article I; see also Private Investment Regulations, Article 16 (establishing that «[o]nly investors who undertake to comply with» the stipulated requirements «may benefit from the legal stability regime [...]» These requirements include the making of «cash contributions to the capital of an enterprise already established or to be established in the country under Peruvian Law [...]»; a minimum capital contribution of US$ 2,000,000 or US$ 500,000, which must be channelled through the National Financial System; the making of a venture capital investment; or the acquisition of shares of a company owned directly or indirectly by the State); Private Investment Law, Article 40 («provided that the total amount of the new investments received by the enterprise is greater than 50% of its capital plus reserves and is used for expanding productive capacity or technological improvement»).

[47] Article 13 of the Foreign Investment Law («In order to benefit from the stability regime referred to in Article 10 hereof, foreign investors must file an application with the National Competent Authority in respect of any of the forms stipulated in Article 11 hereof»). See also Private Investment Regulations, Article 29 («In order to be entitled to the legal stability regime referred to in this title, an application for the execution of the respective agreement should be filed before the Competent National Organization pursuant to the format indicated in Annex II, which is an integral part hereof»).

the Private Investment Regulations[48]. For an LSA to be approved for the local investment-receiving company, it must actually be the target of an investment[49]. Neither the Foreign Investment Law, nor the Private Investment Regulations, contain specific provisions addressing LSAs issued to a holding company. The investment ultimately subject to protection is the local operating company.

3.1.1 Stability of the Tax Regime

The tax stability guarantee implies that a foreign investor cannot be subject to a higher tax effect than that contemplated by the various LSAs relating to the investment in connection with: (i) the income tax payable by the target company that is the recipient of the investment; (ii) the taxes imposed on the profits attributed to the investment receiving company; or (iii) the dividends distributed by the target company. If the income tax payable by the target company is increased by the Government of Peru's actions, the foreign investor is entitled to receive compensation in an equal amount. In this way the foreign investor's

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[48] Article 19 states as follows:

Legal stability guarantees the investors and enterprises in which they participate, as the case may be, the following rights:

(a) Stability of the tax regime regarding the Income Tax in force at the time of execution of the Agreement for the cases considered in sub-section a) of Article 10 of Legislative Decree 662 and in Articles 38, 40 and 41 of Legislative Decree 757, in accordance with the provisions of Article 23 hereof;

(b) The stability of the regime of unrestricted availability of foreign currencies, in accordance with the provisions of sub-section b) of Article 10 of Legislative Decree 662, applied under sub-section a) of Article 3 hereof;

(c) Stability of the right of unrestricted remittance of profits, dividends, capitals and other earnings, in accordance with Article 15 hereof;

(d) Stability of the right to use the most favourable exchange rate available on the exchange market, according to the provisions of Article 13 hereof;

(e) Stability of the right to non-discrimination, according to Article 3 hereof;

(f) Stability of the regime regarding the hiring of workers, in any of its forms, under the provisions of sub-section a) of Article 12 of Legislative Decree 662, specially in that related to regimes covered by Legislative Decree 728, Employment Promotion Law;

(g) Stability of the export promotion regime, in accordance with the provisions of sub-section b) of Article 12 of Legislative Decree 662, including the drawback regime of the indirect taxes considered in Article 8 of Legislative Decree 668, as well as the special regimes contained in Legislative Decree 704, Law for Free Zones, Special Trade Treatment and Special Development Zones; and

(h) In the case of financial leasing contracts: total stability of the tax regime.

[49] See Private Investment Regulations, Article 17 («Legal stability is extended to the enterprises established in the country provided that they receive or are established with new capital contributions made pursuant to the provisions of [Article 16] or […]» they are a state-owned company subject to at least a 50% privatization).

net return on its investment is protected for the term of stabilization granted by the Government. The provisions relevant to the Government's guarantee of tax stabilization for a foreign investor are set forth, *inter alia*, in Articles 10(a) and 12 of the Foreign Investment Law, Article 40 of the Private Investment Law, Articles 19(a) and 23(a) of the Private Investment Regulations, and Articles 38 and 62 of the Peruvian Constitution[50] (hereinafter collectively referred to as the «Tax Stabilization Regime»).

The Tax Stabilization Regime consists not only of law and regulations, but also of (i) the tax rates (*alícuotas*) applicable to dividends (*dividendos*) and profits (*utilidades*); (ii) deductions (*deducciones*); (iii) rules for calculation of taxable income (*reglas para el cálculo de la renta imponible*); (iv) taxable base (*base imponible*); (v) or any other cause with equivalent effects (*cualquier otra causa de efectos equivalentes*), including governmental practices and interpretations[51].

The Tax Stabilization Regime is implemented through the execution of LSAs between the Peruvian State, the foreign investor, and the investment-receiving enterprise (and any such affiliated holding companies that may be integrated in the ownership chain in connection with a specific investment project). Despite the fact that each LSA is individually executed, the LSAs are interlinked and collectively protect the entire investment. Indeed, as explained below, the tax stability provided for in a foreign investor LSA includes stability both of the income tax levied on the profits of the investment-receiving company, as well as the dividends that are attributed and distributed to the foreign investor[52]. As such, the tax stabilization guarantee protects an «effective tax regime» for the investment.

Specifically, Article 23(b) of the Private Investment Regulations emphasizes the import and effect of the tax stability granted by way of a recipient company LSA, as follows:

> Article 23.- The stability of the tax regime implies the following:
>
> (a)[…]
>
> (b)For investment-receiving companies included in sections a and b of Article 17 hereof: it is hereby guaranteed that while the Stability Agreement is effective, the income tax applicable thereto will not be modified. The same terms, as well as the same aliquots [portions], deductions and scales for the calculation of the

[50] Article 38 of the Peruvian Constitution states, «When exercising its taking power, the State has to respect the principles of regulation by law, equality and respect of the person's fundamental rights. No tax may have a confiscatory nature." See also Peruvian Constitution, Article 62.

[51] See <www.proinversion.gob.pe> (describing the tax stabilization commitment under the LSAs as comprising «stability of the Income Tax system in force when the agreement is concluded»).

[52] Private Investment Regulations, Article 23.

> taxable income as the one effective at the time of the agreement's execution will be applicable.
>
> The tax stability system granted to companies under the provisions of Article 40 of Legislative Decree 757 implies that in case the income tax is modified during the term of the Stability Agreement, such modifications will not affect the investment-receiving companies which tax stability is protected by the appropriate agreement whether the aliquots increase or decrease or the taxable base is modified by being extended or reduced, or by any other cause with equivalent effects […][53].

Article 23(b) thus establishes that, by executing an LSA with an investment-receiving company, the Peruvian Government guarantees, for a period of ten years, that the income tax payable by the local investment-receiving company on the income it generates will be determined in accordance with the income tax regime in effect when its LSA is signed.

Article 23(a) of the Private Investment Regulations explains the scope and effect of the Government of Peru's tax stability commitment under Article 10(a) of the Foreign Investment Law. It confirms that:

> Article 23.- The stability of the tax system implies the following:
>
> (a)For investors: It guaranties that while the stability agreement is in force, the income tax which results in a greater tax burden than the one effective as from the date of execution of the agreement will not be imposed on the amounts they are entitled to, in such a manner that they will be entitled to receive effectively such amounts in the same proportion for the following concepts:
>
> a.1. The dividends agreed upon in their favour;
>
> a.2. The profits they are entitled to;
>
> a.3. The profits available thereto; or
>
> a.4. The remittance of sums pertaining thereto for any of the concepts regulated in the various items of this section.
>
> The stability system granted to investors as provided for by section a of Article 10 of Legislative Decree 662 implies that in case the income tax were amended during the effective term of the Stability Agreement results *in a variation of the tax base or the aliquots imposed on the profit generating company, or new taxes were created and imposed on the company's income, or in the percentage reduction of the investor's available profit or dividends with regard to the profit before income as compared to the one subject to allocation or available at the time of setting the guarantied tax system due to any other cause with equivalent effects*, under the stability granted by the agreement, the tax aliquot (s) with regard to the profits or dividends the investor is entitled to will be reduced in order to allow that

[53] Private Investment Regulations, Article 23(b), (official PROINVERSION translation).

> the profits or dividends finally available or subject to allocation are equal to the ones guarantied up to the possible limit as to the tax imposed on profits or dividends[54].

Broken down into its constituent parts, Article 23(a) confirms that: (i) if, in fact, the tax regime that is applied to the investment-receiving company (ii) during the effective term of the foreign investor LSA (iii) is different from the tax regime that was stabilized for the investment receiving company under *its* LSA, then (iv) reparation for such variation of the tax regime will be made to the foreign investor (v) under the foreign investor LSA. In essence, therefore, whereas Article 23(b) confirms that the income tax regime for the investment-receiving company will be frozen for the next ten years, Article 23(a) establishes that it is the foreign investor that may claim for damages caused by the State's breach of that tax regime. More specifically, Article 23(a) provides that: (i) the foreign investor LSA guarantees the investor that (ii) the profits available or dividends distributable to it (iii) will *equal* the amount resulting from the application of the stabilized tax regime to the investment-receiving company's taxable earnings (iv) in effect during the effective term of both the foreign investor and investment-receiving company's LSAs. In other words, the foreign investor is accorded the right to claim back from the Government the difference between the amount it expected to receive under its stabilized regime and the amount it actually received (or could receive) as a result of the Government's breach of that regime.

In sum, the specific purpose of the tax stabilization guarantee is a simple one: to ensure that the tax regime evaluated by the foreign investor in the process of establishing the projected net return on its investment will not vary during the term of its LSA, further reinforcing the emphasis on stability and predictability for the investor underpinning Peru's foreign investment framework.

3.1.2 Stability of the Right to Non-Discrimination

Stabilization of the right to non-discrimination means that the Government of Peru guarantees that it will treat a foreign investor and the enterprise in which it invests on an equal basis with Peruvian nationals, subject only to limited exceptions explicitly set out in the Peruvian Investment Framework Laws[55].

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[54] Private Investment Regulations, Article 23(a), (official PROINVERSION translation). (emphasis added) The importance of Article 23(a) lies in the fact that it gives the foreign investor the right to claim for damage caused to the local investment-receiving company (and hence the foreign investor) for breaches of the tax regime guarantees in Article 23(b). How the investor is then made whole for such damage is subsequently a matter of both of the laws underlying the Foreign Investment Regime (e.g., Article 23(a) itself) and the Civil Code.

[55] UNCTAD (2000: 19).

As such, foreign and national investors are granted identical rights and obligations regardless of nationality, geographic location, or the type or sector of economic activity they are engaged in. The Government's guarantee of non-discrimination can be found in, *inter alia*, Articles 2 and 10(c) of the Foreign Investment Law, Articles 3 and 19(e) of the Private Investment Regulations, and Article 2 of the Peruvian Constitution.

The non-discrimination guarantee is typically found only in LSAs executed between the Peruvian Government and foreign investors, but not in those executed between the Government and investment-receiving companies. This is because, as demonstrated below, the Peruvian Government's non-discrimination protection with respect to an investment is implemented through the LSA executed with the foreign investor. Thus, a claim that the Peruvian State's non-discrimination commitment has been breached cannot be asserted under the local investment-receiving company's LSA, but rather must be brought by the investor under its LSA, as this is the agreement containing the protection that is alleged to have been breached.

Article 10(c) of the Foreign Investment Law guarantees the foreign investor «stability of the non-discrimination rights contemplated in Article 2 hereof»[56]. In turn, Article 2 of the Foreign Investment Law establishes the general principle of equal treatment between foreign and national investors, and clarifies that the non-discrimination protection granted to the foreign investor includes actions taken against the local company in which a foreign investor participates:

> Article 2.- Foreign investors *and the companies in which these participate* have the *same rights and obligations as the local investors and companies*. Such rights and obligations are only limited by the exceptions established in the Political Constitution of Peru and the provisions hereof.
>
> In no case the domestic juridical regulations will discriminate among investors or the companies based on the local or foreign share in the investments[57].

In other words, Article 2 of the Foreign Investment Law makes it clear that both the foreign investor and the company in which it invests have the right to equal treatment on the same terms as those granted to a national investor and recipient company. Equally clear, however, is the fact that only the foreign investor can assert a claim under its LSA for action that falls short of this standard, regardless of whether that discriminatory action is taken against the foreign investor or the

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[56] Foreign Investment Law, Article 10(c).

[57] Foreign Investment Law, Article 2 (official PROINVERSION translation), (emphasis added).

company in which it invests. To reiterate, any discrimination by the Government against an investment at any level is actionable at the foreign investor level.

Additional clarification regarding the scope of the equal treatment standard and the prohibition against discriminating practices is provided in Article 3 of the Private Investment Regulations. Article 3 sets out the various grounds upon which discrimination is prohibited, including «differentiated treatment» on the basis of, *inter alia*, nationality of the investor or «any other cause with equivalent effects»:

> The right to non-discrimination among investors and companies implies that the State, at any of its levels, in the case of Central, Regional or Local Government entities, or companies owned thereby, should grant an equal treatment thereto.
>
> […]
>
> The non-discrimination referred to in this Article implies that no entity or company of the Central, Regional or Local Governments, as appropriate, will establish a differentiated treatment among investors or the companies in which they participate based on the nationality thereof, the sectors or the type of economic activities they are engaged in, or the geographical location of companies. Neither will they be able to establish a discriminatory treatment among investors or companies in which they participate in the following matters:
>
> […]
>
> e) Any other cause with equivalent effects.
>
> A cause with equivalent effects, among others, is the discrimination resulting from any combination of the different factors described in this Article.
>
> The differentiated treatments which are granted in tax or import duties matters based on sectors or types of economic activities or the companies' geographical location are not considered as causes with equivalent effects[58].

The prohibition under Article 3 of the Private Investment Regulations against differentiation based on «any other cause with equivalent effects» is synonymous with the broad guarantee of equal treatment enshrined in the Peruvian Constitution. The Constitution, from which all Peruvian laws emanate and, in reference to which, all Peruvian laws must be interpreted, sets forth the fundamental right to equal treatment in the following terms: «All persons have the right to: […] Equality before the law. No person can be discriminated against for reasons of origin, race, sex, language, religion, opinion, economic or *any other condition*»[59].

The reference in Article 2, subsection 2 of the Peruvian Constitution to «or any other condition», proscribes differential treatment based on *any* unjustified reason.

[58] Private Investment Regulations, Article 3, (official PROINVERSION translation).

[59] Peruvian Constitution, Article 2, subsection 2, (emphasis added).

The Congressional debates that took place at the time of the Constitution's enactment in 1993 help to explain the motivation and significance of this language. In particular, Mr. Enrique Chirinos Soto, the primary drafter of that Constitution, explained that, if the categories of discrimination under the Constitution remained as only race, gender, religion, opinion or language:

> So then, it could be understood that one could not be discriminated against for another reason: for the colour of his hair, for the size of ones skirt or of ones pant. Therefore, it would be indispensable to add, Mr. Chairman: «No one can be discriminated against for such and such a reason, nor for any other» [...] No one should be discriminated against for any reason. That is the end of that. Then, there is no other reason. [...] We must put that «nor for any other reason». We must put that in because, otherwise, there could be discrimination for reasons not in the constitutional text[60].

In other words, the broad protection arising under Article 3 of the Private Investment Regulations against action based on «any other cause with equivalent effects» explicitly mirrors the Constitution by proscribing *any* attempts to violate Peruvian law's overriding tenet of absolute equality through differentiated treatment based on changes in legislation, inconsistent application of law and abuses of administrative discretion.

Under this broad «Non-Discrimination Regime», therefore, the Government of Peru promises not to take *any* actions, or implement *any* measures, that either discriminate against, or have the effect of discriminating against, a foreign investor's investment in Peru on the basis of, *inter alia*, nationality, economic sector, economic activity, or «any other cause with equivalent effects».

3.1.3 Stability of the Right of Free Remittance

As part of the comprehensive framework of legislation to protect foreign investment in Peru, the Government granted foreign investors the right to remit freely the total amount of the net profits earned from their investments and undertook to take no actions to restrict or limit that right. This is, by definition, a right granted exclusively to foreign investors.

Article 7 of the Foreign Investment Law clearly sets forth an investor's right to remit freely its total profits:

> Foreign investors are hereby guaranteed the right to remit abroad in unrestricted convertible currency, without requiring beforehand, for this purpose, an authorization from any central government authority, from decentralized public

[60] Debate ledger of the Democratic Constituent Congress, Session 10.A (Evening), dated February 19, 1993, at p. 55.

> entities or from regional or municipal governments, after paying the taxes required by law, the following:
>
> (a) *The full amount of their capital generated from the investments* contemplated in Article 1 hereof and registered with the national competent agency, including the sale of shares, participations or rights, capital reduction or partial or total liquidation of the companies; and
>
> (b) *The full amount of the dividends or proven net profits generated from their investments*, as well as the payments for the use or enjoyment of goods physically located in the country and registered with the national competent agency, and the royalties and payments for the use and transfer of technology, including any other element forming part of the intellectual property assets authorized by the national competent entity[61].

Article 10 of the Private Investment Law echoes the broad right of a foreign investor to remit its profits:

> The State guarantees the rights of companies, regardless of their corporate form, to freely determine the distribution of all their profits or dividends, and the investors' rights to receive their total share in such profits or dividends, including those pertaining to the current year, based on periodic balance sheets, without prejudice to the obligations regarding the profit-sharing plan, legal reserves and the pertinent obligations stipulated in the General Corporate Law, provided the corresponding tax obligations are satisfied[62].

These same foreign investor protections appear yet again in the Private Investment Regulations:

> The guarantees for national and foreign investors include:
>
> […]
>
> (i) Enterprises' right to freely decide the distribution of the full amount of profits or dividends generated;
>
> (j) Investors' right to receive the full amount of the corresponding profits or dividends they are entitled of […][63]

Hand-in-hand with a foreign investor's right to remit freely the full amount of its profits is the underlying right to those profits. This underlying right is given effect through Peru's constitutional and legislative guarantee to protect private property from Government confiscation or interference. A person's right to private property is enshrined in the Peruvian Constitution, as follows:

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[61] Foreign Investment Law, Article 7 (official Proinversion translation), (emphasis added).

[62] Private Investment Law, Article 10 (official Proinversion translation).

[63] Private Investment Regulations, Rule 1 (official Proinversion translation).

> The right to property is inviolable. The Government guarantees it. It is exercised in harmony with the common good and within the limits of the law. No one can be deprived of property except exclusively for reasons of national security or public need, declared by law, and after payment in cash of a just compensation for possible damages and losses. Action can be taken before the Judicial Branch to contest the value of the property that the Government has indicated in the expropriation procedure[64].

This constitutional protection to private property is overlaid by further legislative guarantees to the same effect. The Private Investment Law, for example, provides:

> The State guarantees private property, subject to no further limits except those stipulated in the Political Constitution. In application of Article 131 of the Political Constitution, which endorses free enterprise, and in conformity with the provisions contemplated in this Chapter, the State shall not expropriate companies nor any shares or interests therein, except for the national interest, to be duly substantiated by a Congress Law[65].

The aforementioned guarantee of free remittance and protection of private property is typically incorporated in, and echoed by, a provision in LSAs executed between the Government and foreign investors. Consequently, investors have the right to remit freely the total amount of the profits generated by investment receiving companies free of any Government-imposed restrictions or limitations to that right.

3.1.4 Stability of the Right to Use the Most Favourable Exchange Rate and the Free Availability of Foreign Currency

Foreign investors are also granted the right to use the most favourable rate of exchange when converting currency. Additionally, foreign investors are granted the right to access foreign currency at the most favourable rate of exchange that is available. The provisions relevant to these guarantees can be found at, *inter alia*, Article 10(b) of the Foreign Investment Law and Article 19(d) of the Private Investment Regulations.

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[64] Peruvian Constitution, Article 70.

[65] Private Investment Law, Article 8. See also, Foreign Investment Law, Article 4 («The ownership right of foreign investors shall not be subject to any further limitations except those stipulated in the Political Constitution of Peru»).

3.2 Juridical Framework Applicable to the Formation, Performance, and Interpretation of LSAs

Under the Peruvian investment promotion laws, the key features of LSAs are that (i) the legal regimes stabilized for investors cannot be changed unilaterally by the State, and (ii) LSAs are subject to private or civil law and not administrative law. As private law contracts, the negotiation, execution, interpretation and enforcement of the provisions set forth in LSAs are subject to the general principles applicable to contracts between private parties under the Peruvian Civil Code. Consequently, the fundamental rights granted by Peru pursuant to an LSA are private contractual rights that are enforceable against the State as if it were a private party.

Indeed, the provisions in the Peruvian Civil Code governing private contracts in general apply to LSAs. In particular, these agreements are subject to the principle of *Contrato-Ley*, as set forth in Article 1357 of the 1984 Civil Code. That Article states as follows: «By law, supported by reasons of social, national or public interest, the State may establish guarantees and assurances by means of a contract»[66].

Article 39 of the Private Investment Law confirms the foregoing:

> Legal stability investment agreements shall be concluded subject to Article 1357 of the Civil Code and shall have the [legal] effect of contracts enforceable as law, such that they may not be modified or terminated unilaterally by the State. Such contracts shall have a private rather than administrative character, and shall only be modified or terminated by agreement between the parties[67].

Moreover, Article 26 of the Private Investment Regulations reinforces these principles regarding the legal nature of LSAs:

> Legal Stability Agreements have the following features:
>
> a. They are civil law contracts, governed by the Civil Code;
>
> bathe have force of law between the parties, so the agreements may not be unilaterally amended for any reason while they are in force;
>
> […][68]

The investment protections provided for by LSAs are guaranteed by the Peruvian Constitution, as set forth in the last paragraph of Article 62 of the Constitution:

[66] Peruvian Civil Code, Article 1357.

[67] Private Investment Law, Article 39.

[68] Private Investment Regulations, Article 26.

> Liberty to contract guarantees that parties may validly agree according to the legal norms in force at the time of the contract. Contract terms may not be modified by law or other dispositions of any type. Conflicts that arise from contractual relations may only be resolved by arbitration or judicial decree, according to the mechanisms of protection set forth in the contract or contemplated by law.
>
> Through contracts-law [special investment-related private contracts of an obligatory character], the State may establish guaranties and grant securities. These may not be modified by legislation, without prejudice to the protection referred to in the preceding paragraph[69].

A critical feature, therefore, of the Peruvian legal stability regime is that the State contractually reinforces a set of constitutional and legal guarantees to protect a private investment, which it cannot unilaterally modify, thereby ensuring that the investor's legitimate and investment-backed expectations regarding the return on its investment are protected. By virtue of the special status constitutionally accorded to such contracts, they are not subject to the State's sovereign prerogative to terminate or modify unilaterally its agreements with a private party. LSAs, by their very nature, are instruments reflecting the State's voluntary limitation of its sovereignty, at least *inter partes*. They therefore operate in a legal relationship —one of civil law— that is fundamentally distinct from, though certainly cognizant of, certain aspects of the administrative law-based relationship between the local company and the local authority.

Finally, as private law contracts, LSAs are subject to the principle of good faith set forth in Article 1362 and 168 of the Civil Code. These articles state as follows:

> Article 1362: Contracts must be negotiated, executed and performed according to the rules of good faith and the common intention of the parties.
>
> Article 168: A legal act shall be interpreted in accordance with what is expressed therein and in accordance with the principle of good faith[70].

3.3 LSAs Granted to Foreign Investors and Investment-Receiving Companies Are Interlinked

The LSAs granted to the foreign investor and to the local investment-receiving company are integrally related to each other. The plain terms of the Foreign Investment Law and the Private Investment Regulations demonstrate that certain of the protections that are specifically applicable to the foreign investor

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[69] Peruvian Constitution, Article 62.

[70] Peruvian Civil Code, Articles 1362 and 168.

are implemented through the LSA between the Peruvian State and the investor. Other stabilized regimes that are necessary to protect the value of the investment, however, are implemented through the LSA between Peru and the local company receiving the investment. This structure is recognized in Article 25 of the Private Investment Regulations:

> Legal stability agreements grant the following guaranties:
>
> (a)To the investors: those contained in sub-section (a) to (e) of Article 19 [of the Regulations];
>
> (b)To the company;
>
> (b.1)To those referred to in the first paragraph of Article 17 hereof: the ones included in sections (f) and (g) of Article 19 [of the Regulations]; and
>
> (b.2)To those referred in the second paragraph of Article 17 hereof: the ones included in sections (a), (f) and (g) of Article 19 [of the Regulations][71].

The inter-linked nature of LSAs is also described in Article 12 of the Foreign Investment Law, which predicates the validity and effectiveness of the local recipient company's LSA on that of the investor's LSA. Article 12, in describing the rights provided to a local investment receiving company, states in pertinent part:

> Such rights shall remain in force as long as the foreign investor does not violate the provisions of the last paragraph of [Article 11], and as long as the respective agreements entered into by the aforementioned companies, their foreign investors and the National Competent Authority, are not resolved or terminated in accordance with the provisions set forth in said paragraph[72].

In sum, because of the interlinked nature of these LSAs and of the protections they provide, in practice, they are viewed and used by foreign investors as a single tool for protecting their investments in Peru. The protections granted by means of such agreements complement each other to create a single legal regime under which the protected investment may be made, maintained, utilized and later remitted abroad[73].

[71] Private Investment Regulations, Article 25.

[72] Foreign Investment law, Article 12.

[73] Private Investment Regulations, Articles 19 and 25. Article 19 lists the legal stability protections provided for under the law. Article 25 identifies which protections are granted to investors and which to investment-receiving companies.

4. Case study: Duke Energy International Investments Nº 1 Ltd. vs. Republic of Peru[74]

4.1 Factual Background

The background of Duke Energy Corporation's investment in Peru lies in the Peruvian Government's unbundling and privatization of *Electricidad del Perú S.A.* or *Electroperú S.A.* («Electroperú»), the largest state-owned electricity generation company in the country. In 1994, the *Comisión para la Promoción de la Inversión Privada* («COPRI»), the Peruvian privatization agency, restructured Electroperú into smaller companies for privatization purposes. One of the resulting companies was *Empresa de Generación Eléctrica Nor Perú S.A.* («Nor Perú-Egenor»), a wholly-owned subsidiary of Electroperú. The privatization of Nor Perú-Egenor was carried out by CEPRI-ELP, a special one-stop privatization committee created by COPRI for this purpose.

In 1996, CEPRI-ELP conducted an international bidding process to sell a 60 percent controlling interest in Nor Perú-Egenor. Dominion Energy International, Inc. («Dominion»), a U.S. company, through Inversiones Dominion de Peru S.A. («IDP»), its wholly-owned local subsidiary, won the privatization bidding process. Later, IDP and Electroperú signed a Privatization Agreement under which Dominion was required to maintain control of Nor Perú-Egenor with a minimum stake totalling 51 percent of IDP. Electroperú maintained the remaining 40 percent interest in Nor Perú-Egenor for sale in a later, second privatization phase.

Shortly after the execution of the Privatization Agreement, Peru entered into two LSAs on July 24, 1996: one with IDP, as an investor in Nor Perú-Egenor (the «IDP Domestic Investor LSA»); the other with Nor Perú-Egenor, as a recipient of the investment from IDP (the «Nor Perú-Egenor LSA»). Later Peru entered into two additional LSAs: one with Dominion, as a US$228.2 million foreign investor in IDP (the «Dominion LSA»); the other with IDP, as a US$228.2 million recipient from Dominion (the «IDP Recipient LSA»).

On November 27, 1996, the majority shareholders of Nor Perú-Egenor, *i.e.*, IDP and Electroperú, approved a merger between Nor Perú-Egenor and Power North S.A., a corporation established by IDP. The resulting company was called Egenor. In 1997, Dominion sold 49 percent of IDP to Gener S.A. («Gener»), a Chilean company, and the remaining 51 percent to one of its own wholly-owned Peruvian subsidiaries, Dominion Holdings Peru S.A. («DHP»). In other words,

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[74] Duke Energy International Investments No. 1, Ltd. v. Republic of Peru, ICSID Case No. ARB/03/28, Decision on Jurisdiction, February 2006 (hereinafter «Duke Energy v. Peru"), available at www.investmentclaims.com.

by 1998, Egenor had three major shareholders —Dominion (through DHP and IDP), Gener (through IDP) and the Peruvian State (through Electroperú).

In late 1998, Duke Energy learned about Dominion's interest in selling its power assets in Central and South America, including in Peru. Duke Energy, however, was interested in acquiring a full 90 percent of Egenor through purchasing 60 percent of its available stock from IDP (owned by Gener and DHP), and the other 30 percent from the Peruvian State[75]. By late 1999, through a complex series of transactions, Duke Energy acquired a 90 percent ownership interest in Egenor from Dominion, Gener and Electroperú for approximately US$288 million. In October 1999, Dominion obtained and provided Duke Energy with a Guarantee Agreement, pursuant to which Peru guaranteed, in connection with the 60 percent part of the sale, that all of the original obligations assumed, representations and warranties made, and liabilities of Electroperú remained effective and enforceable against Peru.

Duke Energy's acquisition of Dominion's Latin American assets also had a number of international tax implications, which Duke Energy intended to account for in a corporate reorganization. At the same time, Duke Energy needed to implement an ownership structure for Egenor generally mirroring the structure reflected in the Privatization Agreement. It was against this backdrop that Duke Energy International Peru Investments No. 1 Ltd. («DEI Bermuda») was incorporated in August 1999. Subsequently, in May 2000, Duke Energy International Peru Holdings SRL («DEI Peru Holdings») was established as a Peruvian holding company wholly-owned by DEI Bermuda. Finally, on December 18, 2002, Duke Energy made a capital contribution of US$200 million to DEI Peru Holdings, through DEI Bermuda. DEI Peru Holdings used these funds to acquire the 90 percent capital stock of DEI Egenor, which, as described above, had already been acquired through various other subsidiaries of Duke Energy, thereby consolidating Duke Energy's interest in Egenor in a clean, tax-efficient corporate structure.

In connection with its investment in Peru, Duke Energy sought to obtain the exact same investment protection regime as Dominion had received through the execution of LSAs with the Peruvian State. A direct transfer or assignment of all of Dominion's LSAs to Duke Energy would have been the most efficient means of accomplishing this objective. For reasons unrelated to Duke Energy, however, the Peruvian Government was reluctant to assign Dominion's LSAs. Nevertheless, an interim LSA between Peru and a Duke Energy subsidiary was executed as

[75] Between 1996 and 1998, Electroperú had transferred 10 percent of Egenor's shares to its workers, as mandated by Peruvian law.

a sign of the Government's good faith intention to ensure that Duke Energy's investment would be subject to comprehensive foreign investor protections and to induce Duke Energy's investment.

Eventually on July 24, 2001, Peru executed new LSAs for Duke Energy, with DEI Bermuda and DEI Peru Holdings respectively, as part and parcel of Duke Energy's corporate restructuring process for its investment in Peru. At Duke Energy's request, the DEI Bermuda LSA contained an ICSID arbitration clause. In addition, the interim LSA and the IDP Domestic Investor LSA were assigned to DEI Peru Holdings, and the Nor Perú-Egenor LSA was assigned to Egenor (renamed DEI Egenor).

Immediately following Duke Energy's post-investment corporate restructuring of its Peruvian holdings, however, on November 24, 2000, SUNAT, the Peruvian tax administration, initiated a tax audit of DEI Egenor for tax year 1999 (*i.e.*, for Egenor). SUNAT expanded the scope of the audit to include tax years 1996, 1997, and 1998 on May 9, 2001 (*i.e.*, the tax compliance of Nor Perú-Egenor and Egenor).

On November 22, 2001, SUNAT assessed a tax liability of approximately US$48 million against DEI Egenor for alleged tax underpayments during the period 1996 to 1998; that is, for events that took place prior to Duke Energy's acquisition of Egenor, during a time when Dominion, Gener and Electroperú (*i.e.*, the Peruvian State) owned the company. The assessment had several components, only two of which are relevant for present purposes: the «Merger Revaluation Assessment» and the «Depreciation Rate Assessment.»

The Merger Revaluation Assessment was based on SUNAT's view under Rule VIII of the Peruvian Tax Code that the 1996 merger between Nor Perú-Egenor and Power North S.A., which created Egenor, was a «sham» transaction only concluded to take advantage of the tax benefits available under Law No. 26283 (previously defined as the «Merger Revaluation Law»). The Depreciation Rate Assessment was based on SUNAT's view that Egenor should have depreciated the assets that Electroperú had transferred to it during the 1996 privatization process using a «special» decelerated depreciation rate that had been specially provided by SUNAT to Electroperú in December 1995, rather than the general statutory depreciation rate set forth for all companies in the Peruvian income tax regulations.

With respect to the Merger Revaluation Assessment, DEI Egenor applied for amnesty under the Peruvian Tax Amnesty Law; at the same time, it reserved its rights. SUNAT accepted the application, and DEI Egenor made a payment of approximately US$12 million. With respect to the Depreciation Rate Assessment, however, DEI Egenor initially filed an administrative complaint with SUNAT,

followed by an appeal to the Peruvian Tax Court. Ultimately, however, on August 7, 2004, following a rejection of its appeals, DEI Egenor again applied for amnesty with a further and separate reservation of rights, this time making a cash payment of approximately US$14 million.

On October 6, 2003, DEI Bermuda, DEI Egenor's foreign investor parent, initiated arbitration before ICSID against the Republic of Peru, on the grounds that SUNAT's assessments not only violated Peru's stabilization commitments to DEI Bermuda, but also Peruvian civil and customary international law. The ICSID Secretary General registered the case on October 24, 2003.

The arbitration filed by Duke Energy was the second arbitration filed against Republic of Peru before ICSID, the first having been brought by Lucchetti, a Chilean company and its Peruvian subsidiary under the Chile-Peru Bilateral Investment Treaty («BIT»), which was subsequently dismissed for lack of jurisdiction[76]. DEI Bermuda's arbitration was not commenced under a BIT. Rather, it was commenced pursuant to the ICSID arbitration clause included in the LSA executed between DEI Bermuda and the Republic of Peru.

On July 26, 2004, Peru informed the Tribunal that it intended to object to the jurisdiction of the Tribunal and admissibility of DEI Bermuda's claims in this case. The Tribunal, pursuant to Rule 41(3) of the ICSID Arbitration Rules, suspended the proceedings on the merits, bifurcated the arbitration into jurisdiction and merits phases, and ordered the parties to present their arguments with respect to the issues of jurisdiction and admissibility.

Hearings on the jurisdictional and admissibility issues were held at the seat of ICSID in Washington, DC on March 29-30, 2005. In a unanimous decision, the Tribunal rendered its Decision on Jurisdiction on February 1, 2006, confirming that it had jurisdiction over the parties' dispute, dismissing one of Peru's admissibility objections and leaving the other to the merits phase of the arbitration.

4.2. The Tribunal's Analysis of the Jurisdictional Issues

Peru objected to the Tribunal's jurisdiction *ratione materiae*, *ratione personae* and *ratione temporis*. The Tribunal examined all of these objections in light of Article 25 of the ICSID Convention[77].

[76] Lucchetti, S.A. and Lucchetti Peru, S.A. v. Peru, ICSID Case No. ARB/03/4 (Chile/Peru BIT), February 7, 2005, available at www.investmentclaims.com.

[77] Article 25 of the ICSID Convention provides in the relevant part that «(1) The jurisdiction of the Centre shall extend to any legal dispute arising directly out of an investment, between a Contracting State (or any constituent subdivision or agency of a Contracting State designated to the Centre by that State) and a national of another Contracting State, which the parties to the

4.2.1 Jurisdiction Ratione Materiae

With respect to jurisdiction *ratione materiae,* Peru contended that the only «investment» for the purposes of determining jurisdiction was DEI Bermuda's US$200 million capital contribution to its local holding company, DEI Peru Holdings. Thus, according to Peru, DEI Bermuda's indirect ownership in DEI Egenor (*i.e.*, through DEI Peru Holdings) could not benefit from the LSA protections. DEI Bermuda, however, contended that in light of the actual investment undertaken and held by Duke Energy, and the overall unity of the investment transaction, Peru's consent to ICSID arbitration, as reflected in the DEI Bermuda LSA's arbitration clause, could apply to losses suffered by DEI Bermuda based on actions taken by the Peruvian State against DEI Egenor.

In addressing the parties' respective positions, the Tribunal examined three issues: the scope of the arbitration agreement, the nature of the dispute, and finally the concept of investment and the principle of unity of the investment.

a) Scope of the Arbitration Agreement

At the outset, the Tribunal noted that the «arbitration agreement should be interpreted with due respect for the principle of good faith, [and] should not follow an *a priori* strict or broad construction […]»[78]. It also noted that the consent to arbitration in Clause Nine of the DEI Bermuda LSA was restricted to the DEI Bermuda LSA[79], and did not expressly extend to disputes arising out of the other LSAs between Duke Energy's various subsidiaries and the Republic of Peru[80]. Nevertheless, the Tribunal noted that the parties' consent in Clause Nine was formulated in the broadest of terms, covering «[…] any dispute […] concerning the interpretation, performance or validity» of the DEI Bermuda LSA. Thus, the Tribunal found that the parties had intended to submit to ICSID any and all disputes between them provided that they concerned the interpretation, performance or validity of the DEI Bermuda LSA[81].

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dispute consent in writing to submit to the Centre. When the parties have given their consent, no party may withdraw its consent unilaterally».

[78] Duke Energy v. Peru, paras. 76-8.

[79] The clause Nine provided in the relevant part that «[…] the parties agree hereinafter that any dispute, controversy or claim between them, concerning the interpretation, performance or validity of this agreement, shall be submitted to the [ICSID]».

[80] Duke Energy v. Peru, *para.* 80.

[81] *Id. para*. 81.

b) Nature of the Dispute

The Tribunal relied on Claimant's enumeration of Peru's breaches of the DEI Bermuda LSA to explain the nature of the parties' dispute, which may be summarized as follows: breach of the guarantees of non-discrimination, tax stabilization, and free repatriation of investments under Clause Three of the DEI Bermuda LSA; breach of the obligations of good faith and the *doctrina de los actos propios* in connection with DEI Bermuda's investment in Peru; and breach of customary international law[82].

The Tribunal opined that, at the jurisdictional phase, it did not need to examine the merits of the case in detail; it only needed to be satisfied that the Claimant's claims were *prima facie* within its jurisdiction[83]. According to the Tribunal:

> The crux of the issue is whether the literal reading of Clause Two, which would seem to restrict the definition of «investment» to DEI Bermuda's capital contribution to DEI Peru Holdings, excludes the possibility that the Tax Assessment (against DEI Egenor) could violate the protections granted to DEI Bermuda in Clause Three of the DEI Bermuda LSA, which are expressed as being granted «in connection with the investment»[84].

The Tribunal concluded that the literal language of Clause Two did not limit the Tribunal's jurisdiction to consider the merits of Claimant's claims under Clause Three (and Peruvian and customary international law generally)[85].

c) Concept of Investment. Principle of Unity of Investment

The Tribunal went on to examine what was the relevant «investment» for the purpose of determining jurisdiction. It stated that although Clause Two of the DEI Bermuda LSA, by its express terms, only referred to DEI Bermuda's US$200 million capital contribution to DEI Peru Holdings; that capital contribution was not the only relevant investment for the purpose of determining the Tribunal's jurisdiction. According to the Tribunal, the meaning of «investment» in the heading of Clause Three of the DEI Bermuda LSA, and for the purposes of Article 25 of the ICSID Convention, could not be restricted just to that transaction for the following reasons:

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[82] *Id. para*. 83.

[83] *Id. paras*. 87-8.

[84] *Id. para*. 89.

[85] *Id. para*. 90.

a) The capital contribution, without more, «would not appear to satisfy the requirement, under Peruvian law, that an «investment» in relation to which an LSA is granted, contribute to economically productive activity[86] (*i.e.*, that it be an «active» investment»)[87]; in fact,

> [u]nder Peruvian law, an investment is a capital contribution that seeks the development of the Peruvian economy. A capital contribution to a holding company must therefore be analyzed in its broader context. It is an operation carried out by a foreign investor in order to have interests and participate in a productive national enterprise. Similarly, any associated LSA must be analyzed in such broader context […] [T]hus, the integrity of the investment-protection regime in Peru requires that the tribunal look beyond the formalities of the holding-company structure of Duke Energy's investment in the country.[88]

b) The capital contribution was «not an isolated transaction, but was rather one of many transactions deliberately concluded as part of the privatization of Egenor [to provide complete protection to Duke Energy's investment in Egenor S.A.A.]»[89];

c) A narrow focus on «the wording of Clause Two of the DEI Bermuda LSA as an indication of the «investment» elevates form over substance, by ignoring the purpose of the capital contribution, which was described in the application DEI Bermuda submitted for the DEI Bermuda LSA referred to in Clause One thereof».[90] The application for each of the DEI Bermuda and DEI Peru Holdings LSAs explicitly stated that the purpose of the capital contribution from DEI Bermuda to DEI Peru Holdings was to permit the consolidation of Duke Energy's ownership interest in Egenor S.A.A. under DEI Peru Holdings.

d) In determining their jurisdiction, ICSID tribunals in similar situations «have recognized the unity of an investment even when that investment involves complex arrangements expressed in a number of successive and legally distinct agreements»[91]. In particular, this was the approach adopted by the tribunals in *Holiday Inns v. Morocco* and *CSOB v. Slovakia*.

On the basis of the foregoing, the Tribunal rejected Peru's objection to jurisdiction *ratione materiae*.

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[86] See Article 1 of the Foreign Investment Law at p. *supra*.

[87] Duke v. Peru, *para.* 92.

[88] *Id. para*s. 97-9. The Tribunal also concluded that he holding company structure would not change the fact that DEI Bermuda had made the investment.

[89] *Id. para.* 92. See also paras. 102-110.

[90] *Id. para*. 92.

[91] *Id. para*. 92.

4.2.2 Jurisdiction Ratione Personae

Peru also argued that DEI Bermuda, as an indirect owner of DEI Egenor through DEI Peru Holdings, lacked standing to bring a claim under Article 25(1) of the ICSID Convention. The Tribunal, however, noted that all Article 25 required was that the dispute before the Tribunal be between a Contracting State and a national of another Contracting State. These requirements were clearly met: Peru is a Contracting State to the ICSID Convention, and DEI Bermuda is a national of Bermuda which, through the United Kingdom, is a member of the ICSID Convention.

4.2.3 Jurisdiction Ratione Temporis

Peru further argued that the parties' dispute was outside of the Tribunal's jurisdiction *ratione temporis* because it addressed matters arising before the DEI Bermuda LSA entered into force. The Tribunal rejected Peru's argument on the grounds that the decisive point in time for the purpose of determining jurisdiction *ratione temporis* is when a legal dispute between the parties arose, not the point in time during which the factual matters on which the dispute was based took place. Here, the Tribunal found that the legal dispute arose when the tax assessments were imposed by SUNAT, which was after the entry into force of the DEI Bermuda LSA and hence the ICSID arbitration agreement between the parties[92].

4.3 The Tribunal's Analysis of the Admissibility of the Claims

Peru also argued that even if the Tribunal decided that it had jurisdiction, it nonetheless had to decline jurisdiction because DEI Bermuda's claims were «inadmissible,» given that the key issues in the dispute were already «fully resolved» within the Peruvian tax system by operation of the Peruvian Tax Court and Peru's Tax Amnesty Law[93].

With respect to the finality of the Tax Court decision on the Depreciation Rate Assessment, the Tribunal rejected Peru's arguments because the issues raised in the ICSID proceedings were different from those at issue before the Tax Court. The following facts further supported the Tribunal's decision in this respect:

— there was no commonality of parties (the parties to the Tax Court proceedings were DEI Egenor and SUNAT, while the parties to the arbitration were DEI Bermuda and Peru);

[92] *Id. paras*. 146-150.

[93] *Id. para*. 152.

— none of the issues in the arbitration (*i.e.*, the claims for breaches by Peru of the guarantees contained in the DEI Bermuda LSA) was, or could have been, within the purview or jurisdiction of the Tax Court;

— the Tax Court did not determine, nor could it determine, the tax regime that was stabilized for Claimant's investment under the DEI Bermuda LSA;

— the causes of action under the two proceedings arose from different laws and under different obligations;

— distinct relief is being sought under each of the proceedings; and

— for the purposes of adjudicating DEI Bermuda's claims, what the Tribunal had to determine was not whether the decision of the Tax Court is right or wrong as a matter of Peruvian Tax Law, but whether that interpretation of the law in 2004, confirming SUNAT's opinion of November 2001, is consistent with the rights stabilized for DEI Bermuda under its LSA[94].

In addition, the Tribunal found that by agreeing to international arbitration in the DEI Bermuda LSA, Peru affirmed «Claimant's right to a review by an ICSID tribunal of the matters considered by the Peruvian administration and court system, to the extent those matters fall within the guarantees contained in the DEI Bermuda LSA»[95].

The Tribunal determined that Peru's «admissibility» arguments with regard to DEI Egenor's availment of the Peruvian Tax Amnesty Law were purported defences on the merits, and accordingly joined them to the merits phase of the arbitration.

4.4 The Tribunal's Analysis of the Applicable Law

The Tribunal's finding with respect to the law applicable to the parties' dispute is also notable, as it clearly recognized the supervening control of international law in the event there is a conflict between Peruvian and international law. In this regard the Tribunal stated that:

> Respondent argues that the Tribunal must apply Peruvian law to resolve this dispute. In fact, the question of the applicable law to the merits of this case is somewhat more complicated. The DEI Bermuda LSA contains no specific provision regarding the applicable substantive law. In such circumstances, Article 42(1) of the ICSID Convention requires the Tribunal to apply «the law of the

[94] *Id. para*. 159.

[95] *Id. para*. 160.

> Contracting State party to the dispute (including its rules on conflicts of laws) and such rules of international law as may be applicable». Furthermore, even if the law of Peru were held to apply to the interpretation of the DEI Bermuda LSA, this Tribunal has the authority and duty to subject Peruvian law to the supervening control of international law[96].

4.5 The Tribunal's Observations Regarding Peru's Foreign Investment Framework and Legal Stability System

The Tribunal recognized that the enactment of the Foreign Investment Law, the Privatization Law and the Private Investment Law had taken place within the context of the Peruvian Government's effort to attract and promote investment in the country[97]. Pursuant to the provisions of the Foreign Investment Law and the Private Investment Law, the Peruvian Government is authorized to enter into LSAs with foreign investors[98]. The Tribunal observed that, under Peruvian law, the investment protections contained in the LSAs are subject to the principle of *Contrato-Ley* and are guaranteed by the Constitution[99]. Thus, the stabilized legal regimes provided for in the agreements cannot be changed unilaterally by the State, and are enforceable against the State as if it were a private party[100].

In analyzing the nature and role that LSAs play within the Peruvian investment regime, the Tribunal recognized that several such agreements may be related inasmuch as each of them is meant to protect the same ultimate investment in the Peruvian economy. As noted above, it was this recognition that allowed the Tribunal to look beyond the narrow wording of the DEI Bermuda LSA and instead consider the purpose of that agreement in light of related, but legally distinct, LSAs. Pursuant to that consideration, the Tribunal held that the Peruvian Government had «granted its approval for the DEI Bermuda LSA because it was part and parcel of the investment being made by Duke Energy in DEI Egenor»[101], even though the LSA in question did not specifically mention the latter company. Likewise, the Tribunal found that «Duke Energy, through various subsidiaries, entered into various LSAs as part of a single, concerted effort

[96] *Id. para*. 162.
[97] *Id. para.* 24-25.
[98] *Id. para*. 26.
[99] *Id. para.* 28-30.
[100] *Id. para*. 31.
[101] *Id. para*. 99.

[…] to obtain complete protection for its investment in Egenor, S.A.A.»[102]. As mentioned above, it is because the Tribunal found that both parties' purposes in entering into the DEI Bermuda LSA were related to the protection of Duke Energy's interest in DEI Egenor, the Tribunal found that the DEI Bermuda LSA could serve as the basis for an arbitration arising out of actions taken against DEI Egenor. Further, the Tribunal held that while the guarantees contained in the DEI Bermuda LSA would serve as the basis for Duke's claims in the arbitration, its «lack of jurisdiction over the other LSAs will not prevent it from taking them into consideration for the purposes of the interpretation and application of the DEI Bermuda LSA»[103].

Given the findings outlined above, the Tribunal's decision on jurisdiction indicates an understanding that LSAs form an integral part of the Peruvian plan to promote foreign investment, and must therefore be interpreted in a manner that ensures such investments receive the highest level of comprehensive protection that could be reasonably expected by the agreements' signatories.

A Final Thought

Whatever the final outcome of the *Duke v. Peru* arbitration on the merits, one thing is clear: the Tribunal's analysis and findings relating to the operation and effect of the Peruvian foreign investment framework in general, and legal stability system in particular, have given substance to a heretofore undefined skeleton. Prior to the Tribunal's evaluation of the parties' respective arguments and evidence, there was little guidance available, whether from scholars or the Peruvian State itself, regarding the scope of the protections available to foreign investors and investment in Peru. This is now no longer the case. Today, it is clear that the Peruvian State's responsibility to a foreign investor will be judged, not only pursuant to the specific terms of the country's foreign investment laws and legal stability framework, but also customary international law and the minimum standard. In large part, how the Tribunal ultimately ruled is a reflection of its appreciation and respect for the lucid.

[102] *Id. para*. 102.
[103] *Id. para*. 133.

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