Topic: Investment and Climate Change

Overview

What is international investment law?

The international law on foreign investment is created primarily by international investment agreements (IIAs). IIAs are treaties between two or more countries containing provisions designed to protect and promote investment. IIAs include multilateral treaties between countries within one or more regions (e.g., the COMESA Common Investment Area IIA\(^1\)), sector-specific multilateral treaties (e.g., the Energy Charter Treaty) and investment chapters in regional trade agreements (e.g., the North American Free Trade Agreement. However, by far the most numerous type of IIAs are bilateral investment treaties (BITs)—of which there are now over 2,600 worldwide!

Member States of the World Trade Organization (WTO) considered the establishment of a multilateral investment agreement in the initial stages of the Doha Development Agenda but the topic was later removed because of a lack of consensus on launching negotiations. The WTO’s 1995 General Agreement on Trade in Services (GATS) could in part be seen as an IIA dealing with investment in the services sectors, but as it covers only national treatment and market access, it provides much more limited investor protections than typical IIAs. The WTO’s Agreement on Trade-Related Investment Measures (TRIMS) requires that Member States’ regulations on foreign investment respect the national treatment and prohibition on quantitative restrictions contained in the 1994 General Agreement on Tariffs and Trade. Like the GATS, the TRIMS Agreement provides only limited investor protections and the majority of international investment law extrudes from the “spaghetti bowl” of IIAs.

What are the key elements of international investment law relevant to climate change?

All IIAs guarantee the investor certain protections after it has made its investment in the host state (sometimes referred to as the “post-establishment” rights). Some IIAs also guarantee the investor protections before it has made its investment in the host state (often called “pre-establishment” rights).\(^2\)

Investor protections typically provided by IIAs after the investment has been made include provisions on national treatment, most favoured nation treatment, fair and equitable treatment and expropriation. Some IIAs also prohibit the host state from imposing performance requirements on the investor.

Investor protections typically provided by IIAs before the investment has been made include provisions on national treatment and most favoured nation treatment.

**National treatment** requires the host state to treat the foreign investor no less favourably than it treats its domestic investors. **Most favoured nation treatment** requires the host state to treat the foreign investor no less favourably than it treats a foreign investor from any other country.

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\(^1\) Common Market for Eastern and Southern Africa

\(^2\) Countries which include pre-establishment rights in their IIAs include the United States, Canada and more recently several Asian countries including Japan and South Korea.
Originally, **fair and equitable treatment** covered actions by the host government that were so unfair and inequitable as to shock the conscience of the objective observer. However, its meaning has expanded considerably over the years. It is now considered to include both procedural fairness requirements (such as transparency) and an obligation to comply with the legitimate expectations of the investor when it made its investment.

**Expropriation** occurs when the host state takes the investment from the investor. IIAs allow the host state to expropriate investments but only for a public purpose and upon payment of the specified measure of compensation. Originally, expropriation required the host state to take physical control of the investment (e.g., through nationalizing the investment). However, most modern IIAs also include indirect and “creeping” expropriation. Indirect expropriation occurs when the host state takes some action that, although not taking physical control of the investment, substantially deprives the investor of the benefit of its investment. A creeping expropriation occurs when a series of host state actions cumulatively add up to substantially deprive the investor of the benefit of its investment.

Some IIAs forbid the host state imposing performance requirements on the investor. For example, the IIA may prohibit the host state from requiring that the investor employ local labour, use local raw materials or sell a certain portion of its product to the local market.
How is investment law enforced?

The vast majority of IIAs give investors the right to take the host state to international arbitration if the investor considers that the host state has breached any of its rights under the IIA. These arbitrations are commonly called investor-state arbitrations. This puts the investor in an unparalleled position in international law. Under international law, states can usually only be sued by other states.

The numbers of investor-state arbitrations have grown exponentially in the last decade. The arbitration awards are binding and generally cannot be appealed. The amount of compensation awarded to investors if they are successful can be substantial — there have been an increasing number of awards over US$100 million in the last few years.

The investor-state process is also notable for the lack of transparency under which the arbitrations are typically conducted. With the exception of arbitrations registered at the World Bank’s International Centre for Settlement of Investment Disputes (ICSID), there is no public record of cases filed by investors, let alone what they are about, and even the final award will only be made public if one—or under some arbitration rules, both—of the parties agree to do so.

What types of measures might be covered? How might they lead to breaches?

Host states might take various measures to address climate change, including:

- Promoting new investment that uses clean, climate-friendly technologies;
- Requiring existing enterprises to limit their GHG emissions;
- Requiring the closure or significant retrofit of facilities with high GHG emissions;
- Adaptation-related policies such as rationing water usage or imposing energy-access requirements.

However, all of the above could potentially be challenged by an investor through arbitration proceedings brought under an IIA.

**i. Promoting new investment that uses clean, climate-friendly technologies**

New investment that uses clean technologies could be promoted through either “carrots” or “sticks.” The host state could use subsidies, tax incentives, locational advantages, government procurement to positively discriminate in favour of clean investments. Alternatively, the host state could ban or penalize new investment that uses unclean technologies.

The majority of IIAs do not give investors rights before they have invested — that is to say, in the pre-establishment stage. Thus, under most IIAs, host states will be safe to favour the establishment of clean investment and discriminate against the establishment of unclean investment as they see fit.

However, the small but growing number of host states that are party to IIAs that provide investors with rights of national treatment and most favoured nation treatment in the pre-establishment stage must ensure that they treat investors covered by their IIAs no less favourably than they treat investors from other countries and domestic investors in “like circumstances.”

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3 From 385 in 1989 to 2,608 by the end of 2007, according to the United Nations Commission on Trade and Development (UNCTAD).
4 Although the tribunal awards cannot be appealed for mistake of fact or law, there are some narrow grounds for seeking an annulment (e.g., if the tribunal failed to give reasons).
What are “like circumstances”? The case law on this is not settled. It is clear that two enterprises engaged in the same activity and using the same technology are in “like circumstances” and the host state cannot treat the enterprise covered by the IIA less favourably than the other enterprise. What if two enterprises are engaged in the same activity but one uses unclean technology and the other clean technology? In early investor-state arbitrations, the key issue was whether the two enterprises were in competition with one another, in which case they were considered in “like circumstances” and the host state would not have been entitled to discriminate on the basis of clean or unclean technology. However, a more recent case has held that host states are entitled to discriminate between enterprises on the basis of public policy, for example, environmental grounds (e.g., Parkerings-Compagniet v. Lithuania, 2007).

It is less clear whether host states are entitled to discriminate between clean technologies, for example between enterprises using solar or wind energy. Local factors, such as the impact of a wind turbine on migrating birds, might mean the two technologies would not be considered in like circumstances. But absent particular local factors, the scope for discriminating between clean technologies will be less than between clean and unclean energy sources.

**ii. Requiring existing enterprises to limit their GHG emissions**

This may take various forms, for example, a cap of GHG emissions, requiring existing facilities to improve their energy efficiency or to reduce their use of non-renewable energy. Such measures could potentially breach IIAs in four ways—as violations of provisions on national treatment, most favoured nation treatment, fair and equitable treatment and expropriation.

So long as the measure affecting investors covered by the IIA applies equally to domestic investors and investors from third states, it should not breach the IIA’s national treatment or most favoured nation provisions.

**Fair and equitable treatment** – While investors must normally recognize that the host state’s regulatory framework may change over time, if the host state has given the investor a commitment to keep its law unchanged, its promise can be enforced through the fair and equitable treatment standard as a breach of the investor’s legitimate expectations.

Such commitments are known as “stabilization clauses” because they stabilize the legal situation for the investor. Stabilization clauses are often included in concession contracts between host states and large investors. The result is that the investor is entitled to continue its climate-unfriendly activities regardless of the effect that the investor’s regulatory non-compliance may have on the public welfare.

As well as the legitimate expectations of investors, the fair and equitable treatment standard requires the host state to adhere to due process in the making and implementation of administrative decisions. Arbitral tribunals have held due process to include a duty not to discriminate against the investor, to be transparent, to be consistent, not to use government powers for improper purposes, not to act in bad faith and not to coerce or harass the investor. So long as the host state follows due process in the adoption and implementation of its GHG regulations, the fair and equitable treatment standard should not be breached (unless the host state has promised not to change the law, as discussed above).
Expropriation – In deciding whether the host state’s action was an expropriation, some investor-state cases have held that the purpose of the host state’s action (e.g., to address climate change) is irrelevant and the economic effect on the investment is the sole element to consider (e.g., Metalclad v. Mexico, 2000). In contrast, several more recent cases have held that as a matter of general international law, a non-discriminatory regulation for a public purpose is not an expropriation unless the host state has promised the investor that it would refrain from such regulation (e.g., Methanex v. United States, 2005).

These two lines of cases cannot be reconciled. Thus, it is not possible to say with certainty that regulations to address climate change will not run into conflict with expropriation provisions in IIAs. To address this uncertainty, a small but growing number of IIAs expressly specify that a public welfare measures will not amount to an expropriation.5

Even if arbitral tribunals prefer the Metalclad “sole effects” doctrine to the Methanex “police powers” rule, whether host state regulations to limit GHG emissions will be found to be expropriatory will depend on their impact on the investment. Not every impact on the investment will amount to an expropriation. Typically, the measure must have substantially deprived the investor of the benefit of its investment.

iii. Closing existing facilities or requiring significant retrofits
Requiring aging or technologically unclean facilities to be closed or significantly refitted will have a significantly greater impact on an investment than the other measures discussed so far. It is clear that such requirements could have a major impact on the ownership rights of an investment and as a result could breach an IIA in several ways: first, as an indirect expropriation if it substantially deprives the investor of the benefit of its investment expropriation; second, as a breach of fair and equitable treatment if it denies the investor its legitimate expectation to be able to operate, and profit from, the facility until the normal end of the lifespan of the facility. If the underlying investment contract contains a stabilization clause, that will make the host state’s position even more difficult.

However, such an outcome is not satisfactory from a climate change perspective. It means that IIAs could prevent a host state from taking action against, or else require it to pay compensation to, older facilities where smaller adjustments or retrofits would not achieve the necessary standards. As a result, such facilities may be able to avoid environmental regulation no matter how harmful their activities are to others. This is clearly not an acceptable outcome.

In light of some recent cases, a measure clearly designed to address the environmental impacts of outdated facilities should fall within the “police powers” exemption to expropriation. It should also escape coverage of the fair and equitable treatment obligation, if it is transparent and non-discriminatory. The clarity of the climate change goal will be essential. But the matter is by no means certain, and the greater the degree of interference with the right to operate an investment, the greater the uncertainty for the host state.

iv. Adaptation-related policies
As the effects of climate change become more apparent, vulnerable countries will increasingly need policies to adapt. Although the specific adaptations needed are difficult to predict, possible

5 For example IIAs from Canada, United States, Norway and the IIA for the Common Market of Eastern and Southern Africa Common Investment Area.
policies include the need to re-allocate or ration water usage or to impose energy access requirements.

The likelihood that such policies will breach a country’s IIAs will depend on the way in which the policies are adopted and implemented, the government’s promises to the investor, the level of impact on the investor and whether or not the IIA prohibits performance requirements. If the policies are applied equally to the investor covered by the IIA as to domestic investors and investors from other countries, there should be no breach of the IIA’s national treatment or most favoured nation standards. So long as the host state applies the policies in a procedurally fair and transparent manner and has not promised the investor to keep the regulatory framework unchanged, there should be no breach of the fair and equitable treatment. As long as the policies do not substantially deprive the investor of the benefit of its investment there should be no expropriation. If the policies do substantially deprive the investor of the benefit of its investment, whether the IIA is breached will depend on whether the arbitral tribunal follows the Metalclad “sole effects” doctrine or the Methanex “police powers” exemption discussed above. A policy that imposes energy access requirements may be in breach of those countries’ IIAs that prohibit performance requirements.

Even if an IIA’s fair and equitable treatment, expropriation or performance requirements provisions appear breached, it may still be possible for the host state to defend the claim against it on the grounds of necessity. That is, that the host state’s need to take action in response to the threat of climate change was so urgent as to amount to a state of emergency. Necessity is included as a defence in some IIAs, but even if it is not, the host state may still be able to rely on the principle as part of customary international law. No investor-state cases have considered a defence of necessity in the environmental context so far. However, in cases dealing with other types of emergencies, tribunals have set the bar for what amounts to necessity at a very high level.6

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6 For example, Argentina claimed a defence of necessity with respect to arbitrations against it by investors who had suffered losses as a result of measures it had taken during its 2001-2002 financial crisis. The majority of tribunals thus far have denied Argentina its necessity defence.
Key issues

What is the potential for investment law to impede the achievement of climate change objectives?

From the above discussion, it is clear that IIAs have the potential to impact on countries’ implementation of their climate change policies, as far as those policies impact on investors. For the majority of countries (whose IIAs do not include pre-establishment rights for investors), IIAs will not prevent them from promoting new investment that uses clean technology and discriminating against new investment that uses unclean technology. Those countries whose IIAs do include pre-establishment rights will need to ensure that they do not treat new investors covered by the IIA less favourably than investors from other countries or domestic investors in like circumstances.

For investors already set up in the host state, the likelihood that policies to achieve climate change objectives will breach a country’s IIAs will depend on the level of impact on the investor, the clarity of the climate change objectives, the way in which the policies are adopted and implemented, any promises made by the host state to the investor, and whether or not the IIA prohibits performance requirements. As long as the policies do not discriminate between investors covered by the IIA and domestic investors/investors from other countries, the IIA’s provisions on national treatment and most favoured nation should not be breached. To the extent that the host state applies the policies in a procedurally fair and transparent manner and has not promised the investor to keep the regulatory framework unchanged, there should be no breach of the fair and equitable treatment. To the extent that the policies do not substantially deprive investors of the benefit of their investments there should be no expropriation. If the policies do substantially deprive investors of the benefit of their investment, whether this would be held by an arbitral tribunal to be an expropriation, will greatly depend on the tribunal’s preference between the Metalclad v. Mexico (2000) “sole effects” doctrine or the Methanex v. United States (2005) “police powers” exemption.

Depending on a country’s vulnerability to climate change, it may be able to defend a claim against it by convincing the tribunal that, while its actions to address climate change were technically in breach of the IIA, it should be excused from liability for reason of necessity. Although no tribunal to date has considered a defence of necessity on environmental grounds, tribunals have set the threshold in other contexts very high.

However, the potential for international investment law to hamper the achievement of climate change objectives extends beyond actual investor-state disputes—even the threat of such disputes may do so. This is known as the “chilling effect.” It occurs when host states step away from adopting proposed public welfare measures for fear that an arbitral tribunal may subsequently hold the measures to be in breach of their obligations to foreign investors under their IIAs.

How might investment law lead to good results from a climate-change perspective?

Although investment law has the potential to hamper climate-change objectives, it could also be used to support these objectives. As most IIAs do not prevent host states from imposing admission requirements on new investment as they see fit, host states can use their admission and screening mechanisms to promote investment that uses clean energy and clean technologies, carbon-
neutral or carbon-trapping investments such as reforestation projects and Kyoto Protocol Clean Development Mechanism (CDM) projects.

To qualify as a CDM, a project must be located in a developing country that has acceded to the Kyoto Protocol, must lead to long-term emissions reduction, must assist in achieving sustainable development, must lead to technology transfer and contain additionality (i.e., not just a business-as-usual project). If these criteria are met, the CDM will result in tradable certified emissions reductions or carbon credits.

Host states could also require, as a condition of establishment, new investors to agree to technology transfer commitments.

Although host states need to tread more carefully in dealing with existing investors, it is still possible for them to promote climate change objectives within certain limits. So long as the host state has not promised investors to keep its regulatory framework unchanged, the climate change measures are adopted and implemented in accordance with due process, the host state does not treat investors covered by its IIAs less favourably than investors from other countries and domestic investors in like circumstances, and the measures do not substantially deprive covered investors of the benefit of their investments, the host state should be on safe ground.

Government investment negotiators should coordinate with their government's climate change negotiators to ensure that IIAs and domestic investment laws are drafted so as to provide opportunities and not obstacles to furthering climate change objectives, and vice versa that climate change policy provides opportunities and not obstacles to foreign investment.
Related resources

UNCTAD IIA database

WTO Agreement on Trade Related Investment Measures

WTO General Agreement on Trade in Services

COMESA Common Investment Area IIA

Energy Charter Treaty

North American Free Trade Agreement
http://www.nafta-sec-ala.org/DefaultSite/index_e.aspx?DetailID=78
Further reading


*Parkerings Compagniet v. Lithuania*, ICSID Case No. ARB/05/8, award, 11 September, 2007.
