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Abstract:
From a climate perspective, not all investment is equal. Desirable investment in clean energy needs encouragement and protection, while undesirable investment in fossil fuels needs clear policy signals to avoid further investment in destructive activities and stranding more assets. In this paper, evidence is presented on how foreign investor protection provisions in trade and investment agreements tilt the playing field in favor of entrenched incumbents and against urgent action on climate; on the potential for a massive expansion of investor-state litigation and risks to climate policy in proposed trade deals; and on key flaws in recent European Commission proposals to reform investor-state dispute settlement (ISDS).

Keywords:
Climate change, foreign investor protection, investor-state dispute settlement.

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To respond to climate change, the world needs to shift rapidly from high-carbon assets, especially fossil fuel resources and related infrastructure, into clean energy. This will require a massive change in investment and the adoption of public policies to support and incentivize the right kinds of investment.

From a climate perspective, not all investment is equal. Desirable investment in clean energy needs encouragement and protection, while undesirable investment in fossil fuels needs clear policy signals to avoid further investment in destructive activities and stranding more assets. Similarly, over-investment in fossil fuel infrastructure creates both massive emissions and roadblocks to climate action.

In theory, trade and investment agreements are supposed to protect all forms of foreign investment, including from new laws and regulations that affect the future revenue stream. For this purpose, they use arguably the most powerful legal mechanisms known to international law today: investor-state dispute settlement, or ISDS. This “climate blind” mechanism presents a problem as not all forms of investment are compatible with a stable climate. ISDS puts a priority on foreign investment protection that skews the playing field in favour of larger incumbents in the resource sector at the expense of domestic investors and smaller players in alternative energy.

ISDS gives foreign investors alone a special right to bring costly claims against countries when they introduce new laws and regulations. As explained below, ISDS is broadly and expansively framed, lending itself to sweeping challenges in the most climate sensitive areas of public policy: resource extraction, and public and environmental health. In turn, ISDS gives a powerful tool for one or a few large fossil fuel companies to frustrate climate change action. As recent revelations about Exxon have suggested, such companies can play an important role in delaying decisive action on the climate challenge.

ISDS can be understood as a system of public insurance for foreign investors. With ISDS, foreign investors are entitled to compensation for the value of their assets – including future revenues – against “risks” of democratic and political decision-making. If a legitimate public policy or measure creates costs for a foreign investor, e.g. to reduce greenhouse gas pollution, the investor can sue for compensation. This set-up inverts the “polluter pays” principle; due to ISDS, polluters have had to be paid from public funds after they were required, in effect, to stop polluting. With the risk of uncertain, uncapped financial liability in ISDS, governments face a powerful deterrent to pursuing and fulfilling their climate change responsibilities.

These are not idle concerns. Foreign investors have used ISDS already to challenge government decisions to phase-out nuclear energy (Vattenfall v Germany No 2), limit industrial gold mining (PacRim), etc.
v El Salvador), restrict a gasoline additive in order to protect auto emissions control systems (Ethyl v Canada), and ban gas fracturing in a major river and estuary (Lone Pine v Canada). The presence of these and other cases shows how major companies can use ISDS to frustrate regulatory changes that they oppose. As one Washington, D.C.-based law firm put it in a client advisory:

“Investment treaty protections should be carefully considered by foreign investors operating in the energy sector.... It may well be possible to use such protections as a tool to assist lobbying efforts to prevent wrongful regulatory change, or they may prove essential in obtaining compensation.”

In short, foreign investment protection in trade and investment agreements creates a potentially massive roadblock to successful climate policy at all levels of government. Though trade and investment agreements could play a positive role to support climate action, at present they do the opposite by creating incentives for governments to avoid climate action because of the financial risks of ISDS.

In the brief that follows, evidence is presented on how ISDS tilts the playing field in favor of entrenched incumbents and against urgent action on climate; on the potential for a massive expansion of ISDS litigation and risks to climate policy in proposed trade deals; and on key flaws in recent European Commission proposals to reform ISDS. For one step that could be taken to prevent ISDS from being used to frustrate climate action, see this proposal for an ISDS carve-out in a multilateral climate change agreement: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2663504.

**ISDS distorts the market in favour of bigger incumbents**

ISDS distorts market signals that could otherwise internalize climate costs by giving large foreign companies special access to compensation for new laws and regulations. It is reasonable to expect that these distortions benefit incumbent resource companies at the expense of new entrants in renewable energy. Because they are not foreign or because they are too small to afford ISDS, most companies do not have access to such compensation, putting them at a competitive disadvantage. They must account for risks of regulation in other ways by buying other forms of insurance, bargaining for stronger dispute settlement clauses in contracts with government, or relying – like everyone else – on the protection given by domestic courts and tribunals.

**ISDS disputes often involve decisions about health, the environment, or natural resources**

Two common themes in ISDS are disputes in the resource sector and disputes relating to health or environmental protection. Both themes point to potential disputes about climate change measures. In the absence of a comprehensive climate policy, other environment and public health-related regulation has gained prominence in the effort to restrict investments in fossil fuels at all levels of government from local to national. It is precisely these measures that can be attacked by one or a few hold out fossil fuel incumbents.

To illustrate, in a review of 196 ISDS claims, it emerged that 34 cases involved conflicts over natural resources including oil and gas, gold, lumber, fisheries, and water. Many of these cases involved vast sums as arbitration tribunals dealt with competing claims to natural resources, allocation of benefits and risks of resource extraction, and associated social and environmental consequences.
In the same review, it emerged that 40 cases arose from government decisions on public health or environmental protection. The health theme was apparent in cases concerning health insurance, drinking water, food safety, pharmaceuticals, environmental health, pesticides regulation, and anti-tobacco measures. The environmental theme arose from decisions on water, land, and biodiversity conservation; pollution control; mining remediation; hazardous waste disposal; and liability for environmental contamination. A related group of 21 cases involved planning or permitting decisions by local governments.

**ISDS tribunals have broad power over public budgets due to their authority to award uncapped amounts of compensation to foreign investors**

Unlike at the World Trade Organization, in ISDS countries have no opportunity to avoid liability after a tribunal has issued its decision. Compensation orders are retrospective and uncapped and ISDS litigation costs are high. As a result, countries face unique incentives to avoid climate change action in order to limit their potential liability in ISDS.

Indeed, ISDS has led to awards of unprecedented size to foreign investors in the context of international review of sovereign countries. The total ordered compensation in ISDS has been approximately as follows based on a review of 86 ISDS awards (all amounts in USD):

- From states to large or extra-large companies: 7.5 billion
- From states to very wealthy individuals: 1.1 billion
- From states to other individuals: 325 million
- From states to other companies: 270 million
- Total from states to foreign investors: 9.2 billion

**Foreign investors’ rights to compensation are broadly-framed and open to expansive interpretation**

Foreign investors’ protections are often stated ambiguously in treaties that allow for ISDS. In turn, such rights are subject to broad discretion of ISDS tribunals to decide issues of state liability. The foreign investor protections typically invoked by tribunals when ordering compensation have been those of ‘fair and equitable treatment’ and compensation for ‘indirect’ expropriation. Both protections have been interpreted by tribunals as broad entitlements to compensation for foreign investors, despite qualifying language or exceptions that purport to protect health or environment measures.

For instance, in a review of 56 instances in which ISDS arbitrators determined whether the concept of fair and equitable treatment (FET) was limited to its most obvious roots – in the minimum standard of treatment for foreign nationals in customary international law, which is generally deferential to a country’s right to regulate – 73% of the arbitrators’ resolutions took the expansive view that FET could be interpreted autonomously from customary international law. Also, in 83% of 137 instances, an arbitrator adopted an interpretation of FET going beyond the customary meaning of the minimum standard and thus enlarging foreign investors’ entitlements to compensation in the face of democratic and regulatory decision-making by countries.

In the case of “indirect expropriation”, 72.5% of arbitrators, in 120 instances where the interpretive issue arose, took an expansive approach to the concept by requiring compensation for foreign investors
(i) by focusing exclusively or primarily on the effect of a law, regulation, or other decision on the foreign investor at the expense of other factors including the regulatory purpose of the decision or (ii) by adopting a low threshold of ‘significant’ or ‘substantial’ impact on a foreign investment in order to identify an indirect expropriation requiring full compensation by the state.

In many of these cases, expansive foreign investor entitlements to compensation emerged from a treaty that also included qualifying language or exceptions ostensibly protecting countries’ right to regulate, including in environmental matters. There was comparatively little evidence of an expansive approach by arbitrators to such qualifying language and exceptions.

In effect, ISDS creates a one-sided ‘purity test’ for new regulations. A government must not put foreign companies at a disadvantage or create new regulatory costs for foreign companies, but it can give them unique advantages including, in ISDS itself, special access to public compensation.

*General laws and regulations are not immune*

ISDS tribunals have interpreted foreign investor protections in ways that require compensation even for general, public purpose changes to a country’s regulatory framework that are applied indiscriminately to all asset owners.

In a review of 158 ISDS cases up to the spring of 2010, approximately half of the cases were found to have involved challenges to decisions that were general in their application in that they appeared likely to affect other constituencies, such as other companies, employees, unions, consumers, or sub-national levels of government. Although it was difficult to classify some cases as involving challenges either to general or to specific decisions, many ISDS cases clearly engaged matters of general policy or discretion, such as in the review of measures that banned the export of a hazardous waste, regulated exploitation of natural resources, auctioned rights for a telecommunications network, or managed water use for a major river.

Foreign investors can bring claims for virtually any action by a country’s legislatures, governments, or courts. They can also bring claims against European Union institutions, for example, where the EU is a party to the underlying trade agreement or investment treaty.

*The explosion of ISDS claims has mostly benefited big multinationals and the very wealthy*

If we assume that incumbent interests are heavily committed to fossil fuels, then ISDS poses an even greater concern. ISDS claims began to explode in the late 1990s and, since then, large foreign companies and very wealthy individuals – often operating in the resource sector – have used ISDS to pressure governments and win compensation.

For example, in a review of 86 ISDS awards favouring a foreign investor, about 95% of ordered compensation went to companies with over USD 1 billion in annual revenue or to individuals with over USD 100 million in net wealth. Major oil companies in particular have used ISDS and have won huge amounts of public compensation. These include, for examples, awards to Occidental Petroleum totaling over USD 1 billion, to Mobil Oil totaling about USD 2.1 billion, and to Chevron totaling at least USD 96 million.
Further, extra-large companies, with over USD 10 billion in annual revenue, have a relatively high success rate in ISDS. In 48 cases, their success rates at the jurisdictional stage, merits stage, and combined stages were 88.5%, 82.9% and 70.8% respectively. This exceeded the success rates for all other foreign investors across 166 ISDS cases: 76.6%, 57.9%, and 42.2% respectively.

Finally, the high cost of ISDS – estimated at USD 8 million on average in legal and arbitration costs for both sides per case, with costs exceeding 30 million in some cases – makes it effectively inaccessible to the great majority of small and mid-sized companies; moreover, domestic investors have no right at all to bring ISDS claims. On the other end, the high cost of ISDS puts more pressure on governments facing the risk of a claim by a large multinational or billionaire.

Governments are at the brink of a huge expansion of foreign investor protection and ISDS

To date, Western European countries have never agreed to ISDS on a comprehensive basis with the U.S. or Canada (or amongst themselves). If they were to do so, especially in the proposed EU-US Transatlantic Trade and Investment Partnership (TTIP) and EU-Canada Comprehensive Economic and Trade Agreement (CETA), it is reasonable to expect many more ISDS claims and compensation orders.

To illustrate, Canada is the only Western developed country that has agreed to ISDS on a comprehensive basis with the U.S. Also, Canada is one of the top-5 most-sued countries in ISDS, worldwide.

Measured by the amount of foreign direct investment (FDI) flows to which it would apply, the proposed TTIP alone is far more significant than all existing treaties allowing for ISDS. For example, the TTIP would cover about 50-60% of investment flows in and out of the U.S whereas only about 15-20% of those flows are covered by existing treaties. Alongside the TTIP, a few other treaties now pursued by governments – especially the Trans-Pacific Partnership (TPP), EU-China investment treaty, and U.S.-China investment treaty – would expand ISDS coverage to over 80% of the investment flows.

The European Commission’s recent proposal on investment in TTIP does not reform ISDS or safeguard the right to regulate adequately

In November 2015, the European Commission released a proposed text on foreign investor protection in the EU-US TTIP. In the proposal, the EC adopts a new acronym to describe ISDS: ICS, which stands for “investment court system”. While it has some positive elements, the EC’s proposal leaves in place too many of the key problems of ISDS and the corresponding threats to climate action.

Procedurally, too many flawed ISDS elements remain in the EC’s proposal – including elements that give rise to unacceptable appearances of bias among ICS “judges” – to use terms like court and judge without being misleading. In particular, the ICS “judges” would continue to have a financial interest in future claims where only one side – foreign investors – can bring claims, they would operate under the usual ISDS arbitration rules, they would not necessarily satisfy conditions for judicial appointment in any country, and they would not be barred from working on the side as ISDS arbitrators.

There is a promising signal in the EC’s proposals: an apparent commitment to establish a full international investment court to replace ISDS in existing treaties. However, this aspect is undermined...
by the EC’s choices about sequencing: the EC is pursuing a version of ISDS in TTIP before going ahead with an international court to replace ISDS in existing treaties.

Substantively, the EC’s proposal includes a right to regulate, but the text includes features that severely undermine the right to regulate in future cases. The features are as follows.

i. The wording of the right to regulate in Article 2(1) of the EC’s proposed text includes a "necessity test" for state decisions that are protected by the right to regulate. While this test might sound reasonable on its face, it has been applied in exceedingly strict ways by a large majority of ISDS tribunals faced with the issue. Thus, the EC’s proposal will make it very difficult for a challenged law, regulation, or other decision to be safeguarded by the EC’s version of the right to regulate.

ii. The wording of the right to regulate in Article 2(1) – when interpreted in the context of the express override of any requirement for a state “to compensate the investor” that is included in Article 2(4) but not in Article 2(1) – makes it clear that compensation orders issued by ISDS tribunals for a new law, regulation, or other decision are not precluded or limited by the right to regulate in Article 2(1). This discrepancy creates a major gap in the EC’s proposal because compensation orders, and the potentially huge price tag they put on future decisions, are at the heart of concerns about ISDS and the right to regulate.

iii. Similarly, in Article 2(2), the wording of the state’s right to “change the legal and regulatory framework”, read again in the context of Article 2(4), makes it clear that compensation orders for legal or regulatory changes are not precluded or limited by the state’s right in Article 2(2).

iv. The compensation orders mentioned in items ii. and iii., above, would typically include reasonable-expected lost profits for a foreign investor even though Article 2(2) appears to preclude awards of expected profits. Since Article 2(2) does not apply to compensation orders by ISDS tribunals, as explained above, the arbitrators’ standard approach of awarding expected profits as part of a monetary compensation award, as allowed for in Article 28(1) of the EC’s proposal, would take over.

These aspects undermine almost entirely the EC’s proposal on the right to regulate and the right to change the legal and regulatory framework. Under the EC’s proposal, foreign investors can still use ISDS – as in most ISDS cases so far – to challenge decisions in areas of agriculture, consumer protection, culture, energy, environment, financial security, intellectual property, land use, mining, public health, taxation, or transportation. Likewise, ISDS tribunals can still order huge amounts of public compensation for foreign investors in any of these areas. The EC’s proposal does not alter this situation.

Conclusion

For a trade and investment agreement to support climate action, they must not give expansive rights and powerful tools for large, incumbent resource companies to thwart such action. Already, ISDS has been used to undermine legislatures and governments in areas closely linked to climate-friendly policies
of prevention, mitigation, and adaptation. Public funds should be used to support the shift to clean energy not to compensate polluters for their lost future revenues when they have not adapted their business model in a timely and responsible way.

3 Ibid.
5 Over USD1 billion in annual revenue, less than USD10 billion.
6 Over USD10 billion in annual revenue.
7 Over USD100 million in net wealth.
8 Under USD100 million in net wealth.
9 Over USD100 million in annual revenue, less than USD1 billion, including companies for which annual revenues were unknown.
11 Ibid. Please note that the initial version of this paper, posted on SSRN, mistakenly omitted the works “83% of” from this sentence in the text.
12 Van Harten, above n ii, p 82-85.
13 Ibid.
14 Van Harten and Malysheuski, above n iv.
15 Ibid.
16 Ibid.
18 This qualifier distinguishes the Energy Charter Treaty which includes various Western European countries as parties but is limited to the energy sector. The Energy Charter Treaty is the only other treaty that has also led to numerous claims against Western developed countries.
20 These approximate figures were calculated based on existing investment treaty coverage of country-by-country inward and outward foreign direct investment (FDI) flows for the U.S. in 2012 from data in OECD, “StatExtracts: FDI flows by partner country”. The figures do not account for possible forum-shopping by foreign investors which is difficult to measure, and handled in different ways by arbitrators and in existing treaties but may expand existing coverage of ISDS.
23 EC Proposal, above note xxi, Section 3, Article 9(14) (linking financial remuneration to claims by incorporating the generous daily rates paid to ISDS arbitrators in the ICSID regulations).
24 EC Proposal, above note xxi, Section 3, Article 6(2) (allowing for foreign investor claims under the ICSID Rules, ICSID Additional Facility Rules, and UNCITRAL Rules, which are commonly-used arbitration rules in ISDS).
25 EC Proposal, above note xxi, Section 3, Articles 9(4) and 10(7) (facilitating the appointment of non-judges who currently dominate ISDS arbitration by adding the flexible category of “jurists of recognised competence”).
26 EC Proposal, above note xxi, Section 4, Article 11(1) (omitting the word “arbitrator” from the list of prohibited side work by ICS “judges”).
27 European Commission, above note xxi.
EC Proposal, above n xxi, Section 2, Articles 2(1) and 2(2). For stronger language that expressly precludes ISDS compensation orders and does not apply a necessity test, albeit only to protect certain types of subsidies and not the right to regulate in other areas, see Articles 2(3) and 2(4).

Van Harten, above n ii, p 66-68.

For example, it has been applied to require that a country made no contribution to the state of affairs requiring the passage of the law or regulation and that the country choose the policy option that would have the least impact on the foreign investor, in circumstances where the state cannot know with certainty how an ISDS tribunal will assessment various policy options in a later proceeding. Ibid.

The explicit override, missing from Articles 2(1) and 2(2), is underlined as follows in the text of Article 2(4): “For greater certainty, nothing in this Section shall be construed as preventing a Party from discontinuing the granting of a subsidy and/or requesting its reimbursement, or as requiring that Party to compensate the investor therefor, where such action has been ordered by one of its competent authorities listed in Annex III.” EC Proposal, above n xxi, Section 2, Articles 2(1) and 2(2).

See e.g. G Van Harten, Sold Down the Yangtze: Canada’s Lopsided Investment Deal with China (Toronto: Lorimer, 2015), p 96-100.

The language in Article 2(2), with weaker language underlined, is: “For greater certainty, the provisions of this section shall not be interpreted as a commitment from a Party that it will not change the legal and regulatory framework, including in a manner that may negatively affect the operation of covered investments or the investor’s expectations of profits.” EC Proposal, above n xxi, Section 2, Article 2(2).

This assessment is based on the practice of ISDS tribunals regularly to award reasonably-expected lost profits to foreign investors under their general power to award damages (which is included in the EC’s proposal in Article 28(1)(a)). I do not see this power as being limited by language in Article 2(2) that refers to expected profits in the context of how foreign investors’ protections are “interpreted”. The interpretation of the substantive obligations of foreign investor protection is a separate step from the award of damages under Article 28(1). EC Proposal, above n xxi, Section 3, Article 28(1).

Van Harten, above n ii, p 10-14 and 82-89.

Instead, the relevance of the new substantive language in the EC’s proposal concerns the likelihood of success of ISDS claims. On this issue, the proposal overall does not seem to make a major difference either way when compared, for example, to the Canada-EU CETA. If anything, the EC’s proposal perhaps increases that overall likelihood of success due to the inclusion of an umbrella clause, which outweighs in general any benefit obtained by the Article 2 language on the right to regulate and to change the regulatory framework.