


Climate Change and International Investment Agreements: Obstacles or opportunities?



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with contributions from
Aaron Cosbey and Deborah Murphy

March 2010

This paper is a product of IISD's
“Bali to Copenhagen” Trade
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Executive Summary

1.0 Introduction

Climate change presents a challenge unprecedented in human history. In November 2007, the International Panel on Climate Change (IPCC) released its fourth assessment report, in which it concluded that warming of the climate system is now unequivocal. It also stated that investment has an important role to play in addressing this challenge. A 2008 technical paper by the United Nations Framework Convention on Climate Change (UNFCCC) estimated that additional investment and financial flows of US\$200–210 billion would be necessary globally in 2030 to return global greenhouse gas (GHG) emissions to current levels.

However, while investment has a key role to play in meeting this challenge, the international treaties that often govern foreign direct investment may in fact work against this objective or, at best, may miss important opportunities to contribute positively. This paper examines the extent to which international investment treaties may in fact help or hinder host States' efforts to mitigate and adapt to climate change. It also considers how future international investment agreements might be designed so as to support a host State's climate change objectives, including through promoting investment which does so.

Part 2 of the paper provides a synopsis of the most currently accepted science on climate change, including possible measures to mitigate or adapt to its effects. Part 3 provides an overview of the current international investment law regime. Part 4 of the paper analyzes the potential impact of the most common investor protections on measures that host States might take to adapt to or mitigate climate change, including measures to promote climate-friendly investment. Part 5 of the paper looks at how future international investment agreements (IIAs) might be designed to support, rather than obstruct, a host State's climate change policies, including how an IIA designed specifically to promote increased inflows of climate-friendly investment might look. It also looks at whether the Kyoto Protocol's Clean Development Mechanism might be a useful model for this task.

2.0 A synopsis of climate change

The IPCC's 2007 fourth assessment report found that the resilience of many ecosystems was likely to be exceeded this century by an unprecedented combination of climate change, associated disturbances (e.g., droughts, floods, wildfires, insects, ocean acidification) and other global change drivers (e.g., pollution, land-use change, fragmentation of natural systems, overexploitation of resources). As the global average temperature increase exceeded about 3.5°C, model projections suggested significant extinctions of species around the world (40 to 70 per cent of species assessed).

The IPCC's report projected that climate change would exacerbate existing stresses on water resources resulting from population growth and economic and land-use change, including urbanization. In Africa, by 2020, between 75 and 250 million people were projected to be exposed to increased water stress due to climate change. By the 2050s, freshwater availability in Central, East, South and Southeast Asia, particularly in large river basins, was projected to decrease. Coastal areas, especially heavily populated mega delta regions in East, South and Southeast Asia, would be at greatest risk due to increased flooding from the sea and, in some large deltas, flooding from the rivers. Endemic morbidity and mortality due to diarrheal disease primarily associated with floods and droughts were expected to rise in East, South and Southeast Asia due to changes in the hydrological cycle. Due to the timescale required for removal of carbon dioxide from the atmosphere, past and future anthropogenic emissions would continue to contribute to warming and sea-level rise for more than a millennium. In a 2008 technical paper, the UNFCCC estimated that additional investment and financial flows (that is, over and above the baseline flows) of US\$200–210 billion will be necessary globally in 2030 to return GHG emissions to 2004 levels. The flows needed for adaptation were tens of billions more again.

Societies can respond to climate change in two main ways—by adapting to its impacts (adaptation) and by reducing GHG emissions to lessen the rate and magnitude of change (mitigation).

2.1 Mitigating the effects of climate change

The IPCC's fourth assessment report found that there are a wide variety of national policies and instruments available to governments to create the incentives for mitigation action. These include regulations and standards, taxes and charges, tradable permits, financial incentives, voluntary agreements, information instruments (e.g., awareness campaigns), and research, development and demonstration (RD&D). Many of these measures would potentially affect foreign investors operating in those sectors, as well as domestic enterprises.

2.2 Adapting to the effects of climate change

The IPCC's report noted that, irrespective of the scale of mitigation measures taken by governments over the next 20 years or so, little can be done to avoid warming that is already “loaded” into the climate system—the benefits of avoided climate change will only accrue beyond that time. Inertia in the climate system means that adaptation measures will inevitably be required. The 2007/2008 *Human Development Report* of the United Nations Development Programme (UNDP) projected that the investment required annually to meet adaptation needs will be US\$86 million by 2015. The IPCC's fourth assessment report identified possible adaptation strategies by sector. As with the mitigation measures identified by the IPCC, a number of these adaptation strategies would

potentially impact both foreign investors and domestic enterprises.

3.0 An overview of the international investment law regime

There is no single cohesive source of international law governing foreign investment. Instead, international investment law stems from a “spaghetti bowl” of approximately 3,000 international investment treaties between various combinations of nations dealing with investment. International investment treaties, often called international investment agreements (IIAs), come in three main forums: bilateral investment treaties (BITs), regional investment treaties and investment provisions in preferential trade agreements. Although IIAs have been around for nearly half a century their numbers grew exponentially during the 1990s and by the end of June 2009 there were 2,701 BITs involving approximately 180 countries. There were also 279 other IIAs, including regional investment treaties and investment provisions in preferential trade agreements.

While their precise wordings differ, IIAs generally bind each contracting state to provide certain protections to the investments of investors from the other contracting state. “Investment” is usually defined widely, for example, it can include both tangible and intangible assets such as intellectual property rights. Typical IIA investment protections include:

- “National treatment” – an obligation to accord the foreign investor treatment no less favourable than that it accords, in like circumstances, to its own investors;
- “Most favoured nation treatment” – an obligation to accord the foreign investor treatment no less favourable than that it accords, in like circumstances, to investors from any other state;
- “Fair and equitable treatment” – an obligation to treat the investor fairly and equitably;
- “Expropriation” – a commitment not to expropriate investments except for a public purpose and upon prompt and adequate compensation.

Possibly the most significant of IIA provisions, and one contained in most IIAs, is the right for investors to have disputes with the host State resolved through international arbitration rather than through the host State’s domestic courts. As at the end of 2008, there were 317 known investment treaty arbitrations brought by investors against host States. At least 77 governments—47 developing countries, 17 developed countries and 13 countries with economies in transition—had been respondents in such arbitrations. These statistics may underestimate the real number of investor-State arbitrations, however, due to the lack of transparency with which such arbitrations are conducted.

Investor-State arbitrations may impact the host State in a number of ways. Most obviously, there is the impact on the public purse of being found liable to pay a substantial damages award. Recent

years have seen a growing number of awards over US\$100 million. The largest arbitration to date, a US\$30 billion claim brought by investors in the Yukos oil company against Russia for the alleged expropriation of their assets in breach of the Energy Charter Treaty is still ongoing. Irrespective of the outcome of the case, there is the cost to the host State of defending the investor-State proceeding, with lawyers' and arbitrators' fees generally well into the millions of dollars.

Less obvious, but no less concerning, are the implications of investor-State arbitrations for host States' policy space and rule making. A number of arbitrations to date have included challenges to measures intended by States to protect the public welfare, including regulations directed to protect indigenous people, disadvantaged groups, the environment and health. In doing so, these arbitrations have the potential to impact the welfare of individuals and communities within the host State. Even the *threat* of an arbitration may discourage host State governments from pursuing regulations in their citizens' interest—the so-called “chilling effect.”

The majority of IIAs cover investment in general, however a small number address investment in specific sectors. Given that the energy sector accounts for 84 per cent of anthropogenic carbon dioxide (CO₂) emissions and 64 per cent of GHG emissions, two regional instruments focusing on investment in the energy sector are worth noting:

3.1.1 The Energy Charter Treaty

The origins of the Energy Charter Treaty (ECT) date back to the early 1990s and the end of the Cold War. Russia and its neighbouring states were rich in energy resources and needing investment for their development, while Western European countries wished to diversify their sources of energy supplies. The Energy Charter Treaty was adopted as a legally binding multilateral instrument in December 1994. A protocol to the treaty, the Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects, was signed at the same time. Both entered into legal force in April 1998. To date the Treaty has fifty-two signatories, having been signed or acceded to by 51 states plus the European Union. The fundamental objective of the ECT's provisions on investment is to ensure the creation of a “level playing field” for energy sector investments between signatories, with the aim of minimizing non-commercial risks associated with energy-sector investments.

3.1.2 The ECOWAS Energy Protocol

The Economic Community of West African States (ECOWAS) is a regional group of fifteen countries, founded in 1975, with a mission to promote economic integration in all fields of economic activity. In 2003, ECOWAS adopted an Energy Protocol. The ECOWAS Protocol's provisions are substantially identical to those of the Energy Charter Treaty. This reflected the view of ECOWAS Members that the ECT was the leading international instrument for the promotion of energy investment, and that adhering to its principles would demonstrate to international investors

the attractiveness of the ECOWAS region.

Under both the ECT and the ECOWAS Protocol, each Contracting Party shall ensure investors of other Contracting Parties certain specified protections, including fair and equitable treatment, national treatment, most favoured nation treatment and protection from expropriation. In contrast to the majority of IIAs, the ECT and the ECOWAS Protocol contain provisions directed to the sustainable development of their Contracting Parties and recognizing those parties' sovereignty over their energy resources. Contracting Parties give their unconditional consent for investors to bring disputes with host States to international arbitration or conciliation. There have been more than 20 known arbitrations under the ECT to date, though none under the ECOWAS Protocol.

4.0 Will IIAs obstruct host State measures to address climate change?

Part 4 of the paper examines whether the investment protections contained in IIAs could constrain host States from taking measures to address climate change and to promote climate-friendly investment. For the purposes of this analysis, “climate-friendly” investment is defined as one of the following:

- Investment that uses only clean energy and clean technologies; or
- Investment with a neutral or “lower than business as usual” GHG footprint; or
- Investment that reduces anthropogenic emissions by sources or enhances anthropogenic removals by sinks of GHGs in any sector of the economy that is additional to any that would otherwise occur.

4.1 Could IIAs obstruct host State efforts to promote climate-friendly new investment?

One way for host States to ensure that foreign investment into their country complies with their national climate change policies is through the screening of new investment to stop the entry of climate-unfriendly investment. Such screening might, for example, require potential investments to have a neutral carbon footprint or to use only clean energy and technologies. Another way, ideally for use in parallel with screening out climate-unfriendly investment, is to use investment incentives that make it economically attractive for investors to make climate-friendly investments, for example, feed-in tariffs, subsidies and tax breaks.

Rather than screening, States have the option of instead laying down regulatory standards that require *all* investments, foreign or domestic, to follow whatever standards they might deem appropriate. That option, being on its face non-discriminatory, might not raise as many potential conflicts with IIA law. However, screening might be a more attractive option in cases where there is

as yet no comprehensive climate or energy law that would legally enable such regulations, but where the State nonetheless realizes the importance of regulating, in particular, the sort of large-scale emitters that are often the object of foreign direct investment. Arguably, this is the case in a large number of lower income countries.

As the majority of IIAs do not include pre-establishment rights, host States to those IIAs are free to impose any conditions allowed under their national law that they wish on the admission and establishment of foreign investments. This means that the vast majority of IIAs will not present an obstacle to host States wishing to officially promote only new investment that conforms to its climate change objectives. However, host States that have at least one IIA with binding pre-establishment rights will have to take more care. With respect to investors from States party to an IIA with pre-establishment rights, the host State must take care to impose the same clean energy or clean technology requirements on those investors as on domestic investors and investors from third States.

4.2 Could IIAs obstruct host State measures to mitigate or adapt to climate change?

This section of the paper considers whether the investment protections found in most IIAs could be a barrier to host States seeking to take measures to mitigate or adapt to climate change, including measures that favour climate-friendly investment over investment with higher GHG emissions. The analysis in this part is prefaced with a qualifier. While arbitral tribunals may in general seek to act consistently with each other, there is no doctrine of precedent in international arbitration. In the end, each tribunal exercises its competence in accordance with the applicable law, which will by definition be different for each IIA and respondent host State.

4.2.1 National treatment

In deciding whether a host State has discriminated against an investor for the purposes of the national treatment standard, the tribunal must compare the State's treatment of the investor with its treatment of others in like circumstances. The tribunal's interpretation of "like circumstances" is thus pivotal. In practice, tribunals have taken several different views as to what constitutes "like circumstances." Under the approach of the tribunal in the 2000 case of *SD Myers v. Canada*, the tribunal looked to the law developed in the context of the World Trade Organization to understand when parties are in "like circumstances." Under the *SD Myers* approach, if an investor's coal power station and a domestically-owned hydro power station were seen as competitors in the electricity market, a ban on coal-generated power may amount to a breach of national treatment, notwithstanding their public policy differences. In contrast, in the 2007 case of *Parkerings-Compagniet AS v. Lithuania*, the tribunal took into account public policy aspects to find that the two companies in that case were not in "like circumstances" at all.

While the *Parkerings* approach would seem to allow host States to discriminate between climate-friendly and non-climate friendly investment, the lack of a doctrine of precedent in investor-State arbitration means that the only way to ensure that host States are entitled to discriminate on such grounds, is through express wording in the IIA.

4.2.2 Most favoured nation treatment

A MFN clause in an IIA may present two distinct challenges for a host State seeking to take measures to address climate change. First, like the national treatment standard just discussed, in the event of an investor-State dispute, a tribunal will have to decide whether the investor's investment and a similar but more climate-friendly investment by an investor from a third State are in "like circumstances." As with the national treatment standard discussed above, whether the tribunal is willing to take account of public policy differences when determining whether the investments are in "like circumstances" will be pivotal here.

A second challenge for host States seeking to take measures to address climate change is that a MFN clause may entitle the investor to circumvent climate-friendly provisions in an IIA by importing more investor-favourable provisions from another IIA to which the host State is a party. This makes an MFN clause a powerful provision as it effectively trumps the intentions of the contracting parties who negotiated the IIA. This has been criticized by some host States and commentators who believe that it allows investors to "cherry-pick" to create a type of "super-treaty." Articles 16 of the ECT and ECOWAS Energy Protocol are worthy of special mention in this context. Article 16 entitles investors to the most favourable investment protections provided under that instrument or any other *past* or *future* IIA to which the host State is a party. This means that ECT and ECOWAS's innovative provisions on environmental protection will be rendered null if there is another IIA between the host and home States that does not contain such elements.

4.2.3 Fair and equitable treatment

The fair and equitable treatment standard has emerged as one of the key protections in international investment law. While the words "fair and equitable" seem simple, their meaning remains hotly debated. Fair and equitable treatment may be considered to have two parts, one substantive and the other procedural. The procedural aspects of the fair and equitable treatment standard relate to the host State's administrative decision-making processes—that is to say, was the decision-making process itself fair and equitable? With respect to the substantive aspects of the standard, the "legitimate expectations" of the investor is now a key component. Tribunals have demonstrated differing views as to what an investor's "legitimate expectations" include. For example, in *Tecmed v. Mexico*, the tribunal seemed to consider the investor's legitimate expectations meant that the host State had no right to introduce unforeseen regulations without compensating the investor for doing

so. In contrast, the tribunal in the 2007 award in *Parkerings-Compagniet AS v. Lithuania* (2007) held that the investor should have known that the conditions in the host State meant that law changes were to be regarded as likely. Whether or not a host State measure to address climate change will breach the investor's legitimate expectations will depend somewhat on whether the tribunal leans more towards the *Tecmed* or the *Parkerings* approach. However, some things are clear. If the host State has created an expectation on behalf of the investor, for example, by assuring the investor that its laws will not change, but it then contradicts that expectation, a breach may well be found. Furthermore, it would be prudent for the host State to act transparently and consistently, giving investors as much advance notice of its intentions as possible.

4.2.4 Expropriation

Past arbitral awards reveal two key determinants as to whether or not a tribunal will view a measure intended to address climate change as an expropriation. The first is the level of impact of the measure on the investor. On this point, tribunals have been comparatively consistent that the threshold of interference required is “substantial deprivation—that is to say, that the investor has been substantially deprived of the enjoyment of its investment. The second determinant is whether the tribunal considers itself bound to take account of the public purpose of the measure. Past tribunals have generally dealt with this issue in one of three ways. The first approach, used in the case of *Metalclad v. Mexico* (2000), is known as the “sole effects doctrine.” This approach considers the purpose of the challenged measure to be irrelevant and the measure's impact on the investor is the sole criterion. The second approach, used by the tribunal in *Tecmed v. Mexico* (2003), weighs the public purpose of the measure against the burden placed on the investor and requires there be a reasonable relationship of proportionality and the burden not to be individual or excessive. The third approach, adopted by the tribunal in *Methanex v. United States* (2005), excludes non-discriminatory public welfare regulatory measures from the scope of expropriation unless the host State has made a specific commitment to the investor not to so regulate.

To apply the above to a possible climate change mitigation measure that a host State might take: If an investor was the owner of a coal-fired power station and the host State passed a regulation banning the use of coal to produce electricity, whether a tribunal would find the regulation to constitute an expropriation would depend first on whether the regulation would have the effect of substantially depriving the investor of the enjoyment of its property. If the investor was easily able to refit its power station to operate on a more climate-friendly source of fuel, then the tribunal may find that no expropriation had taken place. However, if the cost of refitting the power station was very high relative to the value of the investment, the tribunal might find that the investor had suffered a substantial deprivation of its investment. Whether the regulation would then be held to constitute an expropriation will depend largely on whether the tribunal chose to follow the *Metalclad*, *Tecmed* or *Methanex* approach to host State public welfare regulatory measures. If the tribunal

followed *Metalclad*, it may well find that an expropriation had taken place.

4.2.5 Stabilization clauses in investment contracts

Stabilization clauses are clauses contained in contracts between an investor and its host State under which the investor is insulated from changes in the host State's laws. Unless specifically excluded, this may include changes to environmental, labour or health and safety laws. Stabilization clauses in investment contracts have the ability to reach out through various IIA provisions—namely those on expropriation, fair and equitable treatment and umbrella clauses—to become a powerful weapon in an investor's armoury. This is particularly relevant in the climate change context. Stabilization clauses are most often found in sizable infrastructure and extractive sector concession contracts, both of which tend to have large carbon footprints. Host States may wish to review the wording of their contracts with such investors before taking measures intended to significantly reduce GHG emissions from such activities. When entering new contracts with investors in the future, host States should avoid clauses that will potentially limit their ability to take measures in their public welfare.

4.3 The defence of necessity

Many IIAs make express provision for a defence of necessity. Even if the defence is not expressly included in the IIA, the host State may still be able to look to the defence under customary international law, though the threshold to qualify for the defence under customary law (codified in the Article 25 of the International Law Commission's Draft Articles on State Responsibility) is a high one.

No investor-State cases to date have considered the defence of necessity in an environmental context. The most notable attempts by a host State to invoke the defence of necessity have occurred in the line of cases against Argentina concerning measures taken by that government during its 2001–2002 financial crisis. Notwithstanding the factual similarities in the cases, the tribunals have taken very different approaches to how the defence of necessity should be interpreted, allowing the defence (at least partly) in two cases to date and refusing it in five. The jurisprudence is thus far from settled. Although it may be cold comfort, the more gravely and incontrovertibly urgent the host State's need to take measures is, the more likely it will be found to fulfill the defence. Thus, necessity is probably more likely to succeed as a defence in respect of a measure taken under urgency to *adapt* to the effects of climate change. While the need to *mitigate* climate change is essential, mitigation is required at a global level. With the possible exception of a very small number of States with the highest emissions (e.g., the European Union, the United States and China), it would be difficult for an individual host State to prove that *its* mitigation measures were necessary to avoid catastrophic climate change.

5.0 How might an IIA be drafted to support a host State's climate change objectives?

5.1 Ensuring investor compliance and minimizing the risk of investor-State arbitration

This section provides recommendations as to how the typical IIA provisions might be drafted to ensure that inward investment is in line with host State measures to address climate change and to minimize the risk of an investor using the IIA to challenge those measures through international arbitration. The paper makes the following recommendations for the drafting of IIA provisions:

5.1.1 Preamble and object

- Make clear in both the preamble and objective and purpose provisions that the IIA is intended to support the Contracting Parties' sustainable development objectives, including with respect to climate change, for example, the preamble of the ECT recalls the UNFCCC and recognizes the increasingly urgent need for measures to protect the environment.
- Wording from the preamble of the UNFCCC itself might also be incorporated in the IIA's preamble or object and purpose provisions.

5.1.2 Compliance with host State law

- Condition the IIA's protections on the investment's compliance with the laws and regulations of the host State, specifically including its laws on environment, as does Article 10 of the Netherlands-Costa Rica BIT.

5.1.3 Host State commitment not to lower environmental standards

- Stipulate that Contracting Parties shall not attempt to encourage investment by lowering domestic environmental legislation and standards, as do Article 73 of the EU-CARIFORUM Economic Partnership Agreement, and Article 1114.2 of the North American Free Trade Agreement.

5.1.4 Admission and establishment

- If politically feasible in the IIA negotiations, omit provisions granting investors pre-establishment rights from the IIA. If this is not possible, expressly include an investment's environmental characteristics as a criteria allowing differential treatment in the establishment stage.

5.1.5 National treatment

- Insert a non-exhaustive list of criteria in the IIA (including a criterion regarding the investment's environmental effects) to be examined when determining whether investments are in "like circumstances" for the purposes of the national treatment provision, as does Article 17(2) of the investment agreement for the COMESA Common Investment Area.

5.1.6 Most favoured nation treatment

- As with national treatment above, insert a non-exhaustive list of criteria in the IIA (including a criterion regarding the investment's environmental effects) to be examined when determining whether investments are in "like circumstances" for the purposes of the MFN provision.
- To avoid sidestepping negotiators' intent and "importing" more investor-friendly provisions from another IIA to which the host State is a party, omit the MFN clause in its entirety, as does the India-Singapore Comprehensive Economic Cooperation Agreement. If this is not feasible in the IIA negotiations, insert a sub-clause stipulating that the MFN clause will apply only to the substantive provisions of IIAs that enter into force after the current IIA has done so.

5.1.7 Fair and equitable treatment

- Limit the scope of the fair and equitable treatment standard by expressly linking the standard to the minimum standard of treatment under customary international law, as does Article 6 of the ASEAN-New Zealand Free Trade Agreement's Chapter 11 (Investment). In addition, stipulate that differential treatment on the basis of public welfare considerations, such as public health, safety or the environment, does not contravene fair and equitable treatment.

5.1.8 Expropriation

- In light of the divergent approaches by tribunals as to whether bona fide regulations taken by host States for a public purpose can constitute an indirect expropriation, include an express carve-out provision on this point. Article 20(8) of the COMESA investment agreement contains a robust carve-out provision.

5.1.9 General exceptions

- Insert a general overall exception exempting measures designed and applied to protect the environment or human, animal or plant life or health, including from climate change and its effects, from the IIA's investment protections, as does Article 22(1) of the COMESA investment agreement.

5.1.10 Stabilization clauses in investment contracts

- When entering contracts with investors in the future, avoid clauses that will potentially limit the host State's ability to take measures in its public welfare.

5.2 IIAs as tools to help to address climate change more generally

While the recommendations to this point have focused on ensuring that IIAs do not obstruct government actions to address climate change, it is also possible to envisage how an IIA might be a tool to assist contracting parties, working together or alone, to address climate change in their countries more generally. For example, Articles 19(1) of the ECT and the ECOWAS Energy Protocol contain fairly comprehensive instructions to their parties regarding how to minimize the environmental impacts of investments in the energy sector. Article 8(1) of each instrument requires its parties to promote the transfer of technology and, among other things, to implement the objectives of the treaty.

Even if including reference to such provisions in a future IIA is only confirming States' existing obligations under the ECT or ECOWAS Protocol if they are parties, such commitments still add value by increasing transparency and giving potential foreign investors more assurance on what they can reasonably expect in the host country.

5.3 How might IIAs be designed to increase climate-friendly investment?

This section considers the extent to which the Clean Development Mechanism (CDM) of the Kyoto Protocol might serve as a useful model for an IIA seeking to promote climate-friendly investment. It also considers the possible forms an IIA specifically designed to promote climate-friendly investment might take.

In some respects, the CDM can be seen as a type of “new generation” IIA itself—an agreement to promote investment from developed country investors into developing countries with sustainable development of the latter being a central aim. However, in light of the significant backlogs in the CDM's verification, validation and certification processes, its procedural complexities and the fact that it is currently being reviewed in advance of the end of the current commitment period in 2012 leaving its future uncertain, the paper takes a step further to consider the possibility of an IIA that adopts some of the more salient elements of the CDM for contracting parties.

Under this model, investments meeting the IIA's “climate-friendly” criteria would be entitled to the IIA's investment protections and/or investment incentives. The “climate friendly” criteria could be drawn from the ample and detailed list of approved project methodologies that now exists under the

CDM. Alternatively, the IIA might refer to another source of guidance to determine the types of eligible investment. For example, the International Energy Agency's (IEA) Energy Technology Perspectives 2008 describes a number of technology roadmaps for technologies that are key for reducing emissions from the energy sector. Any investments in these technologies/sectors might be designated as eligible. Whether taken from this or some other source, such a list would require management and maintenance, to allow new technologies to enter, and to drop old ones as they become the mainstream.

The IIA itself might include some of the climate-friendly investor protections discussed in part 4.1 of the paper. It might also include one or a number of investment incentives (e.g., subsidized loans, government insurance at preferential rates, fiscal incentives, subsidized services, market access or foreign exchange privileges), albeit carefully designed to encourage climate-friendly investment while remaining consistent with the IIA's investor protections and international trade obligations more generally. The IIA might potentially include incentives offered by both the home and host State.

Another option, specific to the power sector, would address the problem of discriminatory application of incentives that currently exists in some regions with respect to imported power. For example, in Europe a number of States provide incentives such as feed-in tariffs for renewably generated electricity. However, renewably generated electricity that is imported often receives no such benefit. The result is dampened proliferation of renewable generation technologies, particularly in tightly integrated grids. Contracting parties to agreements such as the ECT and ECOWAS Energy Protocol might commit to national treatment with respect to the granting of such incentives.

A final option would be an IIA that contains some of the climate-friendly investor protections discussed in part 4.1 of the paper, but that is silent regarding incentives to promote climate-friendly FDI. Contracting parties to the IIA (both home and host States) would then be free to establish such regulations or incentive schemes in their domestic law to promote climate-friendly investment as they see fit. This could include establishing "climate-friendly" investment criteria in the domestic law, which, if met, will qualify investors for investment incentives. The advantage of this option would be that each State would have maximum flexibility to design appropriate investment regulations and incentives away from the pressure of the negotiating table. Subject to respecting the legitimate expectations of existing investors, the host State could also later revise its investment regime as it sees fit. The disadvantages of this approach may include the loss of transparency and signaling effect (themselves host State investment incentives) that having investment incentives set out in the IIA would otherwise provide.

1.0 Introduction

In November 2007, the International Panel on Climate Change (IPCC) released its fourth assessment report, in which it concluded that warming of the climate system is now unequivocal (IPCC, 2007a, p. 72). It reported that 11 of the 12 years from 1995 to 2006 were in the 12 warmest years since instrumental recording began in 1850 (p. 30). It found that the resilience of many ecosystems is likely to be exceeded this century, resulting in mass extinctions of plant and animal species (p. 56). Climate change is expected to exacerbate current stresses on water resources from population growth and economic and land-use change (p. 49). The health status of millions of people will be affected, including through greater malnutrition; injuries, death and disease due to extreme weather events; increases in diarrhoeal and cardio-respiratory diseases; and the altered spatial distribution of infectious diseases (p. 48). Climate change thus presents a challenge unprecedented in human history.

In its report, the IPCC (2007a) stated that investment has an important role to play in addressing this challenge:

“Without sustained investment flows and effective technology transfer, it may be difficult to achieve emission reduction at a significant scale.” (p. 68)

“Initial estimates show that returning global energy-related CO₂ emissions to 2005 levels by 2030 would require a large shift in the pattern of investment.” (p. 58)

In recognition of investment’s important role, Parties to the United Nations Framework Convention on Climate Change (UNFCCC) requested that the UNFCCC Secretariat in 2007 analyze and assess the investment flows necessary to address climate change mitigation and adaptation in an effective and meaningful way, with a special focus on developing countries’ needs. The resulting technical paper prepared by the UNFCCC estimated that additional investment and financial flows of US\$200–210 billion would be necessary globally in 2030 to return global greenhouse gas (GHG) emissions to current levels (UNFCCC, 2007, p. 92).¹

However, though investment has a key role to play in meeting this challenge, the international treaties that often govern foreign direct investment may in fact work against this objective or, at best, may miss important opportunities to contribute positively. This paper examines the extent to which international investment treaties may indeed help or hinder host States’ efforts to mitigate and adapt to climate change. It also considers how future international investment agreements might be

¹ UNFCCC’s 2008 update to the 2007 report stated that, due to higher capital costs for energy supply facilities, the estimated total additional investment needed in 2030 to reduce energy-related CO₂ emissions is about 170 per cent higher than in the 2007 report. See UNFCCC (2008).

designed so as to support a host State's climate change objectives, including through promoting investment which does so.

Part 2 of the paper provides a synopsis of the most currently accepted science on climate change, including possible measures to mitigate or adapt to its effects. Part 3 provides an overview of the current international investment law regime. Part 4 of the paper analyzes the potential impact of the most common investor protections on measures that host States might take to adapt to or mitigate climate change, including measures to promote climate-friendly investment. Part 5 of the paper looks at how future international investment agreements (IIAs) might be designed to support, rather than obstruct, a host State's climate change policies, including how an IIA designed specifically to promote increased inflows of climate-friendly investment might look. It also looks at whether the Kyoto Protocol's Clean Development Mechanism might be a useful model for this task.

2.0 A Synopsis of Climate Change

In November 2007 the IPCC released a synthesis of its fourth assessment report.² The synthesis report was adopted section by section at the 27th meeting of the IPCC Plenary held in Valencia, Spain on November 12–17, 2007.³ It represented the formally agreed statement of the IPCC regarding the key findings and uncertainties of the three IPCC Working Groups.⁴

In its fourth assessment report, the IPCC found that warming of the climate system was unequivocal (IPCC, 2007a, p. 72).⁵ The linear warming trend over the 50 years from 1956 to 2005 (0.13°C per decade) was nearly twice that for the 100 years from 1906 to 2005 (p. 30). Sea level had increased at an average of 3.1 mm per year from 1993 to 2003, in contrast to an average of 1.8 mm per year from 1961 to 2003 (p. 30).

Global greenhouse gas (GHG) emissions due to human activities had increased significantly since pre-industrial times, with an increase of 70 per cent between 1970 and 2004 (IPCC, 2007a, p. 72). As a result of anthropogenic emissions, atmospheric concentrations of nitrous oxide far exceeded pre-industrial levels spanning many thousands of years, and those of methane and carbon dioxide far exceeded the natural range over the last 650,000 years (p. 72). Due to the timescale required for removal of carbon dioxide from the atmosphere, past and future anthropogenic emissions would continue to contribute to warming and sea level rise for more than a millennium (p. 47).

Annex I countries⁶ were responsible for 46 per cent of global GHG emissions, although having only 20 per cent of the world's population. In comparison, Non-Annex I countries⁷ accounted for 54 per cent of emissions but held 80 per cent of the world's people (IPCC, 2007c, p. 29). The contrast

² IPCC's three previous assessment reports were released in 1990, 1995 and 2001.

³ The IPCC's fourth assessment report has been chosen as the scientific base for this paper because, of all the many studies on climate change, it represents the closest to an international governmental and scientific consensus document around climate change and how to address it. In light of its consensus nature, however, it has received criticism that it is too conservative and underestimates both the likely effects of climate change and what is required to address them. Others have criticized it for going too far. The IPCC is a scientific intergovernmental body set up by the World Meteorological Organization (WMO) and by the United Nations Environment Programme (UNEP). It is open to all member countries of WMO and UNEP. Governments can participate in plenary sessions of the IPCC where main decisions about the IPCC work program are taken and reports are accepted, adopted and approved. They also participate in the review of IPCC Reports. Hundreds of scientists all over the world contribute to the work of the IPCC as authors, contributors and reviewers. See www.ipcc.ch

⁴ The reports of the three IPCC Working Groups are: Working Group I Report: Climate Change 2007: The physical science basis; Working Group II Report: Climate Change 2007: Impacts, adaptation and vulnerability; and Working Group III Report: Climate Change 2007: Mitigation of climate change.

⁵ This report, adopted section by section at IPCC Plenary XXVII (Valencia, Spain, November 12–17, 2007), represents the formally agreed statement of the IPCC concerning key findings and uncertainties contained in the Working Group contributions to the Fourth Assessment Report.

⁶ Countries listed in Annex I to the United Nations Framework Convention on Climate Change (UNFCCC), consisting primarily of industrialized countries.

⁷ Countries not listed in Annex I to the UNFCCC, mostly developing countries and some economies in transition.

between the region with the highest per capita GHG emissions (North America) and the lowest (Non-Annex I South Asia) was particularly marked: 5 per cent of the world's population emitted 19.4 per cent, while 30.3 per cent emitted 13.1 per cent (p. 29).

The fourth assessment report found that the resilience of many ecosystems was likely to be exceeded this century by an unprecedented combination of climate change, associated disturbances (e.g., droughts, floods, wildfires, insects, ocean acidification) and other global change drivers (e.g., pollution, land use change, fragmentation of natural systems, overexploitation of resources) (IPCC, 2007a, p. 48). Carbon removal by terrestrial ecosystems was likely to peak before mid-century and then weaken or even reverse, thus amplifying climate change (p. 48). Observations since 1961 have shown that the ocean had been absorbing more than 80 per cent of the heat added to the climate system and that ocean temperatures has increased to depths of at least 3000 metres (p. 30). It was thought likely that GHGs would have caused more warming than observed if not for the cooling effects of volcanic and human-caused aerosols (p. 39).

The report found that, of the more than 29,000 observational data series from 75 studies that showed significant change in physical and biological systems, more than 89 per cent were consistent with the direction of change expected as a response to warming (IPCC, 2007a, p. 33). It stated, with medium confidence, that approximately 20 to 30 per cent of the species then assessed were likely to be at increased risk of extinction if increases in global average warming exceeded 1.5 to 2.5°C above 1980–1999 levels. As global average temperature increase exceeded about 3.5°C, model projections suggested significant extinctions around the world (40 to 70 per cent of species assessed) (p. 54).

The IPCC expected climate change to exacerbate existing stresses on water resources resulting from population growth and economic and land-use change, including urbanization (IPCC, 2007a, p. 49). Mass losses from glaciers and reductions in snow cover over recent decades were projected to accelerate throughout the twenty-first century, reducing water availability, hydropower potential, and changing seasonality of flows in regions supplied by meltwater from major mountain ranges (e.g., Hindu-Kush, Himalaya, Andes), where more than one-sixth of the world population lives (p. 49).

In Africa, by 2020, between 75 and 250 million people were projected to be exposed to increased water stress due to climate change (IPCC, 2007a, p. 50). By 2020, in some African countries, yields from rain-fed agriculture could be reduced by up to 50 per cent. Agricultural production, including access to food, in many African countries was projected to be severely compromised. This would further adversely affect food security and increase malnutrition (p. 50).

By the 2050s, freshwater availability in Central, East, South and Southeast Asia, particularly in large river basins, was projected to decrease (IPCC, 2007a, p. 50). Coastal areas, especially heavily populated mega delta regions in East, South and Southeast Asia, would be at greatest risk due to

increased flooding from the sea and, in some large deltas, flooding from the rivers (p. 50). Endemic morbidity and mortality due to diarrheal disease primarily associated with floods and droughts are expected to rise in East, South and Southeast Asia due to changes in the hydrological cycle (p. 50).

According to the IPCC, as of 2004, energy-related emissions accounted for 66 per cent of global GHG emissions (energy supply, 26 per cent; industry, 19 per cent; transport, 13 per cent; residential, commercial and service sectors, 8 per cent). Non-energy-related emissions accounted for 34 per cent (land-use change and forestry, 17 per cent; agriculture, 14 per cent; waste, 3 per cent) (2007c, p. 27). The IPCC's fourth assessment report found that:

Without sustained investment flows and effective technology transfer, it may be difficult to achieve emission reduction at a significant scale. (p. 68)

In its 2008 technical paper *Investment and Financial Flows to Address Climate Change*, the UNFCCC (2007) secretariat estimated that additional investment and financial flows of US\$200–210 billion will be necessary globally in 2030 to return GHG emissions to 2004 levels (p. 92).⁸ It projected that about 68 per cent of the global emission reductions would occur in developing countries where mitigation opportunities should be less costly. However, to achieve this, developing countries would need to receive over half of the projected additional global investment and financial flows (p. 93).⁹

Societies can respond to climate change in two main ways—by adapting to its impacts (adaptation) and by reducing GHG emissions to lessen the rate and magnitude of change (mitigation) (IPCC, 2007a, p. 56). These are discussed below.

2.1 Mitigating the effects of climate change

The IPCC found that there are a wide variety of national policies and instruments available to governments to create the incentives for mitigation action. These include regulations and standards, taxes and charges, tradable permits, financial incentives, voluntary agreements, information instruments (e.g., awareness campaigns), and research, development and demonstration (RD&D) (IPCC, 2007a, p. 61).

Listed below are examples of key sectoral mitigation policies and measures identified by the IPCC in its fourth assessment report. It is clear that many of these would affect foreign investors operating in those sectors, as well as domestic enterprises. The implications of this for international investment law are the focus of Part 3 of the paper.

⁸ UNFCCC's 2008 update to the 2007 report stated that, due to higher capital costs for energy supply facilities, the estimated total additional investment needed in 2030 to reduce energy-related CO₂ emissions is about 170 per cent higher than in the 2007 report. See UNFCCC, 2008, p. 18.

⁹ Reiterated in UNFCCC, 2008, p. 18.

Sector	Mitigation policies, measures and instruments considered by the IPCC to be environmentally effective
<ul style="list-style-type: none"> • Energy Supply 	<ul style="list-style-type: none"> • Reduction of fossil fuel subsidies • Taxes or carbon charges on fossil fuels • Feed-in tariffs for renewable energy technologies • Renewable energy obligations • Producer subsidies
<ul style="list-style-type: none"> • Transport 	<ul style="list-style-type: none"> • Mandatory fuel economy, biofuel blending and CO₂ standards for road transport • Taxes on vehicle purchase, registration, use and motor fuels • Road and parking pricing • Influencing mobility needs through land-use regulations and infrastructure planning • Investment in attractive public transport facilities and non-motorized forms of transport
<ul style="list-style-type: none"> • Buildings 	<ul style="list-style-type: none"> • Appliance standards and labelling • Building codes and certification • Demand-side management program • Public sector leadership program, including procurement • Incentives for energy service companies
<ul style="list-style-type: none"> • Industry 	<ul style="list-style-type: none"> • Provision of benchmark information • Performance standards • Subsidies, tax credits • Tradable permits • Voluntary agreements
<ul style="list-style-type: none"> • Agriculture 	<ul style="list-style-type: none"> • Financial incentives and regulations for improved land management, maintaining soil carbon content, efficient use of fertilizers and irrigation
<ul style="list-style-type: none"> • Forestry/forests 	<ul style="list-style-type: none"> • Financial incentives (national and international) to increase forest area, to reduce deforestation and to maintain and manage forests • Land-use regulation and enforcement
<ul style="list-style-type: none"> • Waste 	<ul style="list-style-type: none"> • Financial incentives for improved waste and wastewater management • Renewable energy incentives or obligations • Waste management regulations

Source: adapted from IPCC, 2007a, p. 60, Table 4.2.

2.2 Adapting to the effects of climate change

In its fourth assessment report, the IPCC noted that over the next 20 years or so, even the most aggressive mitigation policies can do little to avoid warming that is already “loaded” into the climate system—the benefits of avoided climate change will only accrue beyond that time. Irrespective of the scale of mitigation measures taken by governments, inertia in the climate system means that adaptation measures will nevertheless be required (IPCC, 2007c, p. 33). Listed below are examples of planned adaptation strategies by sector identified by the IPCC in its fourth assessment report. As with the mitigation measures listed above, a number of these adaptation strategies would impact foreign investors as well as domestic enterprises. The possible implications of these for international investment law will be discussed in Part 3, using some of the measures as examples.

Sector	Adaptation option/strategy
<ul style="list-style-type: none"> Water 	<ul style="list-style-type: none"> Expanded rainwater harvesting Water storage and conservation techniques Water reuse Desalination Water-use and irrigation efficiency
<ul style="list-style-type: none"> Agriculture 	<ul style="list-style-type: none"> Adjustment of planting dates and crop variety Crop relocation Improved land management, e.g., erosion control and soil protection through tree planting
<ul style="list-style-type: none"> Infrastructure/settlement (including coastal zones) 	<ul style="list-style-type: none"> Relocation Seawalls and storm surge barriers Dune reinforcement Land acquisition and creation of marshlands/wetlands as buffers against sea-level rise and flooding Protection of existing natural barriers
<ul style="list-style-type: none"> Human health 	<ul style="list-style-type: none"> Heat-health action plans Emergency medical services Improved climate-sensitive disease surveillance and control Safe water and improved sanitation
<ul style="list-style-type: none"> Tourism 	<ul style="list-style-type: none"> Diversification of tourism attractions and revenues Shifting ski slopes to higher altitudes and glaciers Artificial snow-making
<ul style="list-style-type: none"> Transport 	<ul style="list-style-type: none"> Realignment/relocation Design standards and planning for roads, rail and other infrastructure to cope with warming and drainage
<ul style="list-style-type: none"> Energy 	<ul style="list-style-type: none"> Strengthening of overhead transmission and distribution infrastructure Underground cabling for utilities Energy efficiency Use of renewable sources Reduced dependence on single sources of energy

Source: IPCC, 2007a, p. 56, Table 4.1

The 2007/2008 Human Development Report of the United Nations Development Programme (UNDP) projected that the investment required annually to meet adaptation needs will be US\$86 million by 2015 (UNDP, as cited in UNFCCC, 2008, p. 23).

3.0 An Overview of the International Investment Law Regime

There is no single cohesive source of international law governing foreign investment. Instead, international investment law is founded in the approximately 3,000 international investment treaties between various combinations of nations dealing with investment. Not without reason has it been likened to a “spaghetti bowl” (Cosbey, et al., 2008, p. v). This paper considers the likely impact of this spaghetti bowl for host States seeking to address climate change and its effects.

International investment treaties, often called international investment agreements (IIAs), come in three main forums:

- (i) Bilateral investment treaties (BITs)
- (ii) Regional investment treaties
- (iii) Investment provisions in preferential trade agreements

BITs are treaties between two countries under which each commits itself to certain reciprocal obligations with respect to investments in the territory of one country by nationals of the other country. Regional investment treaties are similar to BITs but impose reciprocal obligations on a larger number of treaty parties. Preferential trade agreements, sometimes called free trade agreements, are treaties between two or more countries under which treaty parties commit to certain reciprocal obligations on a wider range of subjects (e.g., trade, investment, government procurement, and competition).

While the vast majority of IIAs cover investment in general, a few address investment in specific sectors. Given that energy sector accounted for 84 per cent of anthropogenic CO₂ emissions and 64 per cent of GHG emissions—the most of any sector—two regional instruments specifically focusing on investment in the energy sector are worth noting in this regard. These are the 1994 Energy Charter Treaty and the 2003 Energy Protocol of the Economic Community of West African States (ECOWAS). In light of the significance of the energy sector to GHG emissions and thus to measures to reduce those emissions, these instruments are discussed in further detail at the end of this section.

Although IIAs have been around for nearly half a century—the first known IIA was a 1959 BIT between Germany and Pakistan—their numbers grew exponentially during the 1990s. Figures compiled by the United Nations Commission on Trade and Development (UNCTAD) (2000) show that the number of BITs sextupled from 385 in 1989 to 1857 in 1999. According to UNCTAD (2009), by the end of June 2009 there were 2,701 BITs involving approximately 180 countries (pp. 2, 7). There were also 279 other IIAs, including regional investment treaties and preferential trade and investment agreements (pp. 8–9).

Traditionally, IIAs were usually between developed, capital-exporting countries and developing, capital-importing countries. Since the 1990s, an increasing number of IIAs have been signed between developing countries only. However, as at the end of 2008, 7 of the top ten BIT signatories were still developed countries (UNCTAD, 2009, p. 3) and over 60 per cent of BITs had at least one developed country party (p. 5).

Although their precise wordings differ, IIAs generally bind each contracting State to provide certain standards of treatment to investors from the other contracting State. Typically these standards include:¹⁰

- a) “National treatment” – an obligation to accord the foreign investor treatment no less favourable than that it accords to its own investors;
- b) “Most favoured nation treatment” – an obligation to accord the foreign investor treatment no less favourable than that it accords to investors from any other State;
- c) “Fair and equitable treatment” – an obligation to treat the investor fairly and equitably;
- d) “Expropriation” – a commitment not to expropriate investments except for a public purpose and upon prompt and adequate compensation.

“Investment” is usually defined widely, for example including both tangible and intangible assets such as intellectual property rights. Possibly the most significant of IIA provisions, however, and one contained in most IIAs, is the right for investors to have disputes with the host State resolved through international arbitration rather than through the host State’s domestic courts.

The option for investors to take their disputes with host States to international arbitration commenced in the 1960s with the adoption of the Washington Convention on the Settlement of Investment Disputes between States and Nationals of Other States and the resulting establishment of the International Centre for the Settlement of Investment Disputes (ICSID) under the auspices of the World Bank. These developments occurred in response to increasing pressure from investors left unsatisfied by the other remedies available to them—that is to say, the perceived partiality of host States’ domestic courts or the uncertainty of relying on their home State to make a diplomatic intervention on their behalf (Muchlinski, 2005, pp. 534–536).

As at the end of 2008, the number of known investment treaty arbitrations brought by investors against host States had reached 317 (UNCTAD, 2009, p. 2).¹¹ At least 77 governments—47 developing countries, 17 developed countries and 13 countries with economies in transition—had been respondents in such arbitrations (p. 2). These statistics may underestimate the real number of

¹⁰ The scope of each of these standards of treatment is explained in more detail in Part 2 of this paper.

¹¹ This does not include cases in which the investor had notified its intent to commence arbitration but had not yet done so.

investor-State arbitrations however. While ICSID keeps a public register of cases initiated under its auspices on its website, none of the other arbitral bodies (including the United Nations Commission on International Trade Law [UNCITRAL], the Permanent Court of Arbitration, the Stockholm Chamber of Commerce, the International Chamber of Commerce and the Stockholm Chamber of Commerce) do so.

It is notable that while the surge in BIT signing took place during the 1990s, the wave of arbitrations brought by investors against host States under those BITs is a more recent phenomenon. The first known investor-State arbitration was registered by ICSID in 1987.¹² By April 1998, when the crescendo in BIT signing was largely already passed, ICSID had just received another 14 BIT cases, and only two awards and two settlements had been issued (UNCTAD, 2005, p. 4). The surge in arbitrations occurred in the following decade, with the number of known arbitrations reaching 219 by November 2005 (p. 4; Figure 1). The significance of these figures is that they show that the vast majority of BITs in existence today were signed before the risk of facing an investor-State arbitration was fully apparent. In other words, host States may not have been aware just how much BITs can “bite.”

Investor-State arbitrations may “bite” the host State in a number of ways. Most obvious, there is the impact on the public purse of being found liable to pay a substantial damages award. Recent years have seen a growing number of awards over US\$100 million. The largest known award to date is the approximately US\$270 million awarded to CME against the Czech Republic in March 2003.¹³ Also notable is the series of awards against Argentina arising out of measures it took during its 2001–2002 financial crisis, including the May 2005 award of US\$133 million to CMS,¹⁴ the June 2006 award of US\$165 million to Azurix,¹⁵ the May 2007 award of US\$106.2 million to Enron,¹⁶ the September 2007 award of \$128.6 million to Sempra,¹⁷ and the December 2007 award of US\$185 million to BG Group.¹⁸ The largest arbitration to date, a US\$30 billion claim brought by investors in the Yukos oil company against Russia for the alleged expropriation of their assets in breach of the Energy Charter Treaty is still ongoing.

Irrespective of the outcome of the case, there is the cost to the host State of defending the unwanted investor-State proceeding. In the 2008 case of *Plama Consortium v. Bulgaria*, the host State’s legal costs (for both the jurisdiction and merits phases) were \$13.2 million. In *Pey Casado v. Chile*, also decided in 2008, arbitration costs alone amounted to US\$4.2 million (UNCTAD, 2009, p. 11).

¹² Occidental of Pakistan, Inc. v. Islamic Republic of Pakistan, (ICSID Case No. ARB/87/4), registered 7 October 1987.

¹³ CME v. Czech Republic, 2003.

¹⁴ CMS v. Argentina, 2005.

¹⁵ Azurix v. Argentina, ICSID Case No. ARB/01/12. Award, 14 July 2006

¹⁶ Enron v. Argentina, 2007.

¹⁷ Sempra v. Argentina, 2007.

¹⁸ BG Group v. Argentina, 2007.

The second important way that investor-State arbitrations “bite” is their impact on host State policy space and rule-making. A number of arbitrations to date have included challenges to measures intended by States to protect the public welfare, including regulations directed to protect indigenous people,¹⁹ disadvantaged groups,²⁰ the environment²¹ and health.²² In doing so, these arbitrations have the potential to impact the welfare of individuals and communities within the host State.

Related to this is the so-called chilling effect that the threat of an arbitration can have on a host State’s policy-making. Like the sword of Damocles, investors can use the prospect of arbitration proceedings to discourage governments from pursuing regulations in their citizens’ interest. Given the lack of transparency that plagues the investor-State arbitration regime, it is difficult to identify when the threat of arbitration may have caused host governments to step away from intended public welfare regulation.²³

3.1 The Energy Charter Treaty and the ECOWAS Energy Protocol

The majority of IIAs cover investment in general, however a small number address investment in specific sectors. Given that energy sector accounted for 25.9 per cent of total anthropogenic greenhouse gas emissions in 2004 (IPCC, 2007a, p. 96, Fig. 2.1)—the most of any sector—it is appropriate to provide an overview of the two regional instruments specifically focusing on investment in the energy sector.

3.1.1 The Energy Charter Treaty

The roots of the Energy Charter Treaty (ECT) date back to the early 1990s and the end of the Cold War (Energy Charter, n.d.). Russia and its neighbouring States were rich in energy resources and needing investment for their development; meanwhile, Western European countries wished to diversify their sources of energy supplies, hence the energy sector was thought to hold excellent prospects for mutually beneficial cooperation between East and West (Energy Charter, n.d.). On this foundation, the Energy Charter process was born, beginning with the European Energy Charter in 1991 as a non-binding declaration of political intent to promote East-West energy cooperation. Building upon the Energy Charter’s aim to catalyze economic growth by means of measures to

¹⁹ For example, the recently concluded NAFTA case of *Glamis Gold v. United States* (2009), which challenged state regulations requiring back-filling of opencast mines in an area sacred to the local Native American people.

²⁰ For example, the currently ongoing case of *Piero Foresti v. South Africa*, which challenges aspects of the host state’s Black Economic Empowerment Programme.

²¹ For example, the ongoing NAFTA case of *Clayton & Bilcon of Delaware Inc v. Canada*, which challenges the environmental impact assessments required for a basalt mining quarry.

²² For example, the NAFTA case of *Methanex v. United States* (2005), which challenged state regulations banning the fuel-additive polychlorinated biphenyl.

²³ However, some examples are known. For example, in the mid-1990s the U.S. tobacco lobby threatened to commence NAFTA arbitration proceedings against Canada if the latter proceeded with planned restrictions on cigarette packaging. The proposed packaging restrictions were not adopted. See *Been & Beauvais*, 2003.

liberalize investment and trade in energy,²⁴ the Energy Charter Treaty was adopted as a legally-binding multilateral instrument in December 1994. A protocol to the treaty, the Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects was signed at the same time. Both entered into legal force in April 1998. To date, the Treaty has 52 signatories, having been signed or acceded to by 51 States plus the European Communities.²⁵

The ECT's provisions focus on five main areas: the protection and promotion of foreign energy investments; free trade in energy materials, products and energy-related equipment, based on WTO rules; freedom of energy transit through pipelines and grids; reducing the negative environmental impact of the energy cycle through improving energy efficiency; and mechanisms for the resolution of State-to-State or investor-to-State disputes (Energy Charter, n.d.).

The fundamental objective of the ECT's provisions on investment is to ensure the creation of a "level playing field" for energy sector investments between signatories, with the aim of minimizing non-commercial risks associated with energy-sector investments (Energy Charter, n.d.).

3.1.2 ECOWAS Energy Protocol

The Economic Community of West African States (ECOWAS) is a regional group of fifteen countries,²⁶ founded in 1975, with a mission to promote economic integration in all fields of economic activity, particularly industry, transport, telecommunications, energy, agriculture, natural resources, commerce, monetary and financial questions, social and cultural matters (ECOWAS, n.d.). In the field of energy, the revised ECOWAS Treaty of 1992 stipulates that Member States shall co-ordinate and harmonize their policies and program.²⁷ In addition, ECOWAS should institute a common energy policy and a collective solution for the energy development problems (ECOWAS, n.d.).

In 2003, ECOWAS adopted an Energy Protocol. The Protocol's preamble states, among other things:

Considering that the principles articulated and adopted by 51 nations of Europe and Asia, and memorialised in the document known as the Energy Charter Treaty which was signed in December, 1994, and which went into effect in April, 1998, represent the leading internationally accepted basis

²⁴ Energy Charter Treaty preamble.

²⁵ Albania, Armenia, Australia*, Austria, Azerbaijan, Belarus*, Belgium, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, European Communities, Finland, France, Georgia, Germany, Greece, Hungary, Iceland*, Ireland, Italy, Japan, Kazakhstan, Kyrgyzstan, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Moldova, Mongolia, the Netherlands, Norway*, Poland, Portugal, Romania, Russian Federation*, Slovakia, Slovenia, Spain, Sweden, Switzerland, Tajikistan, the former Yugoslav Republic of Macedonia, Turkey, Turkmenistan, Ukraine, United Kingdom, Uzbekistan (* denotes states in which ratification of the Energy Charter Treaty is still pending)

²⁶ ECOWAS member states are Benin, Burkina Faso, Cape Verde, Cote D'Ivoire, Gambia, Ghana, Guinea, Guinea Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone and Togo.

²⁷ ECOWAS Treaty 1992, article 28.

for the promotion, cooperation, integration and development of energy investment projects and energy trade among sovereign nations;
Appreciating the fact that the Energy Charter Treaty is the outcome of a thorough and thoughtful debate, deliberation and compromise among its signatory nations;
Convinced that adherence to the terms and principles of the Energy Charter Treaty by Member States of the Community will demonstrate to international investors and capital markets that the ECOWAS Region is a very attractive region for investing in energy projects and infrastructure;
Wishing to implement the basic concept of the Energy Charter initiative, which is to catalyse economic growth in the ECOWAS region by means of measures to liberalize energy investment and trade in energy;

In keeping with the preamble's conviction that the ECT is the leading international instrument for the promotion of energy investment, and that adhering to its principles will demonstrate to international investors the attractiveness of the ECOWAS region, the ECOWAS Protocol's provisions, including their numbering, are substantially identical to those of the Energy Charter Treaty. To avoid duplication, the next section considers the main investment protection provisions contained in each instrument together.

Under both the ECT and the ECOWAS Protocol, each Contracting Party shall, in accordance with the instrument's other provisions, encourage and create stable, equitable, favourable and transparent conditions for investors of other Contracting Parties to make investments in its area.²⁸ Such conditions shall include a commitment to accord at all times to investments of investors of other Contracting Parties fair and equitable treatment.²⁹ Investments are entitled to enjoy constant protection and security and no Contracting Party shall in any way impair by unreasonable or discriminatory measures their management, maintenance, use, enjoyment or disposal.³⁰ In no case shall such investments be accorded treatment less favourable than that required by international law, including treaty obligations.³¹ Each Contracting Party shall observe any obligations it has entered into with an investor or an investment of an investor of any other Contracting Party.³² "Treatment" means treatment accorded by a Contracting Party that is no less favourable than that to which it accords its own investors or to investors of any other Contracting Party or any third State, whichever is the most favourable.³³ In addition, each Contracting Party shall endeavour to accord

²⁸ Article 10(1) ECT and article 10(1) ECOWAS Energy Protocol.

²⁹ Ibid.

³⁰ Ibid.

³¹ Ibid.

³² Ibid.

³³ Article 10(3) ECT and article 10(3) ECOWAS Energy Protocol. Article 10(7), ECT and article 10(6) ECOWAS Energy Protocol also require Contracting Parties to accord investments national treatment or most favoured nation treatment, whichever is the most favourable, with respect to their management, maintenance, use, enjoyment or disposal.

such treatment to investors of other Contracting Parties with respect to the making of investments in its area.³⁴

In their present form, both the ECT and the ECOWAS Protocol oblige Contracting Parties to accord non-discriminatory treatment only to existing investments made by investors of other Contracting Parties. As regards the making of investments in its area (the so-called pre-investment stage), both instruments require Contracting Parties to limit to the minimum the exceptions to the non-discriminatory “treatment” described above and to progressively remove existing restrictions affecting investors.³⁵ For the ECT only, the issue of adopting a supplementary treaty that would extend this obligation to ensure non-discriminatory treatment during the making of investments remains under discussion among Member States (Energy Charter Secretariat, 2004, p. 14).

Investments of investors of a Contracting Party in the area of any other Contracting Party must not be nationalized, expropriated or subjected to a measure or measures having effect equivalent to nationalization or expropriation except where for a purpose that is (a) in the public interest; (b) not discriminatory; (c) carried out under due process of law; and (d) accompanied by the payment of prompt, adequate and effective compensation.³⁶

While the ECT and ECOWAS Protocol both provide for a number of public interest exceptions to their general provisions, their application to the investment protections is expressly limited. For example, none of the exceptions apply in the case of an expropriation.³⁷ Similarly, a host State is expressly prevented from asserting that a measure was necessary to protect human, animal or plant life or health in order to defend an investor’s claim under the investment protection provisions.³⁸ However, a host State is entitled to taking a measure otherwise in breach of the ECT and ECOWAS Protocol’s investment protections in several circumstances:

³⁴ Article 10(2) ECT and article 10(2) ECOWAS Energy Protocol.

³⁵ Article 10(5) ECT, article 10(4) ECOWAS Protocol.

³⁶ Article 13(1) ECT and article 13(1) ECOWAS Energy Protocol.

³⁷ Article 24(1) ECT and article 24(1) ECOWAS Energy Protocol.

³⁸ Article 24(2)(b)(i) ECT and article 24(2)(b)(i) ECOWAS Energy Protocol.

- (i) If the measure is essential to the acquisition or distribution of energy materials and products in conditions of short supply arising from causes outside the control of that Contracting Party;³⁹
- (ii) If the measure is designed to benefit investors who are aboriginal people or socially or economically disadvantaged individuals or groups and notified to the secretariat as such;⁴⁰
- (iii) If the host State considers the measure necessary for the protection of its essential security interests, for the implementation of national policies respecting the non-proliferation of nuclear weapons, or for the maintenance of public order.⁴¹

Under both the ECT and the ECOWAS Protocol, Contracting Parties give their unconditional consent for investors to bring disputes with host States to international arbitration or conciliation.⁴² The ECT secretariat knows of over twenty investor-State arbitrations under the ECT to date.⁴³ There have been no known cases to date under the ECOWAS Energy Protocol.

In contrast to the majority of IIAs, the ECT and the ECOWAS Protocol do contain provisions directed to the sustainable development of their Contracting Parties. The ECOWAS Protocol's preamble acknowledges the need for environmental protection:

Understanding that sustaining the environment is an essential component of all phases of development and trade in the energy sector;

In both instruments, contracting parties recognize State sovereignty and sovereign rights over energy resources.⁴⁴ Each State continues to hold in particular the rights to: decide the geographical areas within its Area to be made available for exploration and development of its energy resources; the optimization of their recovery and the rate at which they may be depleted or otherwise exploited;

³⁹ Article 24(2)(b)(ii) ECT and article 24(2)(b)(ii) ECOWAS Energy Protocol: "Any such measure shall be consistent with the principles that (A) all other Contracting Parties are entitled to an equitable share of the international supply of such Energy Materials and Products; and (B) any such measure that is inconsistent with this Treaty shall be discontinued as soon as the conditions giving rise to it have ceased to exist."

⁴⁰ Article 24(2)(b)(iii) ECT and article 24(2)(b)(iii) ECOWAS Energy Protocol: "Any such measure (A) must have no significant impact on that Contracting Party's economy; and (B) must not discriminate between Investors of any other Contracting Party and Investors of that Contracting Party not included among those for whom the measure is intended, provided that no such measure shall constitute a disguised restriction on Economic Activity in the Energy Sector, or arbitrary or unjustifiable discrimination between Contracting Parties or between Investors or other interested persons of Contracting Parties."

⁴¹ Article 24(3)(a), (b) and (c) ECT and article 24(3)(a), (b) and (c) ECOWAS Energy Protocol.

⁴² Article 26(3) ECT and article 26(3) ECOWAS Energy Protocol. Under Article 26(3)(c) of the ECT: Contracting Parties listed in Annex IA do not give their unconditional consent with respect to a dispute arising under the last sentence of article 10(1). The ECOWAS Protocol does not include such a carve-out provision.

⁴³ However, the ECT secretariat notes that there is no requirement that it be notified of such disputes. A list of the cases known to the ECT secretariat is available on its website at <http://www.encharter.org/index.php?id=213>.

⁴⁴ Article 18(1) ECT and article 18(1) ECOWAS Energy Protocol.

to specify and enjoy any taxes, royalties or other financial payments payable by virtue of such exploration and exploitation; to regulate the environmental and safety aspects of such exploration, development and reclamation within its Area; and to participate in such exploration and exploitation, among other things, through direct participation by the government or through State enterprises.⁴⁵ However, Contracting Parties reaffirm that State sovereignty over energy resources must be exercised in accordance with and subject to the rules of international law.⁴⁶

Furthermore, in pursuit of sustainable development and taking into account its obligations under those international agreements concerning the environment to which it is party, each Contracting Party shall strive to minimize in an economically efficient manner harmful environmental impacts occurring either within or outside its area from all operations within the energy cycle in its area.⁴⁷ In doing so, each Contracting Party shall act in a cost-effective manner. In its policies and actions each Contracting Party shall strive to take precautionary measures to prevent or minimize environmental degradation.⁴⁸ The Contracting Parties agree that the polluter in the areas of Contracting Parties, should, in principle,⁴⁹ bear the cost of pollution, including transboundary pollution, with due regard to the public interest and without distorting investment in the energy cycle or international trade.⁵⁰ Contracting Parties shall accordingly, among other things:

- (i) take account of environmental considerations throughout the formulation and implementation of their energy policies;⁵¹
- (ii) promote market-oriented price formation and a fuller reflection of environmental costs and benefits throughout the energy cycle;⁵²
- (iii) have particular regard to improving energy efficiency, to developing and using renewable energy sources, to promoting the use of cleaner fuels and to employing technologies and technological means that reduce pollution;⁵³
- (iv) promote and cooperate in the research, development and application of energy-efficient and environmentally sound technologies, practices and processes which will minimize harmful environmental impacts of all aspects of the energy cycle in an economically-efficient manner;⁵⁴

⁴⁵ Article 18(3) ECT and article 18(3) ECOWAS Energy Protocol.

⁴⁶ Article 18(1) ECT and article 18(1) ECOWAS Energy Protocol.

⁴⁷ Article 19(1) ECT and article 19(1) ECOWAS Energy Protocol.

⁴⁸ Ibid.

⁴⁹ The ECOWAS Protocol omits the words “should in principle bear the cost,” instead using the mandatory “shall bear the cost.”

⁵⁰ Article 19(1) ECT and article 19(1) ECOWAS Energy Protocol.

⁵¹ Article 19(1)(a) ECT and article 19(1)(a) ECOWAS Energy Protocol.

⁵² Article 19(1)(b) ECT and article 19(1)(b) ECOWAS Energy Protocol.

⁵³ Article 19(1)(d) ECT and article 19(1)(d) ECOWAS Energy Protocol.

⁵⁴ Article 19(1)(g) ECT and article 19(1)(g) ECOWAS Energy Protocol.

- (v) encourage favourable conditions for the transfer and dissemination of such technologies consistent with the adequate and effective protection of intellectual property rights.⁵⁵

While the above provisions of the ECT and ECOWAS Protocol regarding their Parties' rights to sustainable development and sovereignty over their energy resources are a positive step in comparison to the majority of IIAs, which are silent on these points, the most favoured nation (MFN) clause in Article 16 of each instrument may render these provisions meaningless. Article 16 of the ECT and the ECOWAS Protocol require Contracting Parties to guarantee to investors of other Contracting Parties the most favourable investment protection provisions contained in that instrument or any prior or subsequent international agreement between that Party and the investor's home State.⁵⁶ This means that if the ECT and ECOWAS Protocol's requirements regarding sustainable development and sovereignty over natural resources would result in the investor receiving less favourable protection than it would receive under another IIA to which its home State and host State are party, the relevant provisions of the other IIA will prevail. This issue will be discussed in more detail in Part 4.2.2 of the paper.

The Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects

In addition to the ECT's provisions on the environment,⁵⁷ the Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects (PEEREA) was signed together with the ECT in December 1994. All ECT Member States are signatories to PEEREA. The Protocol requires its participating States to formulate clear policy aims for improving energy efficiency and reducing the energy cycle's negative environmental impact. It is intended to provide transition economies with a menu of good practices and a forum in which to share experiences and policy advice on energy-efficiency issues with Western European states. Particular attention is given to elements of national energy-efficiency strategies like taxation, pricing policy, environmentally-related subsidies and other mechanisms for financing energy efficiency objectives. PEEREA is currently focused on a series of in-depth energy efficiency reviews designed to produce concrete recommendations for individual governments concerning ways of improving their national energy-efficiency strategies (Energy Charter, n.d.).

⁵⁵ Article 19(1)(h) ECT and article 19(1)(h) ECOWAS Energy Protocol.

⁵⁶ Article 16 ECT and article 16 ECOWAS Energy Protocol.

⁵⁷ Article 19 ECT.

4.0 Will IIAs Obstruct Host State Measures to Address Climate Change?

Part 4 examines whether the investment protections contained in IIAs could constrain host States from taking measures to address climate change. This part of the paper is in three sections. Part 4.1 addresses the effect of an IIA on host State measures to promote new climate-friendly inward investment and to keep out new climate-unfriendly investment. Part 4.2 looks at the implications of an IIA on measures intended to mitigate or adapt to climate change. Part 4.3 asks whether host States may be able to use the defence of necessity to avoid being found in breach of an IIA.

For the purposes of this analysis, “climate-friendly” investment might be defined as one of the following:

- (i) Investment that uses only clean energy⁵⁸ and clean technologies⁵⁹; or
- (ii) Investment that has a neutral or “lower than business as usual”⁶⁰ GHG footprint; or
- (iii) Investment that reduces anthropogenic emissions by sources or enhances anthropogenic removals by sinks of GHGs in any sector of the economy that is additional to any that would otherwise occur.⁶¹

It is necessary to add a qualifier at the outset of this section because of the absence of a doctrine of precedent in international investment arbitration. While arbitral tribunals may in general seek to act consistently with each other, in the end each tribunal exercises its competence in accordance with the applicable law, which will by definition be different for each IIA and respondent host State.⁶² This has led to a considerable number of inconsistent decisions,⁶³ including several cases when the

⁵⁸ This paper utilizes “clean energy” as defined in Cosby, et al. (2008): “clean energy technology includes renewable energy, non-renewable low-carbon technologies, such as clean coal technology (CCT), cogeneration processes, as well as energy efficiency technologies. Renewable energy technologies can be grid connected, or stand-alone local grid solutions. Renewable energy sources include wind, solar photovoltaic (PV), solar thermal, geothermal, bioenergy which includes biofuels/biomass/ethanol, small hydro, and marine (wave/tidal). Small hydro is usually defined as 10 MW or less, although the definition varies by country, sometimes up to 30 MW [...]. Non-renewable low-carbon technologies include clean coal technologies and hydrogen and fuel cells. Energy-efficiency technologies include a wide range of technologies including consumer end-use technologies such as smart-meters and energy-efficient appliances, energy-efficient machinery for industrial applications, district heating and power generation, as well as energy-efficient technologies in non-energy sectors such as agriculture, waste management and transportation” (p. 1).

⁵⁹ “Clean technologies” are considered here to mean technologies other than energy technologies. Many sectors have high GHG emissions irrespective of their energy sources. For example, the farming of livestock and the manufacture of cement are both high GHG emitting processes. “Clean technologies” would be technologies that result in the release of less GHG from these operations than would business as usual.

⁶⁰ This would be a similar test to the “clean technologies” test above.

⁶¹ This definition is drawn from article 6(1) of the Kyoto Protocol.

⁶² *SGS Societe Generale de Surveillance S.A. v. Philippines*, 2004, para. 97.

⁶³ For example, awards that favour the sole effects doctrine for expropriation (e.g., *Metalclad v. Mexico*, 2000), are difficult to reconcile with decisions that take the public purpose of a host state measure into account (e.g., *Methanex v. United States*, 2005).

factual and legal backgrounds were almost identical.⁶⁴ Such inconsistency means that it is never possible to predict with any great certainty how a tribunal may view a particular measure taken by a host State. This may cause host States to be more conservative in taking measures to promote their own sustainable development lest the measures be considered to breach their obligations to foreign investors under an IIA.

4.1 Could IIAs obstruct host States' efforts to promote climate-friendly new investment

One way for host States to ensure that foreign investment into their country complies with their national climate change policies is through the screening of new investment to stop the entry of climate-unfriendly investment. Such screening might, for example, require potential investments to have a neutral carbon footprint or to use only clean energy and technologies. Another way, ideally for use in parallel with screening out climate-unfriendly investment, is to use investment incentives that make it economically attractive for investors to make climate-friendly investments, for example, feed-in tariffs, subsidies and tax breaks.

It may not be immediately obvious why a State would choose to use investment screening to mandate climate-friendly new investments. After all, States have the option of instead laying down regulatory standards that require *all* investments, foreign or domestic, to follow whatever standards they might deem appropriate. That option, being on its face non-discriminatory, might not raise as many potential conflicts with IIA law. However, screening might be a more attractive option in cases where there is as yet no comprehensive climate or energy law that would legally enable such regulations, but where the State nonetheless realizes the importance of regulating, in particular, the sort of large-scale emitters that are often the object of foreign direct investment. Arguably, this is the case in a large number of countries, and especially lower income countries.

Under customary international law, countries have the right to regulate the admission of foreign investors and their investments in their territories (UNCTAD, 2007, p. 21). The overwhelming majority of IIAs adhere to this approach. Though they impose a duty on contracting parties to admit foreign investment in accordance with their national legislation, they do not provide investors with a right of establishment. This has been described as the “admission clause” approach (p. 21). It allows the host State to maintain any admission and screening mechanisms for foreign investment in accordance with the law it wishes and to determine the conditions on which foreign investment will be allowed to enter the country.

⁶⁴ For example, the contrary findings in the sister cases of *CME v. Czech Republic* (2003) and *Lauder v. Czech Republic* (2001).

In contrast, a smaller number of IIAs grant foreign investors rights before their investment is even made in the host State, commonly called “pre-establishment rights.” Such rights most often include national treatment and MFN treatment in the establishment of the investment. Under these IIAs, the host State promises to treat investors from another contracting party no less favourably in the making of their investment than its own domestic investors (national treatment) and investors of any third country (MFN treatment).

IIAs providing investors with pre-establishment rights do not necessarily provide such rights across the board. In some cases, the contracting parties may annex to the IIA a list of industries, activities or laws to which the obligations to grant national treatment and MFN treatment in the pre-establishment phase do not apply (UNCTAD, 2007, p. 23).

Originally only IIAs to which the United States was a party included pre-establishment rights for investors. However, since the North American Free Trade Agreement (NAFTA) entered force in 1994, Canada has followed the U.S. approach in its IIAs too (UNCTAD, 2007, p. 23). More recently, several Asian countries, including Japan and Korea, have begun to include provisions on pre-establishment in their IIAs as well (p. 23).

Under Article 10(2) of both the ECT and the ECOWAS Energy Protocol, Contracting Parties must endeavour to accord MFN and national treatment to investors of other Contracting Parties in the making of their investments. The aspirational wording of this commitment means it is unlikely that a host State would be found in breach.⁶⁵

In summary, as the majority of IIAs do not include pre-establishment rights, host States to those IIAs are free to impose any conditions allowed under their national law that they wish on the admission and establishment of foreign investments. This means that the vast majority of IIAs will not present an obstacle to host States wishing to officially promote only new investment that conforms to its climate change objectives.

However, host States which have at least one IIA with binding pre-establishment rights will have to take more care. While they are able to impose requirements as they see fit with respect to investors from States with which they do not have an IIA with pre-establishments rights, they may need to proceed more carefully in respect of investors from States party to their IIAs with pre-establishment rights. In the context of addressing climate change, this means that they must take care to impose the same clean energy or clean technology requirements on those investors as on domestic investors and investors from third States.

⁶⁵ As previously noted, in accordance with Article 10(4) of the ECT, a supplementary treaty that would extend MFN and national treatment to the making of investments remains under discussion among ECT member states.

IAs in existence prior to the imposition of the host State's climate-friendly investment requirements will pose a particular problem. Potential investors, who should on the face of it be subject to the host State's screening requirements, may be able to use an IIA's pre-establishment rights to get around the requirements on the grounds that they are entitled to no less favourable treatment than that received by domestic investors and investors from other States that invested before the screening requirements were imposed.

4.2 Could IIAs obstruct host State measures to mitigate or adapt to climate change?

This section of the paper considers whether the investment protections found in most IIAs could be a barrier to host States seeking to take measures to mitigate or adapt to climate change, including measures to favour climate-friendly investment over investment with higher GHG emissions. It must be noted at the outset that there is no standard set of protections, and that even those examined here are phrased differently across the thousands of agreements in existence. As such, this analysis cannot be accurate for all existing IIAs. But by focusing on those obligations most commonly found in the broad array of existing agreements, it is nonetheless valuable as a survey of how many IIAs could obstruct governments seeking to address climate change.

4.2.1 National treatment

In deciding whether a host State has discriminated against an investor for the purposes of the national treatment standard, the tribunal must compare the State's treatment of the investor with its treatment of others in like circumstances. For example, if a host State passed a law banning the use of coal to produce electricity, and the investor was the owner of the country's only coal-fired power station, whether or not the ban would be a breach of national treatment would depend on whether other power stations not fired by coal were considered in "like circumstances."⁶⁶ The tribunal's interpretation of "like circumstances" is thus pivotal. In practice, tribunals have taken several different views as to what constitutes "like circumstances."

In the 2000 award in *SD Myers v. Canada*, the tribunal turned to the law developed in the context of the World Trade Organization to understand when parties are in "like circumstances." It held that this varies depending on the circumstances and the context, but an important consideration is whether the enterprises are in competition with one another. Underpinning this approach is the rationale that if a measure negatively affects an investor, but not its competitors, it will lose its place in the market to those competitors. Under the *SD Myers* approach, if the different types of power

⁶⁶ This example may also amount to an indirect expropriation, and will be revisited in the discussion in Part 4.2.4 on expropriation below.

stations were seen as competitors in the electricity market, the ban would amount to a breach of national treatment, notwithstanding its public welfare purpose to address climate change.⁶⁷

In the 2001 award in *Pope & Talbot Inc v. Canada*, the tribunal attempted to move beyond a simple “comparator” test to allow considerations of host State policy to some extent:

“the Tribunal believes that, as a first step, the treatment accorded a foreign owned investment [...] should be compared with that accorded domestic investments in the same business or economic sector. However, that first step is not the last one. Differences in treatment will presumptively violate [NAFTA’s “no less favourable treatment” standard] unless they have a reasonable nexus to rational government policies that (1) do not distinguish, on their face or de facto, between foreign-owned and domestic companies, and (2) do not otherwise unduly undermine the investment liberalizing objectives of NAFTA.” (paras. 78–79)

However, it still presumed that a host State measure that treated the investor and another company in the same sector differently was discriminatory unless the host State could prove otherwise.

The tribunal in *Methanex Corporation v. United States* took a more refined approach in its 2005 award, disagreeing that the basic test for “like circumstances” should be simply whether the enterprises are competitors. The tribunal held:

“The key question is: who is the proper comparator? [...] [I]t would be as perverse to ignore identical comparators if they were available and to use comparators that were less “like”, as it would be perverse to refuse to find and to apply less “like” comparators when no identical comparators existed. The difficulty which Methanex encounters in this regard is that there are comparators which are identical to it.” (Part IV Chapter B, para. 17)

The tribunal held there had been no discrimination.

In the 2007 case of *Parkerings-Compagniet AS v. Lithuania*, the tribunal gave new precedence to public policy considerations in determining whether comparators were in like circumstances. That case concerned a contract to construct a multi-storey carpark near the old town of Vilnius, a UNESCO heritage site. Following opposition from community groups and other problems, the project stalled and eventually the city of Vilnius decided to terminate the contract. Parkerings claimed that it had been discriminated against because another company, who had a contract to build a carpark in the same area, was allowed to proceed. The tribunal dismissed the allegation, stating:

⁶⁷ *SD Myers v. Canada*, 2000, paras. 243–251.

the fact that [Parkerings' project] extended significantly more into the Old Town as defined by the UNESCO, is decisive. Indeed, the record shows that the opposition raised against the [Parkerings project] were important and contributed to the Municipality decision to refuse such a controversial project. The historical and archaeological preservation and environmental protection could be and in this case were a justification for the refusal of the project. The potential negative impact of the [Parkerings] project in the Old Town was increased by its considerable size and its proximity with the culturally sensitive area of the Cathedral. Consequently, [the Parkerings project] was not similar with the carpark constructed by [the other company]. (para. 392)

In so finding, the *Parkerings* tribunal took a step beyond the tribunal in *Pope & Talbot*. Rather than considering public policy as a possible justification for discriminating against two companies in like circumstances, the *Parkerings* tribunal found that the public policy aspects meant that the two companies were not in “like circumstances” at all.

Although the *Parkerings* approach, the most recent of the cases discussed above, would likely have sympathy for host State measures that discriminate between climate-friendly and non-climate friendly investment, the lack of a doctrine of precedent in investor-State arbitration means that the only way to ensure that host States are entitled to discriminate on such grounds, is through express wording in the IIA.

4.2.2 Most favoured nation treatment

A MFN clause in an IIA may present two distinct challenges for a host State seeking to take measures to address climate change. First, like the national treatment standard just discussed, an MFN clause may prevent host States differentiating between climate-friendly investments and similar but non-climate friendly investments. By way of example, suppose that a truck manufacturer from Country A and a truck manufacturer from Country B each sell trucks in the host State through local affiliates. Country A’s investor uses advanced diesel engines in its trucks and thus its local affiliate qualifies for clean energy tax incentives, while the trucks of Country B’s investor have traditional diesel engines and its local affiliate is not entitled to the tax incentives. The divergent case law regarding what constitutes “like circumstances” discussed above is once again applicable, and potentially problematic here. In particular, whether a tribunal would consider that the host State’s tax incentives to Company A’s investor breached the IIA’s MFN clause may depend on whether the tribunal follows the *SD Myers* or *Parkerings* approach. Under the *SD Myers* approach, the two investors would be considered “competitors” and thus a host State measure that disadvantaged one competitor would be a breach of the MFN standard. However, under the *Parkerings* approach, the host State would be entitled to take into account the public policy differences between the two companies and thus the investments would not be in “like circumstances” at all.

A second challenge for host States seeking to take measures to address climate change is that a MFN clause may entitle the investor to circumvent climate-friendly provisions in an IIA and substitute more investor-favourable provisions from another IIA to which the host State is a party. A number of tribunals have held that if an investor is covered by an MFN clause in an IIA and the host State has entered into another IIA that contains more favourable investment protections, the investor can use the MFN clause to incorporate the more favourable provisions into its IIA also. For example, in *MTD Equity Sdn. Bhd. & MTD Chile S.A. v. Republic of Chile* (2004), the Malaysian investor successfully claimed that the MFN in the Malaysia-Chile BIT entitled it to invoke the fair and equitable treatment provisions in Chile's BITs with Denmark and Croatia, which contained more extensively worded obligations.

This makes an MFN clause a powerful provision, as it effectively trumps the intentions of the contracting parties to the IIA. This has been criticized by some host States and commentators who believe that it allows investors to “cherry-pick” to create a type of “super-treaty.” A representative of one host State has said that when negotiating IIAs, it was never their understanding or intention that the IIA's MFN clause would extend beyond how an investor was treated to entitle investors to circumvent carefully negotiated treaty clauses (Dunbar, 2008). However, the general view is that the MFN does extend to the provisions of the host State's other IIAs (McLachlan, et al., 2007, p. 254).

For example, in its decision on jurisdiction in *RosInvest v. Russian Federation* (2007), the tribunal held that the very character and intention of an MFN clause is to ensure that “protection not accepted in one treaty is widened by transferring the protection accorded in another treaty.” The tribunal considered that this effect was generally accepted in relation to substantive treaty protections (e.g., fair and equitable treatment or full protection and security), and that it could identify no reason not to apply this approach in the procedural context. In keeping with this, a number of awards have extended it to the treaty's dispute settlement provisions. In *Gas Natural v. Argentina* (2005), the tribunal held that as “a matter of principle MFN provisions in BITs should be understood to be applicable to dispute settlement provisions unless it appears clearly that the parties intended otherwise.”

Given that the energy sector is responsible for approximately 26 per cent of GHG emissions (IPCC, 2007c, p. 36, Fig. 2.1), the ECT and ECOWAS Energy Protocol's approach to the MFN issue is worthy of special mention. In fact, each instrument includes two general MFN provisions⁶⁸ plus a special provision entitling investors to the most favourable investment protections provided under that instrument or any other IIA to which the host State is a party. This special provision is contained in Articles 16 of the ECT and the ECOWAS Protocol. In essence, Article 16 requires each Contracting Party to guarantee to other Contracting Parties' investors and their investments, the most favourable investment promotion and protection provisions and the most favourable

⁶⁸ Articles 10(3) and 10(7) of the ECT and articles 10(3) and 10(7) of the ECOWAS Energy Protocol.

dispute settlement provisions of those contained in that instrument or any prior or subsequent international agreement between that Party and the investor's home State.⁶⁹

In the context of addressing climate change, Article 16 is potentially problematic. Not only does it apply to a host State's IIAs into the future, but also to those that it entered in the past still in force. The ECT and the ECOWAS Protocol's innovative provisions on environmental protection⁷⁰ and sovereignty over energy resources⁷¹ will be voided if there is another IIA, now or in the future, between the host State and home State that does not contain such elements. Similarly, Article 16 has the potential to nullify any wider carve-outs for social and environmental measures than those in the ECT and ECOWAS Protocol that may be included in any so-called "new generation" IIAs between the parties.

4.2.3 Fair and equitable treatment

The majority of IIAs include the fair and equitable treatment standard (OECD, 2004, pp. 5–7)⁷² and it is now considered one of the key elements of international investment law. The scope of the provision however remains hotly debated and, while the words "fair and equitable" themselves seem simple, interpreting their meaning has proved to be anything but. One issue that has come in for particular attention is whether the standard should be interpreted in accordance with the plain and ordinary meaning of the words "fair and equitable" or whether it should be equated to the minimum standard of treatment required in respect of the property of aliens under customary international law.⁷³ The specific wording of the fair and equitable treatment provision in the IIA may be determinative here, in particular whether the provision requires "fair and equitable treatment in accordance with the principles of international law"⁷⁴ or requires fair and equitable treatment

⁶⁹ Article 16 of the ECT provides:

Where two or more Contracting Parties have entered into a prior international agreement, or enter into a subsequent international agreement, whose terms in either case concern the subject matter of Part III [investment promotion and protection] or V [dispute settlement] of this Treaty,

(1) nothing in Part III or V of this Treaty shall be construed to derogate from any provision of such terms of the other agreement or from any right to dispute resolution with respect thereto under that agreement; and

(2) nothing in such terms of the other agreement shall be construed to derogate from any provision of Part III or V of this Treaty or from any right to dispute resolution with respect thereto under this Treaty, where any such provision is more favourable to the Investor or Investment.

Article 16 of the ECOWAS Energy Protocol is substantively identical.

⁷⁰ Article 19 ECT and article 19 ECOWAS Energy Protocol.

⁷¹ Article 18 ECT and article 18 ECOWAS Energy Protocol.

⁷² Although the IIAs of some Asian countries do not—e.g., Pakistan, Saudi Arabia and Singapore typically do not (OECD, 2004, p3–4).

⁷³ "Aliens" in this context means persons that are not nationals of the host State.

⁷⁴ For example, Article 4(1) of the 1988 BIT between France and Mexico: "Either Contracting Party shall extend and ensure fair and equitable treatment in accordance with the principles of International Law to investments made by investors of the other Contracting Party in its territory or in its maritime area, and ensure that the exercise of the right thus recognized shall not be hindered by law or in practice [...]."

without making any reference to international law or to any other criteria to determine the content of the standard.⁷⁵

It is generally considered that the plain and ordinary meaning is a more exacting standard of treatment than the minimum standard under customary international law,⁷⁶ although some tribunals have held that the minimum standard under customary international law has evolved to such an extent that its requirements are substantially similar.⁷⁷

The tribunal in *Waste Management, Inc. No. 2 v. United Mexican States (2004)* made one of the more comprehensive efforts to define the standard:

Taken together, the S.D. Myers, Mondev, ADF and Loewen cases suggest that the minimum standard of treatment of fair and equitable treatment is infringed by conduct attributable to the State and harmful to the claimant if the conduct is arbitrary, grossly unfair, unjust or idiosyncratic, is discriminatory and exposes the claimant to sectional or racial prejudice, or involves a lack of due process leading to an outcome which offends judicial propriety—as might be the case with a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candour in an administrative process. In applying this standard it is relevant that the treatment is in breach of representations made by the host State which were reasonably relied on by the claimant. (para. 98)

The above excerpt has been cited by a number of subsequent tribunals.⁷⁸ However, tribunals have also repeatedly stressed that a judgment of what is fair and equitable cannot be reached in the abstract. It will always depend on the specific circumstances of the particular case.⁷⁹

Fair and equitable treatment might be considered to have two parts, one substantive and the other procedural. The notion of legitimate expectations is a key element of the substantive aspect of the standard.⁸⁰ To illustrate, an investor involved in the manufacture of refrigerators builds a new plant. Shortly after construction is complete, the government introduces a law requiring all refrigerators to

⁷⁵ For example, Article II (2) of the 2001 BIT between Cambodia and Cuba (2001): “Investments of investors of either Contracting Party shall at all times be accorded fair and equitable treatment and shall enjoy adequate protection and security in the territory of the other Contracting Party.”

⁷⁶ For example, the tribunal in *Glamis Gold v. United States (2009)* held that the claimant had not established that the minimum standard under customary international law had evolved to require anything further than that laid down in the *Neer v. Mexico* arbitration in 1926.

⁷⁷ *Azurix Corp v. Argentina*, 2006, para 361; *Tecmed v. Mexico*, 2003, para. 155; *Occidental Exploration and Production Company v. Ecuador (Republic of)*, 2004, para. 190.

⁷⁸ *GAMI Investments, Inc. v. Mexico*, 2004, para. 89; *Methanex v. United States of America*, 2005, Part IV, Chapter C, para. 12; *Siemens v. Argentina*, 2007, para. 297; *Azurix v. Argentina*, 2006, para. 370.

⁷⁹ *CME Czech Republic B.V. v. Czech Republic*, 2001, para. 336; *Mondev v. United States*, 2002, para. 118; *Petrobart v. Kyrgyz Republic*, 2005, para. 26; *Noble Ventures v. Romania*, 2005, para 181; *MTD Equity Sdn. Bhd. & MTD Chile S.A. v. Chile*, 2004, para. 109; *ADC Affiliate Limited and ADC & ADMC Management Limited v. Hungary*, 2006, para. 44; *Waste Management v. Mexico*, para 99 cited in *GAMI Investments v. Mexico*, 2004, para. 96.

⁸⁰ *Saluka v. Czech Republic*, 2006, para. 302.

incorporate low GHG emitting technologies and the investor will have to do a substantial refit to its plant to meet these requirements. Whether or not the new law is a breach of the investor's legitimate expectations may depend on whether the host State had made any representations to the investor as to the continuation of the legislative status quo. The tribunal in *Tecmed v. Mexico* (2003) provided the most far-reaching statement of the notion of legitimate expectations to date:

this provision of the Agreement, in light of the good faith principle established by international law, requires the Contracting Parties to provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment. 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. Any and all State actions conforming to such criteria should relate not only to the guidelines, directives or requirements issued, or the resolutions approved thereunder, but also to the goals underlying such regulations. The foreign investor also expects the host State to act consistently, i.e. without arbitrarily revoking any preexisting decisions or permits issued by the State that were relied upon by the investor to assume its commitments as well as to plan and launch its commercial and business activities. The investor also expects the State to use the legal instruments that govern the actions of the investor or the investment in conformity with the function usually assigned to such instruments, and not to deprive the investor of its investment without the required compensation. (para. 154)

Despite the heavy burden *Tecmed v. Mexico* (2003) places on host States, its words have been endorsed by a series of subsequent tribunals.⁸¹ The tribunal in *Saluka v. Czech Republic* (2006), however, took a more balanced view:⁸²

This Tribunal would observe [...] that while it subscribes to the general thrust of these and similar statements, it may be that, if their terms were to be taken too literally, they would impose upon host States' obligations which would be inappropriate and unrealistic. Moreover, the scope of the Treaty's protection of foreign investment against unfair and inequitable treatment cannot exclusively be determined by foreign investors' subjective motivations and considerations. Their expectations, in order for them to be protected, must rise to the level of legitimacy and reasonableness in light of the circumstances." (para. 304; emphasis in original)

⁸¹ Excerpts from *Tecmed*, para 154, cited in *MTD v. Chile*, 2004, para. 112; *Occidental v. Ecuador*, 2004, para. 185; *Azurix v. Argentina*, 2006, para. 371; *Siemens v. Argentina*, 2007, para. 297; *GAMI Investments v. Mexico*, 2004, para. 88; *Eureka v. Poland*, 2005, para. 235.

⁸² *Saluka v. Czech Republic*, 2006, para. 304.

Similarly, the tribunal in *Parkerings v. Lithuania* (2007) held that the conditions in the host State were relevant to the legitimacy of the investor's expectations:

In 1998, at the time of the Agreement, the political environment in Lithuania was characteristic of a country in transition from its past being part of the Soviet Union to candidate for the European Union membership. Thus, legislative changes, far from being unpredictable, were in fact to be regarded as likely. As any businessman would, the Claimant was aware of the risk that changes of laws would probably occur after the conclusion of the Agreement [...]. Therefore, in such a situation, no expectation that the laws would remain unchanged was legitimate. (para. 335)

The above excerpts show that there exists a range of views about what an investor's "legitimate expectations" covers. However, some principles may be emerging. First, the State must ensure a stable business environment.⁸³ Though exactly what a State must do to meet this requirement is not fully defined, it appears to include maintaining a transparent and predictable framework for investors' business planning and investment.⁸⁴ However, it has also been acknowledged that no investor can reasonably expect that the circumstances prevailing at the time the investment is made to remain totally unchanged.⁸⁵ Second, it is relevant if the treatment complained of is in breach of representations made by the host State that were reasonably relied on by the investor.⁸⁶ Conversely, a lack of representations by the host State may indicate that the standard has not been breached.⁸⁷ Third, the investor should not recover for loss attributable to its own conduct. It has been said that "bilateral investment treaties are not insurance policies against bad business judgments."⁸⁸ An investor is responsible for meeting the requirements of the host State's law; ignorance of the law is no excuse.⁸⁹ Fourth, as the Permanent Court of International Justice held many years ago, an investor must take the conditions of the host State as it finds them.⁹⁰ This view has subsequently been endorsed by a number of tribunals that have held that an investor cannot subsequently complain if its investment fails merely because of practices or laws already in place at the time of investment, and which were, or ought to have been, known to it before investing.⁹¹ Fifth, the scope

⁸³ *Enron v. Argentina*, para 260; *Occidental v. Ecuador*, 2004, para. 183; *CMS v. Argentina*, 2007, paras 274–276; *LG&E Energy Corp., LG&E Capital Corp. and LG&E International Inc. v. Argentine Republic*, 2006, paras. 124, 125; *PSEG Global v. Turkey*, 2007, para. 253, *Saluka v. Czech Republic*, 2006, para. 303.

⁸⁴ *Metalclad Corporation v. Mexico*, 2000, para. 99. Also *Tecmed v. Mexico*, para. 154, as cited in *MTD v. Chile*, 2004, para. 112; *Occidental v. Ecuador*, para 185; *Siemens v. Argentina*, 2004 Award, para 297, *GAMI Investments v. Mexico*, 2004, para. 88.

⁸⁵ *Saluka v. Czech Republic*, 2006, para. 305; cited in *PSEG Global v. Turkey*, 2007, para. 255.

⁸⁶ *Waste Management No. 2 v. Mexico*, 2004, para. 98; see also *McLachlan, Shore & Weiniger*, p. 237, para. 7.108.

⁸⁷ *International Thunderbird Gaming v. Mexico*, 2006, para. 163–166; see also *McLachlan, Shore & Weiniger*, p. 238, para. 7.111.

⁸⁸ *Emilio Augustin Maffezini v. Kingdom of Spain*, 2000, para. 64; see also *McLachlan, Shore & Weiniger*, p. 246, para. 7.140.

⁸⁹ *Emilio Augustin Maffezini v. Kingdom of Spain*, 2000, para. 70; see also *McLachlan, Shore, Weiniger*, p. 246, para. 7.140.

⁹⁰ *The Oscar Chinn Case*, 1934.

⁹¹ *MTD v. Chile*, 2004, para. 205 and *GAMI Investments v. Mexico*, 2004, para. 91. See also *McLachlan, Shore & Weiniger*, p. 237, para. 7.105–7.107.

of the fair and equitable treatment standard cannot exclusively be determined by a foreign investor's subjective motivations and considerations. The investor's legitimate expectations must be balanced against the host State's legitimate right to regulate domestic matters in the public interest.⁹²

The procedural aspects of the fair and equitable treatment standard relate to the host State's administrative decision-making processes, that is to say, was the decision-making process itself fair and equitable? Many of the principles that may be discerned from cases to date appear drawn from the domestic administrative law concepts of due process and the rule of law. These include that outrageous behaviour and bad faith are not required for a State to be found to have treated the investor unfairly and inequitably.⁹³ Second, a government's treatment of a foreign investor may breach the fair and equitable treatment standard even though it treats its own nationals in a similar manner.⁹⁴ Third, if the host State has legally committed to treat an investor in a certain way, it cannot avoid its obligations simply on the grounds that compliance may be difficult or costly.⁹⁵ Fourth, a State's failure to comply with its own laws does not necessarily violate international law and is thus does not constitute a breach of an IIA per se. Something more than simple illegality or lack of authority under the State's national law is required.⁹⁶ Proof of a good faith effort by the State to achieve the objectives of its laws and regulations may counter-balance instances of disregard of legal and regulatory requirements. The record as a whole—not isolated events—determines whether there has been a breach of international law.⁹⁷ Sixth, if a State uses its powers for a purpose other than for which they were intended, this may be found to be a breach of the standard.⁹⁸ For example, in *Tecmed v. Mexico* (2003), the tribunal found that the Mexican environmental agency's refusal to renew the investor's permit for a hazardous waste landfill was in response to political problems arising from public opposition to the landfill, rather than a contravention of environmental regulations by the investor (para. 164–66). Seventh, the host State must never disregard the principles of procedural propriety and due process and must grant the investor freedom from coercion or harassment by its own regulatory authorities.⁹⁹ Eighth, inconsistent conduct by a host State towards an investor can breach fair and equitable treatment. Ninth, discriminating between nationals and foreign investors is not necessarily a breach of fair and equitable treatment, unless the

⁹² *Saluka v. Czech Republic*, 2006, para. 305.

⁹³ *Mondev v. United States*, para. 116; cited in *ADF Group Inc. v. United States of America* 2003, para. 180; *Tecmed v. Mexico* 2003, para. 153; *Waste Management No. 2 v. Mexico*, 2004, para. 93; *Azurix v. Argentina*, 2006, para. 368; *Siemens v. Argentina*, 2007, para. 297; *Eureko v. Poland*, 2005, para. 234; *Occidental v. Ecuador*, 2004, para. 186; *Enron v. Argentina*, 2007, para. 263; *CMS v. Argentina*, 2007, para. 280; *LG&E v. Argentina*, 2007, para. 129. Also see *Loewen v. United States*, 2003, para. 132; cited in *Waste Management No. 2 v. Mexico*, 2004, para. 97, *Azurix v. Argentina*, 2006, para. 369.

c.f. *Genin v. Estonia*, 2003, para. 367.

⁹⁴ *CME v. Czech* 2003, para. 611; *SD Myers v. Canada*, 2000, para. 259; *Petrobart v. Kyrgyz Republic*, 2005, para. 26.

⁹⁵ *GAMI Investments, Inc v. United Mexican States*, 2004, para. 94.

⁹⁶ *ADF Group v. United States*, 2003, para. 190, *GAMI Investments v. United Mexican States*, 2004, para. 98.

⁹⁷ *GAMI Investments v. United Mexican States*, 2004, para. 97.

⁹⁸ McLachlan, Shore & Weiniger, p. 242, para. 7.124.

⁹⁹ *Saluka v. Czech Republic*, 2006, para. 308.

treaty explicitly prohibits discriminatory measures in the standard.¹⁰⁰ Lastly, a lack of transparency may indicate a breach. In the *Metalclad v. Mexico* (2000) case, the tribunal stated:

The Tribunal understands [the principle of transparency] to include the idea that all relevant legal requirements for the purpose of initiating, completing and successfully operating investments [...] should be capable of being readily known to all affected investors. (para. 176)¹⁰¹

From the above, it is apparent that the fair and equitable treatment standard is a multi-faceted investor protection. Predicting whether any given measure that a host State may take to address climate change would contravene the standard is therefore difficult. In particular, it will depend on whether the tribunal leans more towards the *Tecmed* or the *Saluka/Parkerings* view of the standard. However, some things are clear. If the host State has created an expectation on behalf of the investor that the measure then contradicts, a breach may well be found. Furthermore, it would be prudent for the host State to act transparently, consistently and to give investors as much advance notice of its intentions as possible.

4.2.4 Expropriation

This part of the paper considers whether a measure taken by a host State with the objective of mitigating or adapting to climate change might be found to be an expropriation if it impacts on an investment covered by an IIA. An investment may be expropriated either directly or indirectly. A direct expropriation occurs when an investment is nationalized or otherwise by the host State taken through formal transfer of title or outright physical seizure (OECD, 2004, p. 3). An indirect expropriation occurs if the host State interferes with the use of the investment or with the enjoyment of its benefits even though the investment has not been seized and the legal title to the investment is not affected. Indirect expropriation is also sometimes called “creeping,” “de facto” expropriation or “tantamount” to expropriation (pp. 3–4).

By way of illustration in the climate change context, the government’s taking, without adequate compensation, of an investor’s coastal land for the purposes of building a seawall and coastal buffer zone against sea-level rise and flooding might be held to be a direct expropriation. Returning to the example of the coal-fired power station considered in the discussion on national treatment in Part 4.2.1 above, the introduction by the host State of a ban on the use of coal to produce electricity

¹⁰⁰ Although it will very likely breach the national treatment standard in the treaty if that standard is included.

¹⁰¹ This part of the tribunal’s reasoning was annulled by the Supreme Court of British Columbia on the grounds that the reference to a principle of transparency contained in another part of the treaty was outside the scope of a NAFTA Chapter 11 tribunal (see 5 ICSID Rep 236, 253–254). However, commentators have said that the Supreme Court’s decision may go too far as it is not in keeping with the Vienna Convention on the Law of Treaties, which requires regard to be had to the whole of the treaty text, nor NAFTA Article 1131, which directs a Chapter 11 tribunal to decide a dispute in accordance with this Agreement and applicable rules of international law (McLachlan, Shore & Weiniger, p. 241, n. 198).

would effectively deprive the investor of the enjoyment of its investment in the coal-fired power station and may thus be held to be an indirect expropriation.

A distillation of past arbitral awards reveals two key determinants as to whether or not a tribunal will view measures intended to address climate change as expropriatory. The first is whether the tribunal considers itself bound to take account of the public purpose of the measure—as will be seen below, tribunals are divided on this point. The second determinant is the level of impact of the measure on the investor. On this point, tribunals have been comparatively consistent on the threshold of interference required.

As noted above, tribunals are divided as to the weight to be given to the host State’s purpose in adopting a measure. Past tribunals have generally dealt with this issue in one of three ways. The first approach, known as the “sole effects doctrine,” considers the purpose of the challenged measure to be irrelevant and the measure’s impact on the investor is the sole criterion. The second approach weighs the public purpose of the measure against the burden placed on the investor and requires there be a reasonable relationship of proportionality and the burden not to be individual or excessive. The third approach excludes a non-discriminatory public welfare regulatory measure from the scope of expropriation unless the host State made a specific commitment to the investor not to so regulate.

Despite the apparent differences in the three approaches, each has found support in subsequent arbitral awards, creating considerable uncertainty for all parties concerned. The three divergent approaches are discussed in more detail below:

The 2000 NAFTA case of *Metalclad v. Mexico* (2005) encapsulates the first approach. The *Metalclad* tribunal took the view that the purpose of a measure depriving an investor of the benefit of its investment is irrelevant to whether or not the measure may amount to an expropriation. At issue in that case were a decision by the municipal authority not to grant a permit to operate a hazardous waste site and a subsequent government decree declaring the site part of a nature reserve for the protection of rare cactus. The *Metalclad* tribunal held:

The Tribunal need not decide or consider the motivation or intent of the adoption of the Ecological Decree. Indeed, a finding of expropriation on the basis of the Ecological Decree is not essential to the Tribunal’s finding of a violation of NAFTA Article 1110. However, the Tribunal considers that the implementation of the Ecological Decree would, in and of itself, constitute an act tantamount to expropriation. (para. 111)¹⁰²

¹⁰² *Metalclad Corporation v. United Mexican States*, 2000, para. 111

The second approach is illustrated by another NAFTA case involving a hazardous waste site, *Técnicas Medioambientales Tecmed S.A. v. Mexico* (2003). In its ICSID arbitration proceedings, Tecmed alleged that the Mexican government's failure to re-license its hazardous waste site amounted to an expropriation in breach of the Spain-Mexico BIT. In its 2003 decision as to whether Mexico's conduct was an expropriation requiring the investor to be compensated, the tribunal cited jurisprudence from the European Court of Human Rights in *In the case of James and Others* (1986):¹⁰³

*Not only must a measure depriving a person of his property pursue, on the facts as well as in principle, a legitimate aim 'in the public interest,' but there must also be a reasonable relationship of proportionality between the means employed and the aim sought to be realised [. . .]. The requisite balance will not be found if the person concerned has had to bear "an individual and excessive burden." [. . .] The Court considers that a measure must be both appropriate for achieving its aim and not disproportionate thereto. (p. 19–20, para. 50)*¹⁰⁴

*non-nationals are more vulnerable to domestic legislation: unlike nationals, they will generally have played no part in the election or designation of its authors nor have been consulted on its adoption. Secondly, although a taking of property must always be effected in the public interest, different considerations may apply to nationals and non-nationals and there may well be legitimate reason for requiring nationals to bear a greater burden in the public interest than non-nationals. (p. 24, para. 63)*¹⁰⁵

In light of the above, the *Tecmed* tribunal held that Mexico's actions did amount to an expropriation. It is noteworthy that the Tribunal in this case cites the European Court of Human Rights, and its application of the proportionality test. The sort of balancing of rights, duties and obligations inherent in applying that test may be well served by vast panoply of EU State and EC law, and the well developed institutions that administer them. It can be argued, however, that such a balancing is far more difficult to undertake in the context of investment treaties that do not contain the range of obligations on investors found in the EU legal system.

The third approach is encapsulated in *Methanex Corporation v. United States* (2005), also a NAFTA case. Methanex, a producer of methanol, claimed that the state of California's ban on methyl tertiary butyl ether (MTBE), of which methanol is a key ingredient, was a measure tantamount to expropriation within Article 1110 of NAFTA. In its 2005 award, the tribunal dismissed Methanex's claim, holding:

¹⁰³ European Court of Human Rights, *In the case of James and Others*, judgment of February 21, 1986, p. 19–20, para. 50, as cited in *Técnicas Medioambientales Tecmed S.A. v. The United Mexican States*, 2003, para. 122.

¹⁰⁴ Also cited in *Técnicas Medioambientales Tecmed S.A. v. The United Mexican States*, 2003, para. 122.

¹⁰⁵ Also cited in *Técnicas Medioambientales Tecmed S.A. v. The United Mexican States*, 2003, para. 122.

In the Tribunal's view, Methanex is correct that an intentionally discriminatory regulation against a foreign investor fulfils a key requirement for establishing expropriation. But as a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and, which affects, inter alios, a foreign investor or investment is not deemed expropriatory and compensable unless specific commitments had been given by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulation. (Part IV, Chapter D, para. 7)

The tribunal held that the United States had made no such commitments to Methanex and dismissed its claim.

Although the point was not expressly addressed in the *Methanex* award, it would seem that under its approach, if a tribunal accepts that the challenged measure qualifies as a “non-discriminatory regulation for a public purpose [...] enacted in accordance with due process,” then the burden of the measure on the investor is irrelevant—the measure is not an expropriation. In contrast, under the *Metalclad* and *Tecmed* approaches, the burden on the investor is a determining factor.

However, the dust is not so long settled on the *Methanex* award and future tribunals may yet read its formulation of a “non-discriminatory regulation for a public purpose” in a less expansive way. For example, future tribunals may be quicker to find that a regulation that imposes an excessive burden on the investor is discriminatory in fact, if not on its face. If so, it would fall outside the scope of the *Methanex* carve-out for regulatory measures.¹⁰⁶

The *Methanex* approach was affirmed in the 2006 award in *Saluka Investments BV v. Czech Republic* (2006), in which the tribunal held:

In the opinion of the Tribunal, the principle that a State does not commit an expropriation and is thus not liable to pay compensation to a dispossessed alien investor when it adopts general regulations that are “commonly accepted as within the police power of States” forms part of customary international law today. There is ample case law in support of this proposition. (para. 262)

However, the tribunal then made clear that difficulties remain:

That being said, international law has yet to identify in a comprehensive and definitive fashion precisely what regulations are considered “permissible” and “commonly accepted” as falling within the police or regulatory power of States and, thus, noncompensable. In other words, it has yet to draw a bright and easily distinguishable line between non-compensable regulations on the one hand and,

¹⁰⁶ A number of past tribunals have held that discriminatory treatment includes both de facto and de jure discrimination. For example, *Martin Feldman v. Mexico*, *S.D. Myers Inc. v. Canada*, 2000, para. 252.

on the other, measures that have the effect of depriving foreign investors of their investment and are thus unlawful and compensable in international law. (para. 263)

It thus inevitably falls to the adjudicator to determine whether particular conduct by a state “crosses the line” that separates valid regulatory activity from expropriation. Faced with the question of when, how and at what point an otherwise valid regulation becomes, in fact and effect, an unlawful expropriation, international tribunals must consider the circumstances in which the question arises. The context within which an impugned measure is adopted and applied is critical to the determination of its validity. (para. 264)

Unfortunately for host States, this means that even on the most progressive of approaches, there still remains a degree of uncertainty over the circumstances in which a regulatory measure for a public purpose will be considered expropriatory. This emphasizes the importance of clearly-worded provisions addressing this point to be included in IIAs themselves.

Not every measure that negatively impacts an investment is an expropriation. The degree of interference to the investment is a key determinant as to how a tribunal might view such a measure. In comparison to the divergent views as to the importance of the purpose of the measure, the tribunals have been more consistent as to level of interference the measure must cause to be an expropriation. As summarized in the 2005 award of *CMS Gas Transmission Company v. Argentina*:

The essential question is therefore to establish whether the enjoyment of the property has been effectively neutralized. The standard that a number of tribunals have applied in recent cases where indirect expropriation has been contended is that of substantial deprivation. (para. 262)

The *CMS* tribunal followed earlier tribunals in affirming the *Metalclad* (2001) award, which had noted that expropriation includes:

not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favour of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonable-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State.” (para. 103)¹⁰⁷

A measure to address climate change may be expropriatory even if does not deprive the investor of legal title to its property:

¹⁰⁷ *Metalclad*, 40 ILM 55 (2001), para. 103, as cited in *CMS v. Argentina*, 2007, para. 262 and *Occidental Exploration and Production Company v. Ecuador*, Award, 2004, para. 89.

A deprivation or taking of property may occur under international law through interference by a state in the use of that property or with the enjoyment of its benefits, even where legal title to the property is not affected. (Tippetts, Abbott, McCarthy, Stratton v. TAMS-AFFA Consulting Engineers of Iran, the Government of the Islamic Republic of Iran, 1984)¹⁰⁸

Thus, if a measure to address climate change will have the effect of substantially depriving the investor of the enjoyment of its property, it is potentially at risk of being found to be an expropriation under an IIA. Whether it will be so, will depend largely on whether the tribunal chooses to follow the *Metalclad*, *Tecmed* or *Methanex* approach to host State regulatory measures.

Applying the above analysis to a possible climate change mitigation measure that a host State might take: If an investor was the owner of a coal-fired power station and the host State passed a regulation banning the use of coal to produce electricity, whether a tribunal would find the regulation to constitute an expropriation would depend on two factors. First, whether the regulation would have the effect of substantially depriving the investor of the enjoyment of its property. If the investor was easily able to refit its power station to operate on a more climate-friendly source of fuel, then the tribunal may find that no substantial deprivation has been suffered, and no expropriation had taken place. However, if the cost of refitting the power station was very high relative to the value of the investment, the tribunal might find that the investor had suffered a substantial deprivation of its investment. Whether the regulation would then be held to constitute an expropriation will depend largely on the tribunal's approach to the second factor, that is whether it chooses to follow the *Metalclad*, *Tecmed* or *Methanex* approach to host State public welfare regulatory measures. If the tribunal followed *Metalclad* it may well find that an expropriation had taken place.

4.2.5 Stabilization clauses in investment contracts

Stabilization clauses are clauses contained in contracts between an investor and its host State under which the investor is insulated from changes in the host State's laws. A 2008 study found that stabilization clauses exist in three main forms: "freezing clauses," which freeze the law of the host State for the investor for the life of the project;¹⁰⁹ "economic equilibrium clauses," which leave the investor to comply with new laws, but promise compensation to the investor for the cost of compliance; and "hybrid clauses," which have characteristics of the two previous forms and commit the State to restore the investor to the same position it was in prior to the law change, including by exempting it from the effects of new laws (Shemberg, 2008, p. 27, vi).

¹⁰⁸ See also *Compañía del Desarrollo de Santa Elena S.A v. Republic of Costa Rica*, 5 ICSID Rep 153, 172 and *Occidental Exploration and Production Co v. Republic of Ecuador*, 2004, para. 85.

¹⁰⁹ The Shemberg study found that of the contracts containing freezing clauses analyzed in the research, 83 per cent were in extractive sector contracts (all were mining projects) (p. ix).

Such clauses came into the spotlight earlier this decade as a result of civil society's anger at its inclusion in contracts between the consortium of oil companies and host States involved in the controversial Baku-Tbilisi-Ceyhan (BTC) gas pipeline project through Azerbaijan, Georgia and Turkey. In their original form, the project contracts contained clauses exempting the investors from the effects of law changes in the host States, including changes in health, safety and environmental laws (Shemberg, 2008, p. 27).¹¹⁰

As stabilization clauses are normally found in investment contracts rather than IIAs, at first glance they might appear misplaced in the present discussion of the implications of IIAs on the ability of host States to take measures to address climate change. However, as discussed below, arbitral tribunals are increasingly recognizing interlinkages between IIAs and investment contracts and stabilization clauses have played a large part in this, in at least three respects.

First, if the investment contract contains a stabilization clause, an otherwise non-compensable public welfare measure may be found to be an expropriation requiring compensation to the investor. The leading case on this point is *Methanex Corporation v. United States* (2005). With respect to Methanex's claim that its investment had been expropriated, the tribunal held:

as a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and, which affects, inter alios, a foreign investor or investment is not deemed expropriatory and compensable unless specific commitments had been given by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulation. (Part IV, Ch. D, para. 7)

In the *Methanex* tribunal's view, a non-discriminatory regulation, which was adopted for a public purpose and in accordance with due process, would not normally be an expropriation. However, if the host State had made a specific commitment to the investor to refrain from such regulation—for example such as through a stabilization clause in the investment contract—the regulation may be found to be an expropriation after all.

Second, a stabilization clause in an investment contract has potential ramifications for a tribunal's findings with regard to an investor's claim that the host State breached the fair and equitable treatment standard. It is now widely recognized that an important component of fair and equitable treatment is the requirement that the host State respect the legitimate expectations of the investor when it decided to invest.¹¹¹ In *Parkerings v. Lithuaniai* (2007), the tribunal held that a stabilization

¹¹⁰ In 2003, after considerable criticism from civil society groups, the project contracts were amended with a "Human Rights Undertaking," which expressly recognized the States' international human rights legal obligations and exempts from the stabilization clause any law change reasonably required for the host State to meet its international human rights, labour, and health, safety and environmental treaty obligations.

¹¹¹ E.g., *Técnicas Medioambientales Tecmed, S.A. v. Mexico*, 2003, Para. 154.

clause in the underlying investment contract can give rise to a legitimate expectation by the investor that the investment will not be negatively affected by law changes (para. 332). Hence, a failure to honour a stabilization clause in an investment contract could result in a tribunal finding that the IIA's fair and equitable treatment standard was breached.

Lastly, if the IIA contains an “umbrella clause” a host State breach of a stabilization clause in the investment contract may be treated as a breach of the IIA itself. The precise wording varies somewhat between IIAs, but Article II(c) of the U.S.-Argentina BIT gives an indication of the basic form of an IIA umbrella clause:

Each Party shall observe any obligation it may have entered into with regard to investments.

It is estimated that of the over 2,500 BITs currently in existence approximately 40 per cent contain an “umbrella” clause (UNCTAD, 2007, p. 73). However, there is uncertainty as to the precise nature and effect of umbrella clauses, in particular tribunals have taken very different meanings as to what is meant by “any obligation.” On the more expansive reading, the phrase has been interpreted to convert all the host State's commitments to the investment, whether contractual, legislative or otherwise, into international treaty obligations. An illustration of this approach is the award in *Eureko v. Poland* (2005), which held:

the plain meaning—the ‘ordinary’ meaning—of a provision prescribing that a state ‘shall observe any obligations it may have entered into’ with regard to certain foreign investments is not obscure. The phrase ‘shall observe’ is imperative and categorical. ‘Any’ obligations is capacious; it means not only obligations of a certain type, but ‘any’—that is to say, all obligations entered into with regards to investments of investors of the other Contracting Party. (para. 246)

Amongst other things, this interpretation gives investors the right to bring any contractual grievances with the host State to international arbitration as well as in the host State's national courts. In this way the investor may get “two bites of the cherry” to contest the host State's conduct.¹¹²

The first known tribunal to consider such a clause took a much narrower view. In *SGS v. Pakistan* (2004), the tribunal held that it could not be that such a clause was intended to convert any host State commitment of any kind to a treaty obligation (para. 166). It held that the legal consequences of this would be:

¹¹² To prevent such “double-dipping” some IIAs contain “fork in the road” provisions. For example, Article 28(3) of the COMESA investment agreement provides: “If the COMESA investor elects to submit a claim at one of the fora set out in paragraph 1 of this Article, that election shall be definitive and the investor may not thereafter submit a claim relating to the same subject matter or underlying measure to other fora.”

so far-reaching in scope, and so automatic and unqualified and sweeping in their operation, so burdensome in their potential impact upon a Contracting Party, we believe that clear and convincing evidence must be adduced by the Claimant [...] that such was indeed the shared intent of the Contracting Parties to the Swiss-Pakistan Investment Protection Treaty. (para. 167)

The tribunals in *El Paso v. Argentina*, *Sempra v. Argentina* (2006) and *Pan American Energy LLC and BP Argentina Exploration Company v. Argentina* (2006) fell somewhere between the two previous extremes. The *El Paso* tribunal held:

the umbrella clause read in conjunction with Article VII, will not extend the Treaty protection to breaches of an ordinary commercial contract entered into by the state [...] but will cover additional investment protections contractually agreed by the state as a sovereign—such as stabilization clause—inserted in an investment agreement (para. 81)¹¹³

Notwithstanding the conflicting interpretations of umbrella clauses, the above cases reveal that on all but the most conservative of interpretations (i.e., *SGS v. Pakistan*), a stabilization clause—being a contractual commitment made by the host State in its sovereign capacity—will be picked up by an umbrella clause in an IIA. A commitment by a host State in an investment contract that it will refrain from changing its laws could thus be used by an investor to challenge regulations adopted by the host State to address climate change as if the contractual commitment were a treaty provision itself.

In sum, stabilization clauses in investment contracts, although invisible on the face of the IIA itself, have the ability to reach out through various IIA provisions—namely those on expropriation, fair and equitable treatment and umbrella clauses—to become a powerful weapon in an investor's armoury. This is particularly relevant in the climate change context. Stabilization clauses are most often found in sizable infrastructure and extractive sector concession contracts, both which tend to have large carbon footprints.

4.3 Defence of necessity

Part 4.2 considered the implications of the typical investment protections in IIAs on measures taken by a host State to mitigate or adapt to climate change. Part 4.3 considers whether it might be possible for a host State to defend an investor claim against it on the grounds of necessity.

Many IIAs make express provision for a defence of necessity. For example, Article XI of the United States-Argentina BIT provides:

¹¹³ *El Paso Energy International Company v. The Argentine Republic*, 2006, para. 81. The *El Paso* approach was followed by the tribunal in *Pan American Energy LLC and BP Argentina Exploration Company v. Argentine Republic*, 2006 and *BP America Production Co. and Others v. Argentine Republic*, 2006. *Sempra Energy International v. Argentina*, 2007 took a similar approach.

This Treaty shall not preclude the application by either Party of measures necessary for the maintenance of public order, the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.

The ECT and ECOWAS Energy Protocol also include a defence of necessity. Article 24(3)(c) of both instruments provide that their respective provisions shall not be construed to prevent any Contracting Party from taking any measure that it considers necessary for the protection of its essential security interests, for the implementation of national policies respecting the non-proliferation of nuclear weapons, or for the maintenance of public order.¹¹⁴ The defence contains a significant limitation, however, as it cannot be used as a defence against a claim of expropriation.¹¹⁵

Even if the defence is not expressly included in the IIA, the host State may still be able to look to the defence under customary international law, although the threshold to qualify for the defence under customary law is a high one. The customary law defence of necessity was codified by the International Law Commission in Article 25 of the Draft Articles on State Responsibility:

1. *Necessity may not be invoked by a State as a ground for precluding the wrongfulness of an act not in conformity with an international obligation of that State unless the act:*
 - (a) *is the only way for the State to safeguard an essential interest against a grave and imminent peril; and*
 - (b) *does not seriously impair an essential interest of the State or States towards which the obligation exists, or of the international community as a whole.*
2. *In any case, necessity may not be invoked by a State as a ground for precluding wrongfulness if:*
 - (a) *the international obligation in question excludes the possibility of invoking necessity; or*
 - (b) *the State has contributed to the situation of necessity.*

No investor-State cases to date have considered the defence of necessity in an environmental context. However, given the potential for climate change to have far-reaching and serious impacts, it would appear possible to argue, at least for more vulnerable countries, that climate change jeopardizes both their essential security interests and their public order. In this respect, the Commentary to the Draft Articles on State Responsibility (International Law Commission, 2001) notes that the natural environment can constitute an “essential interest” to be safeguarded against a “grave and imminent peril” under Draft Article 25 (para. 6). Moreover, the natural environment in question need not be subject to the jurisdiction of the State that took the impugned measure (para. 6).

¹¹⁴ Article 24(3)(a), (b) and (c), ECT and ECOWAS Energy Protocol.

¹¹⁵ Article 24(1), ECT and ECOWAS Energy Protocol.

As the IPCC has indicated, the subject of climate change contains considerable uncertainty. Regarding the issue of uncertainty, the Commentary to the Draft Articles observes:

It is true that in questions relating, for example, to conservation and the environment or to the safety of large structures, there will often be issues of scientific uncertainty and different views may be taken by informed experts on whether there is a peril, how grave or imminent it is and whether the means proposed are the only ones available in the circumstances. By definition, in cases of necessity the peril will not yet have occurred. (para. 16)

The Commentary opines that, for the purposes of Article 25(1)(a), it is not sufficient that the peril is merely apprehended or contingent (para. 16). However, it notes that the International Court of Justice has held that the invoking State could not be the sole judge of the necessity but a measure of uncertainty about the future would not necessarily disqualify a State from invoking necessity, if the peril was clearly established on the basis of the evidence reasonably available at the time (*Gabčíkovo-Nagymaros Project* case, cited in UN, 2001, Article 25, para. 16).

To date, the most notable attempts by a host State to invoke the defence of necessity have occurred in the ongoing line of cases against Argentina concerning measures taken by the Argentine government in response to its 2001–2002 financial crisis. So far, awards considering the necessity defence have been issued in seven of these cases, namely *CMS*, *LG&E*, *BG Group*, *Sempra*, *Enron*, *Continental Casualty* and *National Grid*. Notwithstanding the factual similarities in the cases, the tribunals have taken very different approaches to how the defence of necessity should be interpreted. The tribunals allowed the defence in two cases (albeit for the duration of the emergency only)¹¹⁶ but found no such defence in the other five.¹¹⁷ How the tribunals approached the defence of necessity is discussed further below.

The first decision to consider the defence of necessity in an investor-State dispute was the May 2005 award in *CMS v. Argentina* (2005). In its defence, Argentina argued that the Emergency Law challenged by CMS was enacted with the sole purpose of bringing under control the chaotic situation that would have followed the economic and social collapse that Argentina was facing. It sought to invoke the defence of necessity under both customary international law and the provisions of the United States–Argentina BIT (para. 308). The tribunal remarked that the defence is an exceptional one and has to be addressed in a prudent manner to avoid abuse (p. 317). The tribunal noted the International Law Commission’s comment to the effect that the plea of necessity is “excluded if there are other (otherwise lawful) means available, even if they may be more costly or less convenient” (p. 324). The tribunal considered that a number of the required elements of necessity were partially present, but when examined as a whole, it could not be concluded that all

¹¹⁶ *Continental Casualty v. The Argentine Republic*, 2008; *LG&E v. The Argentine Republic*, 2006.

¹¹⁷ *CMS v. The Argentine Republic*, 2005; *BG Group v. The Argentine Republic*, 2007; *Sempra v. The Argentine Republic*, 2007; *Enron v. The Argentine Republic*, 2007; *National Grid v. The Argentine Republic*, 2008.

such elements cumulatively met the test under customary law (para. 331). In particular, the tribunal found that the measures Argentina took were not the only ones available to it as was required by Article 25(1)(a) (p. 324). Moreover, the tribunal considered that Argentine government policies and their shortcomings had significantly contributed to the crisis (p. 329). Thus the tribunal held that Argentina did not meet the requirements of necessity under customary international law (p. 331). Argentina was found in breach of the BIT and ordered to pay US\$133.2 million damages to CMS (p. 472).

Argentina subsequently applied for an annulment of the *CMS* award on various grounds. The annulment committee expressed considerable sympathy for Argentina's concerns. With respect to the tribunal's finding that Argentina had not satisfied the requirements of the necessity defence contained in Article XI of the BIT, the annulment committee found that the tribunal had made two manifest errors of law: first, the tribunal had "assimilated the conditions necessary for the implementation of Article XI of the BIT to those concerning the existence of the state of necessity under customary international law" (*CMS v. Argentine Republic*, 2007, para. 128)¹¹⁸ and second, "it did not examine whether the conditions laid down by Article XI were fulfilled and whether, as a consequence, the measures taken by Argentina were capable of constituting, even *prima facie*, a breach of the BIT" (para. 135). The annulment committee held that "If the Committee was acting as a court of appeal, it would have to reconsider the Award on this ground" (para. 135). However, despite the Committee's sympathy for Argentina's position, it held that Article 52 of the ICSID Convention gave it only limited jurisdiction to annul an award. In particular it had no power to annul an award for manifest error of law (para. 136).

The *LG&E* tribunal in its September 2006 award took a different approach to the question of whether Argentina's financial crisis qualified as a defence under Article XI of the U.S.-Argentina BIT. It did not consider that it needed to use Article 25 of the Draft Articles as a threshold test to determine whether the measures were necessary for the protection of its own essential security interests. Rather, it held that it must decide first whether the conditions that existed in Argentina during the relevant period were such that the State was entitled to invoke the protections included in Article XI of the treaty and second, whether the measures implemented by Argentina were necessary to maintain public order or to protect its essential security interests, albeit in violation of the treaty (para. 205).

It held that Argentina was excused under Article XI of the U.S.-Argentina BIT from liability for any breaches of the treaty during the seventeen months of extreme crisis (*LG&E v. Argentine Republic*, 2007, para. 229). It held that in this period the crises in the economic, political and social sectors reached their apex, threatening total collapse of the government and the Argentine State. It held that

¹¹⁸ Article XI of the United States-Argentina BIT provides "This Treaty shall not preclude the application by either Party of measures necessary for the maintenance of public order, the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests."

the evidence before it indicated that the conditions at this time constituted the highest degree of public disorder and threatened Argentina's essential security interests (para. 231). In contrast to the *CMS* tribunal, the *LG&E* tribunal held that Argentina also met the requirements of the defence of necessity under customary law during this period:

The essential interests of the Argentine State were threatened in December 2001...Although there may have been a number of ways to draft the economic recovery plan, the evidence before the Tribunal demonstrates that an across-the-board response was necessary, and the tariffs on public utilities had to be addressed. (para. 257)

The tribunal held Argentina was not excused from liability for its breaches of the BIT outside the seventeen-month period.

Despite the findings of the *CMS* annulment committee and the *LG&E* tribunal, the next two tribunals to consider the defence of necessity, *Sempra* (2007) and *Enron* (2007), stayed close to the *CMS* tribunal's approach. The *Sempra* and *Enron* tribunals both held that as the United States-Argentina BIT did not itself define necessity or the legal elements necessary for its invocation, the rules governing such questions should be found under customary law as enshrined in Article 25 of the Draft Articles on State Responsibility (*Enron*, para 322–342; *Sempra*, para 364–391). In very similar language, both tribunals held that those requirements and conditions had not been fully met (*Sempra*, para. 378; *Enron*, para. 334).¹¹⁹ The *Sempra* and *Enron* tribunals held that the first condition under Article 25 of the Draft Articles is that the act in question must be the only way for the State to safeguard an essential interest against a grave and imminent peril (*Sempra*, para 347; *Enron*, para 305). The tribunals held that it was quite evident that measures had to be adopted to offset the unfolding crisis, but whether the measures taken under the Emergency Law were the “only way” to achieve this result was a question on which the parties and their experts were profoundly divided (*Sempra*, para 350; *Enron*, para 308). The tribunals were in no doubt that there was a severe crisis, and that in such a context it was unlikely that business could have continued as usual. Yet, they found that the argument that such a situation compromised the very existence of the State and its independence, and thereby qualified as one involving an essential State interest, was not convincing (*Sempra*, para 348; *Enron*, para 306). They found that there had to some extent been a substantial contribution of the State to the situation, giving rise to the state of necessity (*Sempra*, para 354; *Enron*, para 312). In the light of the various elements, the tribunals concluded that the requirements for a state of necessity under customary international law have not been fully met (*Sempra*, para 355; *Enron*, para 313).

¹¹⁹ The *Enron* and *Sempra* tribunals had the same president. Two members of the *Sempra* tribunal also sat on the *CMS* tribunal.

The *BG Group* (2007) case was brought under the U.K.-Argentina BIT, which does not have a necessity provision along the lines of Article XI of the U.S.-Argentina BIT. The *BG Group* tribunal held that lacking an express provision on necessity in the BIT there was no support for Argentina's contention that one should be implied (para 386).

In the *Continental Casualty Co v. Argentina* award released in September 2008, the tribunal upheld Argentina's defence of necessity under Article XI of the United States-Argentina BIT.¹²⁰ In contrast to the *CMS*, *Enron* and *Sempra* awards, the tribunal held that the elements of the defence of necessity under Article XI of the BIT and under customary law were not the same:

The strict conditions to which the ILC text subjects the invocation of the defence of necessity by a State is explained by the fact that it can be invoked in any context against any international obligation. Therefore "it can only be accepted on an exceptional basis." This is not necessarily the case under Art. XI according to its language and purpose under the BIT. (Continental Casualty, para. 167)

The *Continental Casualty* tribunal held that the effect of the defence of necessity under customary law and Article XI differed also. While the customary law defence would excuse a respondent from liability once it had been found in breach of its treaty obligations, under the treaty defence of necessity the challenged "measures would lie outside the scope of the Treaty so that the party taking it would not be in breach of the relevant BIT provision" (para. 164) in the first place.

Drawing on WTO law, the tribunal held that "a measure is not necessary if another treaty consistent, or less inconsistent alternative measure, which the member State concerned could reasonably be expected to employ is available [...] an alternative measure may be found not to be 'reasonably available,' however, where it is merely theoretical in nature, for instance, where the Responding Member is not capable of taking it, or where the measure imposes an undue burden on that Member, such as prohibitive costs or substantial technical difficulties" (*Continental Casualty*, para. 195).¹²¹

The tribunal held that it was impossible to deny that the various severe effects of Argentina's 2001–2002 crisis, taken together, did "not qualify as a situation where the maintenance of public order and the protection of essential security interest of Argentina as a state and as a country was vitally at stake" (*Continental Casualty*, para. 180). The tribunal held that "[t]he protection of essential security interests recognized by Art. XI does not require that 'total collapse' of the country or that a 'catastrophic situation' has already occurred before responsible national authorities may have

¹²⁰ See footnote 118 above for the text of Article XI of the BIT.

¹²¹ Citing WTO Appellate Body, *US-Gambling*, para 308, referring to Art. XIV GATS.

recourse to its protection [. . .]. There is no point in having such protection if there is nothing left to protect” (para. 180).

The most recent decision against Argentina to consider the necessity defence was the November 2008 award in *National Grid PLC v. Argentina* (2008).¹²² National Grid, a UK electricity company with a large stake in the Argentine electricity transmission sector, claimed that its investments were destroyed by the emergency measures taken by Argentina during its 2001–2002 financial crisis. Like the cases discussed above, Argentina sought to defend the claim against it on the basis that the measures were taken during a state of necessity. However, like *BG Group*, the claim was brought under the United Kingdom-Argentina BIT, which lacks a provision like Article XI of the United States-Argentina BIT. Thus, Argentina could only invoke the defence of necessity under customary law.

The tribunal stressed that under customary law a “state of necessity” will excuse a State’s breach of a treaty only in exceptional circumstances. Considering Article 25 of the Draft Articles on State Responsibility, the tribunal held that various internal factors, including national fiscal, debt and labour policies, had contributed to the onset of the financial crisis. Thus, Argentina could not establish that it had not itself contributed to the situation of necessity as was required under the customary law test. Despite finding that Argentina had not satisfied the requirements for the defence of necessity, the tribunal acknowledged the gravity of the crisis, and observed that investors cannot expect to be fully insulated from such crises. While it held that Argentina had breached its obligations to provide “fair and equitable treatment” and “protection and constant security” under the BIT, it qualified its finding by noting:

*What would be unfair and inequitable in normal circumstances may not be so in a situation of an economic and social crisis. The investor may not be totally insulated from situations such as the ones the Argentine Republic underwent in December 2001 and the months that followed.*¹²³

Thus, the tribunal went on to hold that the BIT was not breached in the period when the crisis was at its peak. The tribunal awarded National Grid damages for Argentina’s breaches of the BIT outside this period. Although it did not allow a defence of necessity, the tribunal’s interpretation of the investor’s legitimate expectations provides an interesting alternative approach.

¹²² *In the Matter of an UNCITRAL arbitration between National Grid PLC v. The Argentine Republic*, Award of November 3, 2008, unpublished, reported in *Investment Arbitration Reporter*, 17 December 2008, “UK electricity company wins UNCITRAL arbitration with Argentina; Argentina’s necessity defence is rejected, but tribunal rules that foreign investor had no legitimate expectation to stability during 6 month peak of crisis” (Peterson, 2008).

¹²³ *In the Matter of an UNCITRAL arbitration between National Grid PLC v. The Argentine Republic*, Award of November 3, 2008, unpublished, reported in *Investment Arbitration Reporter*, 17 December 2008, “Tribunal in *National Grid v. Argentina* finds no expropriation or discrimination, but ‘fair and equitable treatment’ and ‘protection and constant security’ obligations are breached.”

Tribunals have also taken diverging views on the question of compensation during a state of necessity under customary law. Article 27 of the Draft Articles on State Responsibility provides:

The invocation of a circumstance precluding wrongfulness in accordance with this chapter is without prejudice to:

- (a) compliance with the obligation in question, if and to the extent that the circumstance precluding wrongfulness no longer exists;*
- (b) the question of compensation for any material loss caused by the act in question.*

With respect to Draft Article 27(b), the LG&E tribunal noted that the Commentary on the Draft Articles states that Article 27(b) does not specify in what circumstances compensation would be payable. The tribunal held that its interpretation of Article XI of the Treaty provided the answer, that is to say, that compensation was not payable during the period covered by the defence of necessity but was payable again after that date (para. 260).

In direct contrast, the *BG Group* tribunal read the wording in Draft Article 27(b) to mean that compensation remained payable even if there was a state of emergency under Draft Article 25. The *CMS* and *Enron* tribunals noted that the Commentary to the Draft Articles suggests that the States concerned should agree on the possibility and extent of compensation payable in a given case. They held that in the absence of agreement between the Contracting Parties the duty of the tribunal was to determine the compensation due (*CMS*, para 392–393; *Enron*, para 344–345).

Although the *Sempra* tribunal found that Argentina's financial crisis did not amount to a state of necessity under the BIT or under customary international law, it held that the application of the law could not ignore the realities resulting from a crisis situation. The tribunal accordingly held that it would take into account the crisis conditions affecting Argentina when determining the compensation due for the liability found in connection with the breach of the treaty standards (para. 394).

The above cases demonstrate the diverse approaches—almost as many as there have been cases—taken by the tribunals that have considered the defence of necessity to date. Of particular note, the *CMS*, *Sempra* and *Enron* tribunals held that, to qualify for the defence of necessity under the BIT, the host State still had to meet the high standards of necessity under customary law, whereas the *LG&E* tribunal considered that Argentina was not required to meet this standard to satisfy the defence of necessity in Article XI of the U.S.-Argentina BIT, but that Argentina had satisfied the customary law requirements anyway. The *Continental Casualty* tribunal, likewise, held that Article XI was a separate defence from the customary law and that Argentina satisfied the treaty defence. However, it differed from the *LG&E* tribunal on the effects of Argentina's successful defence. While *LG&E* held that Argentina had breached the BIT, but was excused from liability for any breaches during the period

of necessity (para. 229), the *Continental Casualty* tribunal held that the effect of the defence was that there were not breaches of the BIT during the period of necessity. In *BG Group* and *National Grid plc*—the two cases to date under the United Kingdom-Argentina BIT in which there was no necessity defence in the BIT—neither tribunal considered Argentina had satisfied the customary law test for necessity nor had they accepted that, absent a specific treaty provision on necessity, one should be implied. However, the tribunal in *National Grid* took an interesting alternative approach, holding that the BIT was not breached during the extreme stages of the financial crisis because the investor could not have legitimate expectations of stability during that period. All tribunals to date have held that a treaty defence of necessity is not self-judging unless the clear intent of the clause indicates otherwise (e.g., *Sempra*, para. 374).

What do all these apparently conflicting decisions mean for a host State wishing to know whether it is able to take measures to address climate change without risk of a sizeable arbitration award against it? Unfortunately, the jurisprudence is far from settled. Although it may be cold comfort, the more gravely and incontrovertibly urgent the host State's need to take measures is, the more likely it will be found to fulfill the defence under both the treaty (if it contains such a defence) and customary international law. Thus, necessity is probably more likely to succeed as a defence with respect to a measure taken under urgency to *adapt* to the effects of climate change. While the need to *mitigate* climate change is essential, mitigation is required at a global level. With the possible exception of a very small number of States with the highest emissions (e.g. the European Union, the United States and China), it would be difficult for an individual host State to prove that *its* mitigation measures were necessary to avoid catastrophic climate change. While it would be appear easier for a host State to satisfy an arbitral tribunal that a measure to adapt to climate change is necessary, the safest course would be to include more appropriately worded necessity clauses in the IIAs themselves. This is discussed in Part 5.1 next.

5.0 How Might an IIA Be Drafted to Support a Host State's Climate Change Objectives?

This part of the paper is in three sections. The first section discusses how an IIA might be drafted so as to ensure that incoming investment is in line with measures taken by the host State to address climate change and to minimize the risk of an investor successfully using international arbitration to challenge such measures. The second section looks at how an IIA might be a tool to support its Contracting Parties' actions to address climate change more generally. The third section considers how an IIA might be drafted to increase the climate-friendly investment flows between the Contracting Parties.

5.1 Ensuring investor compliance and minimizing the risk of investor-State arbitration

This section of the paper discusses how a number of typical IIA provisions might be drafted so as to ensure that inward investment is in line with host State measures to address climate change, and to minimize the risk of an investor using international arbitration to challenge such measures.

5.1.1 Preamble and object

Under Article 31(1) of the Vienna Convention on the Law of Treaties 1969, a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose. Under 31(2) of the Vienna Convention, the context for the purpose of the interpretation of the treaty shall comprise, among other things, its preamble. Thus, an arbitral tribunal in an investor-State arbitration should look to the IIA's preamble and the object provisions to assist it in resolving any issues of interpretation. The majority of current IIAs state that their object and purpose is the promotion and protection of investment, while remaining silent as to the sustainable development needs of the host State.¹²⁴ This has proved problematic for host States in the past, as tribunals have relied on the stated purpose in the treaty to resolve issues of interpretation in favour of the investor.¹²⁵ In one case, a tribunal took a more nuanced view, calling for a balanced approach to the interpretation of the treaty's provisions,

¹²⁴ For example, the preamble of the 2003 BIT between China and Djibouti: "The Government of the People's Republic of China and the Government of the Republic of Djibouti,

Intending to create favorable conditions for investment by investors of one Contracting Party in the territory of the other Contracting Party;

Recognizing that the reciprocal encouragement, promotion and protection of such investment will be conducive to stimulating business initiative of the investors, flow of capital and technology, and will increase prosperity and economic development and that fair and equitable treatment of investments is desirable in both States;

Desiring to intensify the cooperation of both States on the basis of equality and mutual benefits;

Have agreed as follows: [...]"

¹²⁵ E.g. *MTD v. Chile*, 2004, para. 113; *Siemens v. Argentina*, 2007, para. 289; *Azurix v. Argentina*, 2006, para. 360.

on the grounds that an interpretation that exaggerates the protection to be accorded to foreign investments may serve to dissuade host States from admitting foreign investments. It said that this would undermine the overall aim of extending and intensifying the parties' mutual economic relations (*Saluka v. Czech Republic*, para. 300). However, even under this more nuanced approach, the tribunal still viewed the ultimate aim as investment promotion without regard as to whether the said investment contributed to the sustainable development of the host State.

If the preambles and objective provisions of IIAs remain silent as to the need to balance the interests of the various stakeholders and to ensure the sustainable development of the host State, tribunals may find it hard to introduce these considerations later. In the context of the current discussion, it would be important to make clear in both the preamble and object and purpose provisions that the IIA is intended to support its Contracting Parties' sustainable development objectives, including with respect to climate change. This is not without precedent. For example the preamble of the Energy Charter Treaty provides:

*Recalling the United Nations Framework Convention on Climate Change, the Convention on Long-Range Transboundary Air Pollution and its protocols, and other international environmental agreements with energy-related aspects; and
Recognizing the increasingly urgent need for measures to protect the environment, including the decommissioning of energy installations and waste disposal, and for internationally-agreed objectives and criteria for these purposes, [...]*

It may even be helpful to use some of the wording from the United Nations Framework Convention on Climate Change itself. For example, the following lines of its preamble might be appropriate in an IIA context:

*Acknowledging that change in the Earth's climate and its adverse effects are a common concern of humankind,
Acknowledging that the global nature of climate change calls for the widest possible cooperation by all countries and their participation in an effective and appropriate international response, in accordance with their common but differentiated responsibilities and respective capabilities and their social and economic conditions,
Reaffirming the principle of sovereignty of States in international cooperation to address climate change,
Recognizing that States should enact effective environmental legislation, that environmental standards, management objectives and priorities should reflect the environmental and developmental context to which they apply [...]*

5.1.2 Investor compliance with domestic law

One way to ensure that inward investment is in line with host State measures to address climate change is by conditioning the IIA's protections on compliance. For example, Article 10 of the Netherlands-Costa Rica BIT provides:

The provisions of this Agreement shall, from the date of entry into force thereof, apply to all investments made, whether before or after its entry into force, by investors of one Contracting Party in the territory of the other Contracting Party in accordance with the laws and regulations of the latter Contracting Party, including its laws and regulations on labour and environment.

Under such a provision, an investment would have to be made in compliance with all the host States' laws and regulations, including any on climate change, before it would qualify for the IIA's investment protections.

5.1.3 Host State commitment not to lower environmental standards

On the flipside, a number of more recent IIAs contain clauses intended to prevent Contracting Parties lowering environmental standards as a lure for new investment. For example, Article 73 of the EU-CARIFORUM Economic Partnership Agreement provides:

The EC Party and the Signatory CARIFORUM States shall ensure that foreign direct investment is not encouraged by lowering domestic environmental, labour or occupational health and safety legislation and standards [...]

Although “domestic environmental legislation and standards” would almost certainly be wide enough to encompass host State measures to address climate change, for extra emphasis, express wording along the lines “or climate-related” legislation and standards could be inserted into such a clause.

5.1.4 Admission and establishment

As discussed in Part 3 of this paper, the majority of IIAs do not include pre-establishment rights. Thus, under those IIAs, host States are free to impose such admission conditions or screening mechanisms as they see fit. For example, in its domestic investment law, the host State might require that new investments undertake an environment impact assessment to estimate their potential carbon footprint or to use only clean energy technologies.

Though most IIAs do not provide pre-establishment rights, an increasing number do. For example, the recent adopted investment agreement for the COMESA Common Investment Area, and some

IAs to which the United States, Canada, Japan and Korea are party, guarantee investors national treatment and minimum national treatment in the pre-establishment stage. For States seeking to preserve sufficient policy space to address a rapidly evolving issue like climate change, it would seem prudent not to agree to the inclusion of pre-establishment rights in any future IAs. However, if the relative bargaining strengths of the States negotiating an IIA make avoiding pre-establishment rights impossible, in order to preserve the ability for host States to screen out climate-unfriendly new investment, it would be prudent to expressly include an investment's GHG or environmental characteristics as a criteria allowing differential treatment. Some IAs expressly provide for pre-admission screening mechanisms on environmental grounds, for example, through environmental impact assessments (UNCTAD, 2001, p. 56). For example, Article 19(1) of both the ECT and ECOWAS Energy Protocol provide:

*In its policies and actions each Contracting Party shall strive to take precautionary measures to prevent or minimize environmental degradation [. . .] Contracting Parties shall accordingly:
[. . .]
(i) promote the transparent assessment at an early stage and prior to decision, and subsequent monitoring, of Environmental Impacts of environmentally significant energy investment projects; [. . .]*

Possible drafting for the national treatment and minimum national treatment standards allowing host States to discriminate in favour of admitting climate-friendly investment is discussed in part 5.1.5 below. In addition, a provision limiting the IIA's protection to investments made in accordance with host State laws, as discussed above, would be a valuable backstop.

5.1.5 National treatment

In most IAs, national treatment provisions are deceptively short and simple. For example, Article 4(2) of the 2000 Mauritius-Zimbabwe BIT provides:

Each Contracting Party shall accord to the investments of investors of the other Contracting Party made in its territory a treatment which is no less favourable than that accorded to investments of its own investors

Some IAs specifically clarify that national treatment applies only between investors in "like circumstances." For example Article 1102(1) of NAFTA provides:

Each Party shall accord to investors of another Party treatment no less favorable than that it accords, in like circumstances, to its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.

The difficulties come in the application of the standard, as tribunals are left to their own devices to determine what constitutes “like circumstances”. As is evident from the discussion in Part 4 above, this has resulted in various approaches, which in turn results in uncertainty for all concerned. The recently adopted investment agreement for the COMESA Common Investment Area attempts to reduce this uncertainty by establishing a non-exhaustive list of criteria for tribunals to consider when applying the national treatment standard. Article 17 of the COMESA investment agreement provides:

1. *Subject to Article 18, each Member State shall accord to COMESA investors and their investments treatment no less favourable than the treatment it accords, in like circumstance, to its own investors and to their investments with respect to the establishment, acquisition, expansion, management, operation and disposition of investments in its territory.*
2. *For greater certainty, references to ‘like circumstances’ in paragraph 1 of this Article requires an overall examination on a case by case basis of all the circumstances of an investment including, inter alia:*
 - (a) its effects on third persons and the local community;*
 - (b) its effects on the local, regional or national environment, including the cumulative effects of all investments within a jurisdiction on the environment;*
 - (c) the sector the investor is in;*
 - (d) the aim of the measure concerned;*
 - (e) the regulatory process generally applied in relation to the measure concerned; and*
 - (f) other factors directly relating to the investment or investor in relation to the measure concerned; and the examination shall not be limited to or be biased towards any one factor.*

Article 17(2)(b) above should provide enough room for a host State to differentiate between otherwise similar investments on the basis of their respective GHG characteristics. However, if the Contracting Parties want to send a clear signal of the importance they ascribe to addressing climate change, they may wish to expressly add “its effect on GHG emissions” to the list.

5.1.6 Most favoured nation treatment

Although usually of only a few words, as discussed in Part 4, IIA provisions on MFN treatment can result in unforeseen problems for host States.

As outlined in Part 4.2.2, in the context of climate change, these problems may arise in two key respects. First, an MFN clause may prevent host States discriminating between investments on the basis of their GHG impacts. Second, IIA clauses specifically designed to preserve host State policy space to address climate change issue may be rendered nullatory by an MFN clause. As mentioned in Part 4.2.2 above, this is a major failing of the Energy Charter Treaty and the ECOWAS Protocol.

The first problem can be addressed by including in the IIA a list of criteria akin to Article 17(2) of the COMESA investment agreement set out above that a tribunal could refer to when assessing whether an investor is in like circumstances with an investor from a third State. As with national treatment, although a provision like Article 17(2)(b) should sufficiently preserve a host State's ability to differentiate between investments because of their GHG impacts, expressly adding a criterion regarding an investment's effect on GHG emissions would add transparency and also demonstrate the importance the States give to the climate change issue.

The second difficulty, identified in Part 4.2.2 above, is that an MFN clause can be used by an investor to circumvent other clauses in the IIA intended to preserve the host State's policy space. This difficulty can be addressed in several ways. One option, as with the recent India-Singapore Comprehensive Economic Cooperation Agreement, is to do away with the MFN clause in its entirety. Perhaps less controversial and easier to negotiate would be to add a sub-clause to the standard stating that the clause applies only to the substantive provisions of other IIAs that enter into force after the current agreement has done so.

Alternatively, a sub-clause could be added precluding the MFN clause's application to IIAs entered by the Contracting Parties with third States prior to the entry into force of the current IIA. Article 19(1) of the COMESA investment agreement adopts this approach:

Subject to the exceptions provided for under paragraph 3 of this Article, each Member State shall accord to COMESA investors and their investments treatment no less favorable than that it accords, in like circumstances, to investors and their investments from any third country with respect to the establishment, acquisition, expansion, management, operation and disposition of investments in its territory. This paragraph shall not apply to investment agreements entered into by Member States with non-Member States prior to the entry into force of this Agreement. (emphasis added)

5.1.7 Fair and equitable treatment

To avoid a tribunal deciding an investment dispute solely on the basis of what it subjectively considers fair and equitable (which risks a tribunal that has little regard for the host State's climate change needs), the provision on fair and equitable treatment might be drafted so as to clearly delineate and narrow its scope. In the first place this might include limiting the standard to the minimum standard of treatment under customary international law. For example, Article 6 of the ASEAN-New Zealand Free Trade Agreement's Chapter 11 (Investment) provides:

1. *Each Party shall accord to covered investments fair and equitable treatment and full protection and security.*
2. *For greater certainty:*
 - [...]*
 - c. the concepts of “fair and equitable treatment” and “full protection and security” do not require treatment in addition to or beyond that which is required under customary international law, and do not create additional substantive rights.*

In addition, the clause could stipulate something to the effect that “Differential treatment on the basis of public welfare considerations, such as public health, safety or the environment, does not contravene this standard.”

5.1.8 Expropriation

As discussed in Part 4, tribunals have taken divergent approaches to the question of whether bona fide regulations taken by host States for a public purpose can amount to an indirect expropriation. This could create considerable uncertainty for host States seeking to regulate the GHG impacts of inward investment. However, this uncertainty can be avoided by following the approach taken in a number of more recent IIAs, including the COMESA investment agreement and recent U.S. and Canadian BITs. The COMESA investment agreement contains an express carve out provision, stating:

*Consistent with the right of states to regulate and the customary international law principles on police powers, bona fide regulatory measures taken by a Member State that are designed and applied to protect or enhance legitimate public welfare objectives, such as public health, safety and the environment, shall not constitute an indirect expropriation under this Article.*¹²⁶

The model IIAs of Canada and the United States each contain a similar, albeit weaker, provision. The U.S. model BIT prefaces the carve-out provision with “Except in rare circumstances,”¹²⁷ with no guidance as to what constitutes rare circumstances. Canadian BITs preface the carve out provision with “Except in rare circumstances, such as when a measure or series of measures are so severe in the light of their purpose that they cannot be reasonably viewed as having been adopted and applied in good faith.”¹²⁸ While the Canadian model is to be preferred to the U.S. version, the COMESA investment agreement is the most reassuring for host States wishing to take measures to address climate change.

¹²⁶ Article 20(8) COMESA investment agreement.

¹²⁷ US 2004 model IIA, Annex B.

¹²⁸ Canadian 2004 model IIA, Annex B.13(1)(c).

5.1.9 General exceptions

The treaty standards discussed above have been drafted so as to protect host States' ability to ensure that inward investment supports its measures to address climate change. Adding a general overall exception for such measures to the IIA would give such "climate-friendly" IIA provisions greater interpretative force.

General exceptions have been included in many international agreements. For example, Article XIV of the General Agreement on Trade in Services provides:

Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures:

[...]

(b) necessary to protect human, animal or plant life or health;

Article 13 of the Framework Agreement on the ASEAN Investment Area contains an identical provision.

The obvious difficulty with the GATS and ASEAN wording is that the State that has taken the challenged measures is required to prove that those measures were "necessary" to protect human, animal or plant life or health. As was apparent from the discussion of necessity in Part 4 of this paper, this is no easy task as tribunals have a) held the threshold for necessity to be very high and b) taken diverging views as to what exactly is required to meet the threshold.

The 1992 North American Free Trade Agreement (NAFTA), which slightly predates the GATS, avoids the necessity test but uses wording that renders its usefulness practically nullatory. Article 1114(1) states that:

Nothing in [Chapter Eleven on investment] shall be construed to prevent a Party from adopting, maintaining or enforcing any measure otherwise consistent with this Chapter that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns. (emphasis added)

Once again, the COMESA investment agreement offers a more useful alternative. Article 22(1) of the COMESA investment agreement provides:

Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between investors where like conditions prevail, or

a disguised restriction on investment flows, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member State of measures:

- (a) designed and applied to protect national security and public morals;*
- (b) designed and applied to protect human, animal or plant life or health;*
- (c) designed and applied to protect the environment; or*
- (d) any other measures as may from time to time be determined by a Member State, subject to approval by the CCLA Committee.*

The COMESA investment agreement thus imposes the lower standard of “designed and applied to protect” rather than “necessary to protect” and does not include the “otherwise consistent with this Chapter” Achilles heel.

The COMESA investment agreement wording is arguably already broad enough to provide the policy space for host States to address climate change and its effects. However, just as with the other suggested IIA provisions discussed above, for added clarity and signal effect, express wording could be added, for example, to 1(c) so it would read “designed and applied to protect the environment, including from climate change and its effects.”

5.1.10 Stabilization clauses in investment contracts

As noted in Part 4.2.5 above, a stabilization clause is a clause contained in a contract between an investor and its host State under which the host State commits to insulate the investor from changes in the host State’s laws. While not visible on the face of the IIA itself, stabilization clauses can reach out through various IIA provisions—namely those on expropriation, fair and equitable treatment and umbrella clauses—to become a powerful tool to protect investors against new host State regulations. As stabilization clauses are most often found in sizable infrastructure and extractive sector concession contracts, both which tend to have large carbon footprints, such clauses may have particular relevance for regulations taken to address climate change. When entering new contracts with investors in the future, host States should avoid clauses that will potentially limit their ability to take measures in their public welfare. Host States may also wish to review the wording of their existing contracts with extractive sector and large infrastructure investors before taking measures intended to significantly reduce GHG emissions from such activities.

5.2 IIAs as tools to help to address climate change more generally

Part 5.1 examined how IIAs could be designed to preserve host States’ policy space to take measures to address climate change, and to minimize the risk of an investor-State arbitration. Part 5.2 looks briefly at how an IIA might be a tool to assist contracting parties, working together or alone, to address climate change in their countries more generally.

Articles 19(1) of the Energy Charter Treaty and the ECOWAS Energy Protocol contain some fairly comprehensive instructions to their parties regarding how to minimize the environmental impacts of investments in the energy sector:

In pursuit of sustainable development and taking into account its obligations under those international agreements concerning the environment to which it is party, each Contracting Party shall strive to minimize in an economically efficient manner harmful Environmental Impacts occurring either within or outside its Area from all operations within the Energy Cycle in its Area, taking proper account of safety. In doing so each Contracting Party shall act in a Cost-Effective manner. In its policies and actions each Contracting Party shall strive to take precautionary measures to prevent or minimize environmental degradation. The Contracting Parties agree that the polluter in the Areas of Contracting Parties, should, in principle,¹²⁹ bear the cost of pollution, including transboundary pollution, with due regard to the public interest and without distorting Investment in the Energy Cycle or international trade. Contracting Parties shall accordingly:

- (a) take account of environmental considerations throughout the formulation and implementation of their energy policies [...];*
 - (b) promote market-oriented price formation and a fuller reflection of environmental costs and benefits throughout the Energy Cycle;*
 - (d) have particular regard to Improving Energy Efficiency, to developing and using renewable energy sources, to promoting the use of cleaner fuels and to employing technologies and technological means that reduce pollution;*
- [...]*
- (g) promote and co-operate in the research, development and application of energy efficient and environmentally sound technologies, practices and processes which will minimize harmful Environmental Impacts of all aspects of the Energy Cycle in an economically efficient manner;*
 - (h) encourage favourable conditions for the transfer and dissemination of such technologies consistent with the adequate and effective protection of Intellectual Property rights;*
 - (i) promote the transparent assessment at an early stage and prior to decision, and subsequent monitoring, of Environmental Impacts of environmentally significant energy investment projects;*

Article 8(1) of the Energy Charter Treaty and the ECOWAS Energy Protocol require their parties to promote the transfer of technology:

The Contracting Parties agree to promote access to and transfer of energy technology on a commercial and non-discriminatory basis to assist effective trade in Energy Materials and Products and

¹²⁹ The words “in principle” do not appear in article 19(1) of the ECOWAS Energy Protocol.

Investment and to implement the objectives of the Charter subject to their laws and regulations, and to the protection of Intellectual Property rights.

In a similar vein, Article 7 of the Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects provides:

- 1. Consistent with the provisions of the Energy Charter Treaty, Contracting Parties shall encourage commercial trade and co-operation in energy efficient and environmentally sound technologies, energy-related services and management practices.*
- 2. Contracting Parties shall promote the use of these technologies, services and management practices throughout the Energy Cycle.*

Even if including reference to such provisions in a future IIA is only confirming States' existing obligations under the ECT or ECOWAS Protocol if they are parties, such commitments still add value by increasing transparency and giving potential foreign investors more assurance on what they can reasonably expect in the host country (UNCTAD, 2008, p. xiii).

5.3 How might IIAs be designed to promote climate-friendly investment?

Part 5.3 of the paper considers how IIAs might be designed to promote climate-friendly investment. This takes the enquiry a step further than part 5.1, which asked how IIAs might be designed so as to ensure that they do not interfere with host State policies to address climate change, and part 5.2, which asked how IIAs might support their contracting parties to address climate change more generally. In this regard, this section will consider the extent to which the CDM of the Kyoto Protocol might serve as a useful model for an IIA seeking to promote climate-friendly investment. It will also consider the possible forms an IIA specifically designed to promote climate-friendly investment might take.

The Clean Development Mechanism as a model IIA

The Kyoto Protocol, a protocol to the 1992 United Nations Framework Convention on Climate Change (UNFCCC), was adopted in 1997. Following its ratification by the Russian Federation in November 2004, the Protocol entered into force in February 2005.¹³⁰ It obliges developed countries to reduce their GHG emissions by specified individual targets in the period 2008–2012. The Protocol establishes three market-based mechanisms for the trading of carbon permits, based on the

¹³⁰ To enter force, the Protocol required at least 55 parties to the Convention to ratify it, including enough industrialized countries listed in the Convention's Annex I to encompass 55 per cent of that group's carbon dioxide emissions in 1990. In practice, this meant that for the Protocol to ever enter force, either the United States or Russia needed to ratify it.

principle that emission reductions will occur where they are most economically efficient. The CDM is the only one of the three to give developing countries a role in the international carbon market.¹³¹

The CDM, established through Article 12 of the Kyoto Protocol, is a mechanism through which public or private entities from Annex I countries can carry out projects in non-Annex I countries to gain certified emission reductions. As set out in Article 12(2), the CDM has a two-fold purpose: first, to assist non-Annex I countries to achieve sustainable development and in contributing to the ultimate objective of the UNFCCC,¹³² and second, to assist Annex I countries to achieve compliance with their quantified emission limitation and reduction commitments under Article 3.

As was noted in Part 3 of this paper, an IIA is typically defined as an agreement to promote and protect investment. Although traditionally, promoting and protecting investment was the sole stated objective, a “new generation” of agreements also includes sustainable development considerations as key aims. In some respects, the CDM can be seen as a type of “new generation” IIA itself—an agreement to promote investment from developed country investors into developing countries with sustainable development of the latter being a central aim.

The implementation of the CDM is quite complex and involves a number of (somewhat bureaucratic) procedural steps. To participate as a host, a country must have ratified the Kyoto Protocol and established a Designated National Authority (DNA). Following the design of a potential project, the DNA of each country involved must confirm that all parties’ participation in the proposed CDM project is voluntary. Both public and private entities can participate.¹³³ The DNA of the developing host State must also confirm that the proposed project will contribute to its country’s sustainable development. The project design document will then be forwarded to a Designated Operational Entity (DOE) for validation and certification. DOEs are independent auditors accredited by the UNFCCC Conference of the Parties serving as the Meeting of the Parties to the Protocol. Before a potential project starts, the DOE is responsible for assessing whether it meets all the eligibility requirements of the CDM (validation). Following the project’s implementation, the DOE must assess whether the project has achieved its GHG emission reductions (verification and certification). The Executive Board, appointed by the Parties, is the CDM’s supervisory body and is responsible for the administration and, at the direction of the Parties, further elaboration of the CDM rules and modalities.

¹³¹ The two other mechanisms are: (i) International Emissions Trading, which allows Annex I countries (i.e., industrialized countries and countries with economies in transition, such as Russia, Ukraine and Romania) to buy and sell parts of each country’s assigned amount units (AAUs) thereby increasing allowable emissions in the recipient country and reducing those of the seller country; and (ii) Joint Implementation, a project-based mechanism whereby a project to mitigate climate change in an Annex I country can earn carbon credits that can be used by another Annex I Party to help meet its emissions limitation commitment.

¹³² The objective of the UNFCCC, as stated in its Article 2, is to achieve “stabilisation of GHG concentrations in the atmosphere at a level that would prevent dangerous anthropogenic interference with the climate system.”

¹³³ Article 12(9) Kyoto Protocol.

To be certified by the DOE for emission reductions, a CDM project must result in real, measurable and long-term GHG emission reductions.¹³⁴ One of the key requirements of any CDM project is that it demonstrate additionality; the reductions in emissions must be additional to any that would occur in the absence of the certified project activity.¹³⁵ A share of the proceeds from certified project activities is to be used to assist developing country Parties that are particularly vulnerable to the adverse effects of climate change to meet the costs of adaptation.¹³⁶

A 2008 World Bank study found that the primary CDM market was worth US\$7,426 million, up from US\$5,804 million in 2006 (Capoor & Ambrosi, 2008, p. 19). It should be noted that this does not mean that the combined value of CDM *investments* was US\$7,426 million. Rather, this is the value of the primary market for carbon emission reductions. The underlying investments that gave rise to those credits would be many times that large.

In addition to the compliance-driven CDM investments, a developing country's participation in CDM projects may help to increase its climate-friendly investment inflows more broadly. This could occur in a number of ways. For example, establishing a well-functioning DNA might demonstrate to potential investors the country's ability to develop effective institutions and frameworks to support climate-friendly investment. The structures of DNAs vary between countries, but most have set up some type of inter-ministerial committee to oversee and guide its work. The inter-ministerial structure may help to raise government awareness of climate change issues, beyond the environment ministry, which might in turn inspire investor confidence. The requirement that the DNA confirm that a CDM project will contribute to the country's sustainable development has been used as an opportunity by some governments to consider possible linkages between investment and broader national development goals.¹³⁷ A number of developing countries have DNAs or "CDM promotion offices" that provide technical assistance, awareness-raising and training to potential investors, public officials and financiers. As well as supporting CDM projects, this assistance may help investors to identify investment opportunities and inspire investor confidence for climate-friendly investment more broadly.

From the above, it could be argued that the CDM is in fact more effective than traditional IIAs in promoting investment—after all the evidence that traditional IIAs actually result in increased investment in the absence of other factors is not strong.¹³⁸

¹³⁴ Article 12(5)(b) Kyoto Protocol.

¹³⁵ Article 12(5)(c) Kyoto Protocol.

¹³⁶ Article 12(8) Kyoto Protocol.

¹³⁷ For example, China has a priority list of CDM project sectors, including renewable energy and energy efficiency, where the CDM can have a positive impact on its sustainable development.

¹³⁸ The empirical evidence on whether or not IIAs do in fact increase FDI is mixed. An extensive 2003 study by Hallward-Driemeier found that BITs had no significant effect on FDI flows. A 2005 study by Salacuse and Sullivan found a positive relationship between FDI and strict BITs while less strict BITs had no significant effect. Another 2005

However, while the World Bank's valuation of the primary CDM market makes for an impressive figure, before the CDM is held up as an ideal model IIA to promote climate-friendly investment, it must be recalled that it differs from traditional IIAs in a key respect. CDM investment is propelled by the binding obligation on Annex I countries to achieve compliance with their quantified emission limitation and reduction commitments.¹³⁹ Traditional IIAs contain no comparative obligations on developed home States that might act as a driver for climate-friendly investment.

The above discussion gives rise to some interesting possibilities as to how IIAs could be drafted in the future to promote climate-friendly investment. Given the significant backlogs in the CDM's verification, validation and certification processes, its procedural complexities and the fact that it is currently being reviewed in advance of the end of the current commitment period in 2012 leaving its future uncertain, one option might be an IIA that uses a model with some similarities to the CDM, but with its own approval process and incentive schemes. Another option might be an IIA that stays silent as to incentives to promote climate-friendly FDI, leaving them to each State to decide at the domestic level, but which contains investor protections drafted to be climate-friendly.

These options are discussed below.

The first option would be an IIA that adopts some of the more salient elements of the CDM for its contracting parties. The IIA would contain a mechanism under which investments meeting the "climate-friendly" criteria specified in the IIA would be entitled to the IIA's investment protections and/or investment incentives. There are a number of potential sources from which the contracting parties might draw to establish the criteria for such benefits.

study, by Tobin and Rose-Ackerman, concluded that the relationship between BITs and FDI is weak, although slightly more positive at high levels of country risk. A second study by Tobin and Rose-Ackerman in 2006 found a positive relationship. Another 2005 study, by Neumayer and Spees, the most extensive to date, found that BITs have a positive and significant effect on FDI. However, a 2007 review of Neumayer and Spees's study by Yackee found that with some small but justifiable changes in methodology the apparently positive effect of BITs on FDI largely fell from statistical significance. Thus, on the basis of these diverse findings, it would seem that the evidence on whether IIAs do in fact increase FDI is not strong. See M. Hallward-Driemeier, *Do Bilateral Investment Treaties attract FDI? Only a bit...and they could bite*, World Bank Policy Research Working Paper No. WPS 312 (2003); J.W. Salacuse and N.P. Sullivan (2005), *Do BITs really work? An evaluation of Bilateral Investment Treaties and their grand bargain*, *Harvard International Law Journal*, 46, p. 67; J. Tobin and S. Rose-Ackerman (2005), *Foreign direct investment and the business environment in developing countries: The impact of Bilateral Investment Treaties*, Yale Law & Economics Research Paper No. 293; J. Tobin and S. Rose-Ackerman, (2006), *When BITs have some bite: The political-economic environment for Bilateral Investment Treaties*, retrieved March 2010 from: http://www.law.yale.edu/documents/pdf/When_BITs_Have_Some_Bite.doc; E. Neumayer and L. Spees (2005), *Do Bilateral Investment Treaties increase foreign direct investment to developing countries?* *World Development*, 33, p. 1567; J.W. Yackee (2007, October), *"Do BITs really work? Revisiting the empirical link between investment treaties and foreign direct investment"*, Univ. of Wisconsin Legal Studies Research Paper No. 1054.

¹³⁹ Article 3, Kyoto Protocol.

One such source is the ample and detailed list of approved project methodologies that now exist under the CDM. The difficulty here is that the CDM seeks to establish not only that a project reduces GHG emissions, but also that it contributes to sustainable development in the host country, with certification of the latter being the host's responsibility on a more or less ad hoc basis. In the context of an IIA such an arrangement might be emulated, with broad guidance set at the international level and specific approval coming from the host government. Note that in the context of the CDM a number of analysts have basically concluded that the criteria are generally not rigorously applied by governments hungry for investment, and that a "do-no-harm" standard results in the end (UNDP, 2006). Also note that the discretion on the part of the potential hosts may give rise to issues of MFN treatment, if they are seen to be unfairly applied.

Box 1: IEA's Significant Technologies

Power Generation Sector

- CO₂ capture and storage (CCS)
- Nuclear power plants
- Onshore and offshore wind energy
- Biomass integrated combined cycle
- Solar photovoltaic systems
- Concentrating solar power systems
- Coal integrated gasification combined cycle
- Coal ultra-supercritical steam cycle

Buildings sector

- Energy efficiency in buildings and appliances
- Heat pumps
- Solar space and water heating

Transport sector

- Energy efficiency in transport
- Second-generation biofuels
- Electric and plug-in hybrid vehicles
- Hydrogen fuel cell vehicles

Industry sector

- CCS in industrial applications
- Industrial motor systems

Alternatively, the IIA might simply set out a defining set of guidelines that list the types of eligible projects. For example, the International Energy Agency's (IEA's) Energy Technology Perspectives 2008 describes a number of technology roadmaps for technologies that are key for reducing emissions from the energy sector (responsible for over 60 per cent of anthropogenic GHG emissions)(see Box 1). Any investments in these technologies/sectors might be designated as eligible. But whether taken from this or some other source, of which there are several possibilities, such a list would require management and maintenance, to allow new technologies to enter, and to drop old ones as they become the mainstream. There are a number of difficult issues associated with such management (Aguilar, et al., 2009).

The contracting parties might make the criteria more or less exacting as they wish. Probably, the easier that it is to meet the criteria, the more investments might result from the IIA. On the other hand, the more rigorous the criteria, the more "climate-friendly" the investments made under the IIA are likely to be.

The procedure for assessing whether an investment met the IIA’s “climate-friendly” criteria could be more or less institutionalized, depending on the contracting parties’ preferences. At the lesser end, a designated official within the contracting party itself might be charged with assessing whether investments made in that country by investors from other contracting parties meet the IIA’s “climate-friendly” criteria. At the more institutionalized end, the contracting parties might establish one centralized independent body to assess all investments made under the IIA to certify whether they satisfy the IIA’s “climate-friendly” criteria and thus qualify for its protections and/or incentives. For IIAs with a number of parties, one centralized body may have the benefit of a standardized consistent approach. However, it comes with obvious constraints, most notably a risk of bottlenecks like those that dog the CDM. For smaller IIAs, national-level certification within the host State would seem more cost-effective.

The IIA itself might include some of the climate-friendly investor protections discussed in Part 5.1 of this paper. It might also include one or a number of the incentives set out in Box 2 below, albeit carefully designed to encourage climate-friendly investment while remaining consistent with the IIA’s investor protections and international trade obligations more generally.¹⁴⁰ The IIA might potentially include incentives offered by both the home and host State.

¹⁴⁰ The World Trade Organization’s Agreement on Subsidies and Countervailing Measures (SCM) prohibits Member States from providing “specific subsidies.” While many of the investment incentives listed in Box I might qualify as “subsidies” under article 1 of the SCM, so long as the incentives are applied according to clear, published, automatic and objective criteria they will not be considered “specific subsidies” under article 2 of the SCM, and thus would be permissible.

Box 2: Types of investment incentives**Financial incentives**

- Investment grants: “direct subsidies” to cover (part of) capital, production or marketing costs in relation to an investment project
- Subsidized credits and credit guarantees: subsidized loans/loan guarantees/guaranteed export credits
- Government insurance at preferential rates/publicly funded venture capital participating in investments involving high commercial risks. Government insurance at preferential rates, usually available to cover certain types of risks such as exchange rate volatility, currency devaluation, or non-commercial risks such as expropriation and political turmoil (often provided through an international agency)

Fiscal incentives

- Profit-based: reduction of the standard corporate income tax rate/profit tax rate/tax holiday
- Capital-investment-based: accelerated depreciation/investment and reinvestment allowance
- Labour-based: reduction in social security contributions/deductions from taxable earnings based on the number of employees or on other labour-related expenditure
- Sales-based: corporate income tax reductions based on total sales
- Import-based: duty exemptions on capital goods, equipment or raw materials, parts and inputs related to the production process; tax credits for duties paid on imported materials or supplies
- Export-based: export tax exemptions; duty drawback; preferential tax treatment of income from exports, income tax reduction for special foreign-exchange-earning activities or for manufactured exports; tax credits on domestic sales in return for export performance; income tax credits on net local content of exports; deduction of overseas expenditures and capital allowance for export industries
- Based on other particular expenses: corporate income tax deductions based on, for example, expenditures relating to marketing and promotional activities
- Value-added-based: corporate income tax reductions or credits based on the net local content of outputs; granting income tax credits based on net value earned
- Reduction of taxes for expatriates

Other incentives*Subsidized services*

- Subsidized dedicated infrastructure: electricity, water, telecommunication, transportation/designated infrastructure at less than commercial price
- Subsidized services, including assistance in identifying sources of finance, implementing and managing projects, carrying out pre-investment studies, information on markets, availability of raw materials and supply of infrastructure, advice on production processes and marketing techniques, assistance with training and retraining, technical facilities for developing know-how or improving quality control

Market privileges

- Preferential government contracts
- Closing the market to further entry or the granting of monopoly rights; protection from import competition

Foreign exchange privileges

- Special treatment with respect to foreign exchange, including special exchange rates, special foreign debt-to-equity conversion rates, elimination of exchange risks on foreign loans, concessions of foreign exchange credits for export earnings, and special concessions on the repatriation of earnings and capital

Source: UNCTAD, 2004, p. 6–7, Box 1.1

Another option, specific to the power sector, would address the problem of discriminatory application of incentives that currently exists in some regions with respect to imported power. For example, in Europe, a number of States provide incentives such as feed-in tariffs for renewably generated electricity. However, renewably generated electricity that is imported often receives no such benefit, being paid at the less favourable market rates. The result is dampened proliferation of renewable generation technologies, particularly in tightly integrated grids. Contracting parties to

agreements such as the ECT and ECOWAS might commit to national treatment with respect to the granting of such incentives.

Finally, as always, there is the “zero option.” The IIA could be silent regarding incentives to promote climate-friendly FDI. Contracting parties to the IIA (both home and host States) would then be free to establish such regulations or incentive schemes in their domestic law to promote climate-friendly investment as they see fit. This could include establishing “climate-friendly” investment criteria in the domestic law, which, if met, will qualify investors for investment incentives.

Though silent as to incentives, the IIA might still contain a number of the climate-friendly investor protections discussed in Part 5.1 of the paper. The advantage of this option would be that it leaves each State with the maximum flexibility to design appropriate investment regulations and incentives away from the pressure of the negotiating table. It also means that, subject to respecting the legitimate expectations of existing investors,¹⁴¹ the host State can later revise its investment regime as it sees fit. The disadvantages of this approach may include the loss of transparency and signalling effect (themselves host State investment incentives) that having investment incentives set out in the IIA would otherwise provide.

¹⁴¹ See the discussion on fair and equitable treatment in Part 3.2.3 above.

6.0 Conclusion

Climate change is now recognized as one of the greatest, if not the greatest challenges in history. In its fourth assessment report, the IPCC found that warming of the climate system is unequivocal and its potential effects are likely to be far-reaching and devastating, particularly for some of the poorest countries of the world.

The IPCC considered that investment has a key role to play in meeting the challenges presented by climate change. This may be so. However, the investment protections contained in the “spaghetti bowl” of approximately 3,000 international investment agreements worldwide have the potential to impede host States taking measures to mitigate or adapt to climate change, including to take measures to promote climate-friendly investment.

This paper examined the potential barriers that existing IIAs might present to host States taking measures to address climate change. It noted that the lack of a doctrine of precedent in international investment arbitration has resulted in tribunals taking inconsistent, sometimes irreconcilable, interpretations of the standard investment protections. As a result, there is a risk that each of the investment protections examined—national treatment, most favoured nation treatment, fair and equitable treatment, expropriation and stabilization clauses—could potentially impede a host State’s ability to take measures to address climate change, depending on which of the earlier tribunals’ interpretations the tribunal prefers to follow. That being said, some recent awards appear more willing to acknowledge the public interest aspects of the case before them and to give a more balanced reading of the investor protections. No doctrine of precedent, however, coupled with a lack of right of appeal means that the more balanced outcomes are by no means certain. In sum, the only way to ensure that host States have the policy space to take measures to mitigate or adapt climate change unimpeded is by explicitly stipulating this in the IIAs themselves.

With this in mind, the paper showed how the standard IIA provisions could be redrafted, sometimes in very minor ways, to ensure that host States have the necessary policy space to take measures to address climate change without risking an arbitration award against them. It also drew together provisions from the UNFCCC and existing IIAs that states negotiating an IIA might wish to consider with respect to addressing climate change more generally. Lastly, the paper explored a number of options for what an IIA specifically designed to promote increased inflows of climate-friendly investment might look like, including the extent to which the Kyoto Protocol’s Clean Development Mechanism could be a useful model.

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