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**Background paper on
Vattenfall v. Germany arbitration**

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1. Background

In April 2009 the Swedish energy utility Vattenfall brought the German government to international arbitration¹. The arbitration challenges environmental restrictions imposed on a €2.6 billion coal-fired power plant being under construction along the banks of the Elbe River. While it is reported that Vattenfall is suing Germany for several millions of Euros, the exact amount and reasons for the challenge remain unknown because the arbitration is proceeding entirely in secret, at the choice of the parties.

The challenge is taking place at the World Bank's International Centre for the Settlement of Investment Disputes (ICSID)² under the terms of the Energy Charter Treaty³. It follows a bumpy relationship between the investor Vattenfall and the city of Hamburg.

Ever since Vattenfall first announced its plan to build the coal-fired power plant in 2004, the project has stirred controversy on a number of fronts. A coalition of environmental and political groups have maintained that the plant would be far larger than what is needed to meet Hamburg's energy needs, and would take an unnecessarily destructive toll on the environment. It is argued that a variety of smaller, more environmentally friendly alternatives exist. In October 2007, some 12,000 citizens signed a petition objecting to the power plant.

Despite the public opposition, the City of Hamburg agreed to a provisional contract with Vattenfall in 2007 for the construction of the plant, which included certain environmental limits on the impact of the plant on waters in the Elbe River. The terms of the contract were, however, made dependant on the final permit. Hamburg's Urban Development and Environment Authority (BSU) then issued a preliminary ("vorläufige") construction permit in November 2007, allowing Vattenfall to proceed with certain aspects of construction. Final approval was granted in September 2008, and included additional restrictions on the power plant's impact on the Elbe River. (i.e., impact on water volume, temperature, and oxygen content). It is these additional measures relating to water quality in the Elbe River that appear to be at the heart of the dispute.

According to the City of Hamburg, the conditions stipulated in the water permit are necessary under European Law, and are consistent with the restrictions required of all industry along the Elbe River. Hamburg has explained that it is striving to meet the EU's Water Framework Directive, which requires all EU Member States to ensure certain levels of water quality in rivers, lakes, estuaries, coastal waters and groundwater by 2015. Vattenfall, however, counters that the water regulations

¹ Vattenfall AB, Vattenfall Europe AG, Vattenfall Europe Generation AG v. Federal Republic of Germany (ICSID Case No. ARB/09/6)

² <http://icsid.worldbank.org/ICSID/FrontServlet>

³ <http://www.encharter.org/>

would make the plant impractical and uneconomical, and go beyond what was agreed to in the 2007 contract with the City of Hamburg.

By imposing a more stringent standard in the final construction permit, Vattenfall alleges that Germany has violated an international agreement called the Energy Charter Treaty, a multilateral agreement that governs among other things investments in the energy sector. Germany ratified the Treaty in 1997. Although Vattenfall's complaint is essentially with the City of Hamburg, it is the federal government of Germany that is liable under the Energy Charter Treaty.

This short paper will look at how the above situation has translated into an international arbitration, how international arbitration works, and how it affects environmental law making, including in the energy sector.

2. How can Germany be sued under international law in a three-person tribunal?

To date the Energy Charter Treaty has fifty-two Signatories, having been signed to by fifty-one states plus the European Communities. The Energy Charter Treaty provides broad protection to foreign investors in the energy sector, such as guarantees of “fair and equitable treatment” and guaranteed compensation in case of expropriation. It also gives investors from one party to the Treaty the right to sue other parties to the treaty in whose territory they make an investment. Therefore a three-person tribunal (Schiedsgericht) will determine whether Germany has violated the terms of the Energy Charter Treaty by imposing stringent environmental standards on the construction of Vattenfall's power plant.

The Energy Charter Treaty does not have its own tribunal or court as does the World Trade Organization (WTO). Instead, the Treaty allows for either ad hoc arbitration under UN Rules without any institutional framework, the World Bank's International Center on the Settlement of Investment Disputes, or the Arbitration Institute of the Stockholm Chamber of Commerce to administer the dispute. Vattenfall chose to bring the case to ICSID.

Vattenfall and Germany have refused to comment publicly about the arbitration, so that most aspects of the case are unknown. Among the unknowns are the legal arguments that Vattenfall is employing to substantiate its claim. The firm has also not disclosed what sort of “relief” it is seeking through international arbitration, including monetary damages. The German Federal Ministry of Economics and Technology, which is responsible for handling the case, has remained resolutely silent on the matter despite the obvious public welfare issues and the public interest in the arbitration. Apart from saying that it is in talks with Vattenfall in an effort to reach an amicable settlement, the German government has offered no specifics on the dispute.

3. Situating the Energy Charter Treaty in the universe of investment treaties

While the Energy Charter Treaty provides investment protection in a specific sector and Germany is bound by this treaty, it is not the only investment treaty that binds Germany. In fact, the first modern bilateral investment treaty was entered into between Germany and Pakistan in 1959. That treaty became the model for what is now over 3000 investment treaties concluded around the globe. Germany's 1959 investment treaty did not have one important feature, however: It did not give the foreign investor the right to directly sue the state hosting the investment. The more recent treaties, including the Energy Charter Treaty, typically allow for private parties (investors) to directly initiate arbitration with host states, using what is known as an investor-state dispute mechanism. This procedure contrasts with the process for trade law disputes, for example in the WTO, which are strictly state-to-state.

Today, Germany has over 130 bilateral investment treaties, making it the country with the largest number of such treaties in the world. Since the older German bilateral agreements do not provide investors the right to sue, Germany is in process of re-negotiating its older investment treaties to incorporate this right.

The right to sue was increasingly incorporated in investment treaties beginning in the 1980s, but it was only in the late nineties that foreign investors began to increasingly and aggressively sue host states under these treaties. Often, investors use investment treaties in ways that can catch the host state by surprise, as in the dispute initiated by Vattenfall against Germany. Well over 300 arbitrations are known to have been launched under these treaties, almost all of them since 1997. The total number of cases is unknown due to the secrecy in the system.

4. Protections given to foreign investments

Although their precise wordings differ, investment treaties, including the Energy Charter Treaty, bind each contracting state to provide certain standards of treatment to investors from the other contracting states. Typically, these standards, all of which are also among the standards guaranteed in the Energy Charter Treaty, include:

- (a) The host State (in this case Germany) must treat foreign investors of the home State (in this case the Swedish investor Vattenfall) no less favorably than its own investors;
- (b) The host State (Germany) must treat the foreign investor of the home State (Vattenfall) no less favorably than it treats investors from other states;
- (c) The host State (Germany) must compensate for expropriation (Enteignung); and
- (d) The host State (Germany) must at all times treat the foreign investor of the home State (Vattenfall) in a "fair and equitable" manner.

At first glance, all of these obligations appear reasonable and fair. The problem is that it is impossible to predict what they will actually mean to any specific tribunal called upon to apply them to a specific case. Tribunals interpreting the same obligations have come to completely different conclusions. Many have interpreted the obligations broadly, expanding the protection provided to investors. The protection provided in investment treaties therefore often widely surpasses the protection of domestic investors – even in industrialized countries, such as Germany: A German investor would have had only German laws and courts available. It is not by chance that Vattenfall initiated a proceeding against Germany in an international tribunal rather than in German courts. Arbitration under ICSID provides investors with extensive guarantees not available at the national level. Had the investor been German, it would not have had this option.

5. Possible basis for claims in Vattenfall v Germany

Since all the documents in this arbitration are confidential, including the notice of arbitration, the basis for the claims in *Vattenfall v Germany* remain unknown to the public. However, based on past experience gained in other arbitrations involving environmental regulation, it is likely that the issues of expropriation, and/or fair and equitable treatment are the key issues in dispute.

Expropriation and compensation

Take for example the issue of expropriation. Under German law and the jurisprudence of the *Bundesverfassungsgericht* the scope of expropriation is limited to the intentional physical confiscation of property for the fulfillment of a public task by or pursuant to a law. The constitutional guarantee of the Grundgesetz therefore only applies to so-called direct expropriations. So-called “regulatory expropriations”, such as the imposition of environmental standards under the EU’s Framework Directive on Water or greenhouse gas emission reduction commitments are excluded from the definition of “expropriation”. At the same time, certain types of interferences with property, though not amounting to a formal expropriation might still trigger an obligation for the state to compensate losses (“*Ausgleichspflicht*”). However, because German law defines property in light of its “social obligations”, the obligation of the State to compensate remains limited. Under the Grundgesetz each owner is, in fact, expected to use his or her property in a way that takes due account of public interest. When safeguarding the public interest, the legislator is obliged to strike a proportionate balance between the public interest and the individual interest of the owner when adopting regulation to define content and limits of property. Since the Grundgesetz directs the State to be committed to the protection of “*the natural basis of life*”, ecological considerations have gained additional weight among other public interest considerations and can be seen as part of the social function of the property. As a consequence, the need for the government to compensate the negative impacts of environmental legislation is extremely restricted.

The dominant case law under investment treaties on the other hand has taken the exact opposite approach, applying the so-called sole-effects test. Under that test, tribunals deem irrelevant the intent of host States when assessing if a regulation is expropriatory and compensable. It focuses exclusively or primarily on the effects of regulation on foreign investments, and is oblivious to the form and intent of the governmental measure. By contrast, the German Grundgesetz, typically does not require compensation because each owner is, in fact, expected to use his/her property in a way that takes due account of public interest, such as environmental protection.

Other tribunals have taken an approach that is more aligned with that of the German Grundgesetz.

This line of cases, which hold that these types of regulatory measures are not expropriatory and therefore not subject to compensation, ensure that governments can continue to regulate in a normal manner even when an investment treaty is in place.

It is impossible to speculate which approach will be taken in the Vattenfall v Germany arbitration, since this depends entirely on the composition of the tribunal.

Fair and equitable treatment

The Energy Charter Treaty commits host States – like many other investment treaties - to accord fair and equitable treatment at all times to investments of investors of other State parties. Similarly, fairness and equity are fundamental principles in virtually every legal system of the world. However, the rapid rise of investor-state arbitrations has revealed the complexity behind this seemingly simple phrase at the international level. Respondent states in investor-state arbitrations have discovered that the fair and equitable provision can result in expansive obligations imposing a high threshold of protection in favour of the investor. In fact, the “fair and equitable” treatment standard has emerged as “a catch all” provision used by investors to challenge a range of state conduct that has been adverse to the investor’s investment.

For example, host States have been found to violate the fair and equitable treatment obligation for a failure to act in a transparent manner in administrative decision-making. Other violations have been found in the inconsistent actions of host state agencies vis-à-vis the investor, such as the encouragement and approval of the investment by one agency and the denial of the necessary zoning permits by another. While these actions are surely not desirable, their consequences are likely to be much more significant and costly in international arbitration. Another important element tribunals have considered in determining whether or not there was a violation of the fair and equitable treatment standard is the notion of the “legitimate expectation of the investor”. The tribunal in the ICSID case *Tecmed v Mexico*, for example, stated that the host State must provide to the investor: “*treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment.*”

The Tribunal continued:

“The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations.”

6. Implications of international investment arbitration for environmental law and policy making

Germany’s well over 130 investment treaties, including the Energy Charter Treaty, have important implications for environmental regulation and policy in Germany and partner States. In particular, changes in policies or laws which have adverse implications on a foreign investor may be challenged in international tribunals for violating the fair and equitable standard, or constituting a compensatory expropriation. As a result, international investment law may require compensation for investors where German law would not.

The present case is particularly troubling, given that the water regulations appear to be an implementation of EU-wide law. With future measures on climate change soon to be agreed at the international level, one must wonder if this is a prelude to the arbitration of measures not just in Germany but any state that takes the measures necessary to implement new global standards and targets. Where even the implementation of internationally agreed measures is subject to challenge, this makes environmental regulation and policy-setting especially difficult where a government makes environmental commitments at the regional or global levels, whether to reduce greenhouse emissions or to protect water sources in Europe.

Many environmental laws and policies have been challenged under investment treaties, including the bans of various chemicals for environmental reasons (for example, a gasoline additive and a type of lawn pesticide); a permit refusal for a hazardous waste landfill; an export ban on PCB waste; or measures requiring open-pit metallic mines to backfill. Though not all claims have been successful and many are still pending or have been settled, the problems for environmental regulation and policy setting remain. The dispersed system of tribunals makes it impossible to rely on past decision or to predict future decisions of other tribunals. Moreover, the threat of an arbitration can have a so-called regulatory chill effect, seeking either lower standards to be applied or no standards at all. The settlement negotiations apparently taking place now with Vattenfall may raise such a concern. Finally, even where governments win, they may well be left with very significant arbitration costs.

7. Conclusion

Vattenfall v Germany has brought Germany's international investment policies to the attention of local decision-makers and the public. Unfortunately, international investment arbitration is now conducted behind closed doors in Germany, leaving citizens to speculate what is at issue in the dispute and how much tax-payer money Germany might have to pay. This lack of transparency has been addressed by other States that have been sued under international investment treaties: the United States, Canada and Mexico as well as a number of other States have amended their treaties and laws to make all phases and documents in investment disputes public. Nothing in the ICSID Arbitration Rules inherently imposes such secrecy. Moreover, in order to avoid broad interpretations of standards such the fair and equitable standard or expropriation, many countries have begun using more restrictive language in their investment treaties. Germany has not yet taken any of these steps, perhaps because until today Germany has not been sued (to public knowledge). Given the extensive net of investment treaties Germany has concluded, and given Germany's generally strong environmental leadership position, it is likely that this case will not be the last.