



# **SUSTAINABLE DEVELOPMENT LAW ON CLIMATE CHANGE**

**LEGAL WORKING PAPER SERIES**

**01  
FOREIGN INVESTMENT LAW  
AND CLIMATE CHANGE:  
LEGAL CONFLICTS ARISING FROM  
IMPLEMENTING THE KYOTO PROTOCOL  
THROUGH PRIVATE INVESTMENT**

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# FOREIGN INVESTMENT LAW AND CLIMATE CHANGE: LEGAL CONFLICTS ARISING FROM IMPLEMENTING THE KYOTO PROTOCOL THROUGH PRIVATE INVESTMENT<sup>1</sup>

Freya Baetens<sup>2</sup>

## 1. Introduction

'May you live in interesting times' is reputed to be an ancient Chinese curse, but many contemporary international lawyers would rather consider it a blessing. The international developments over the last century, the implementation of international rules and the interaction between different fields of international law have fascinated many legal minds. The expansion of international investment law in particular is occurring at such speed and in such a manner that overlap with other areas of law, such as international rules relating to sustainable development, seems unavoidable. One international rule-set promoting sustainable development is the climate change regime formed by the United Nations Framework Convention on Climate Change and the Kyoto Protocol.<sup>3</sup> More specifically, the UNFCCC aims at enabling 'economic development ... in a sustainable manner', recognizing that the goal of 'sustainable social and economic development' will entail a growth in energy consumption, and linking this to climate change rules that provide 'possibilities for achieving greater energy efficiency and for controlling greenhouse gas emissions'. The concept of sustainable development also forms the background of the Kyoto Protocol, which intends to contribute via more specific actions such as 'sustainable forest management' and 'sustainable forms of agriculture'. Both international instruments form good illustrations of the current ground-breaking trends in thinking about international law. One particularly interesting innovation is that the Protocol explicitly provides

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<sup>1</sup> This working paper has been adapted from 'The Kyoto Protocol in Investor-State Arbitration: Reconciling Climate Change and Investment Protection Objectives,' in Marie-Claire Cordonier Segger, Markus W Gehring & Andrew Newcombe eds., *Sustainable Development in World Investment Law* (Kluwer Law International BV, 2010) 681. The author would like to acknowledge the kind authorization of Kluwer.

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<sup>3</sup> United Nations Framework Convention on Climate Change, 20 Jun. 1992, 31 ILM 848 (adopted in New York on 9 May 1992, opened for signature on 20 Jun. 1992 and entered into force 21 Mar. 1994, currently 192 ratifications (last checked 25 Jan. 2009))[UNFCCC]; Kyoto Protocol to the United Nations Framework Convention on Climate Change, 16 Mar. 1998, 37 ILM 22 (adopted in Kyoto (Japan) on 11 Dec. 1997, opened for signature on 16 Mar. 1998 and entered into force 16 Feb. 2005, currently 184 ratifications (last checked 25 Jan. 2009))[Kyoto Protocol].

for the involvement of private entities, such as foreign investors, to achieve its goals of limiting and reducing greenhouse gas emissions.

This Paper will first provide a brief overview of the climate change regime and in particular, the different ways in which private investors can participate in the execution of the Protocol, the so-called Kyoto Flexibility Mechanisms: Joint Implementation, the Clean Development Mechanism and Emissions Trading. Secondly, through the analysis of a number of investment protection standards found in most international investment treaties (expropriation, non-discrimination, fair and equitable treatment, and the prohibition on performance requirements), this Paper will address the problems that the implementation of the Kyoto Protocol could create for the functioning of investment arbitration (and vice versa). Finally and most importantly, the present Paper will make a number of proposals as to how the Kyoto Protocol and investment protection objectives could be reconciled and even reinforce each other.

## **2. Overview of the Current Climate Change Regime**

### **2.1. The United Nations Framework Convention on Climate Change**

The United Nations Framework Convention on Climate Change (UNFCCC), which entered into force in 1994, recognizes that 'human activities have been substantially increasing the atmospheric concentrations of greenhouse gases, thereby enhancing the natural greenhouse effect'.<sup>4</sup> Hence, it establishes an overall framework for intergovernmental efforts to address the challenge posed by climate change, that is, 'additional warming of the Earth's surface and atmosphere which may adversely affect natural ecosystems and humankind'. It emphasizes that the climate system is a shared resource whose stability can be affected by industrial and other emissions of carbon dioxide and other greenhouse gases. The UNFCCC is certainly not 'anti-economy'; on the contrary, it regards economic development as an essential element of any sustainable development policy that member States have a duty to promote and a crucial factor in addressing climate change.<sup>5</sup>

Under the UNFCCC, governments are encouraged to gather and share data on greenhouse gas emissions, national policies, and best practices. They are also urged to launch national strategies for addressing greenhouse gas emissions and adapting to expected impacts. Moreover, they endeavour to cooperate in preparing for adaptation to the impact of climate change, particularly focusing on providing financial and technological assistance to developing countries. However, the UNFCCC is

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<sup>4</sup> UNFCCC, *supra* note 3, in Preamble. This section of the Paper aims at providing the reader with a brief introduction to the context in which the Kyoto Protocol was established, framing it as the product of an ongoing development. For more on the UNFCCC itself, see George de Berdt Romilly, 'UNFCCC/COP-12; Kyoto Protocol/MOP-2: Further Consideration of Challenges', *Envtl. Pol'y & L.* 37 (2007) 1, 9; E. Lisa F. Schipper, 'Conceptual History of Adaptation in the UNFCCC Process', *RECIEL* 15 (2006) 1, 82; Sophia Tsai, 'UNFCCC Technical Workshop on Mechanisms of the Kyoto Protocol', *Colo. J. of Int'l Env'tl. L & Pol'y* 11 (2000) 220.

<sup>5</sup> UNFCCC, *supra* note 3, art. 3: Principles (4)–(5). See also UNFCCC, *ibid.*, art. 4: Commitments 1(d) and 2(a).

only a framework convention with few substantive obligations; hence, it was necessary to conclude a Protocol that entails more precise substantive obligations, imposing concrete greenhouse gas reduction targets. With 194 ratifications, the UNFCCC currently enjoys quasi-universal membership, although with 193 ratifications, the Kyoto Protocol is not lagging far behind.

## 2.2. THE KYOTO PROTOCOL

### 2.2.1. Establishing an Emission Reduction Regime

In 2005, the Kyoto Protocol finally entered into force.<sup>6</sup> The Protocol is an international agreement setting binding targets for thirty-seven industrialized countries plus the European Community (the UNFCCC Annex I Parties)<sup>7</sup> in order to reduce greenhouse gas emissions.<sup>8</sup> These targets amount to an average of 5% against 1990 levels over the five-year period of 2008–2012. The major difference between the Protocol and the UNFCCC is that, while the latter merely encourages industrialized countries to stabilize greenhouse gas emissions, the Protocol legally binds them to do so. The detailed rules for the implementation of the Protocol were adopted at the seventh Conference of the Parties (COP 7) in Marrakesh in 2001 and are called the 'Marrakesh Accords'.

Due to their industrialisation history, developed countries are held principally responsible for the current high levels of greenhouse gas emissions in the atmosphere; hence the Protocol places a heavier burden on those State Parties under the principle of 'common but differentiated responsibilities'.<sup>9</sup> The current level of economic development of countries and their ensuing capabilities were also taken into account in the determination of States' obligations under the Kyoto Protocol. As will be shown in the next section of this Paper, this could possibly create a major stumbling block when applied in connection with international investment law principles. To guide implementation of the Protocol, registry systems have been established to track and record transactions by Parties under the mechanisms used to reduce emissions (discussed further below) and to monitor Parties' actual emissions.<sup>10</sup> The UN Climate Change Secretariat keeps an international transaction log to verify that transactions are

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<sup>6</sup> For an overview of the negotiating history, see Rene Lefeber, 'From the Hague to Bonn to Marrakesh and Beyond, a Negotiating History of the Compliance Regime under the Kyoto Protocol', *Hague Yb Int'l Law* 14 (2001) 25.

<sup>7</sup> UNFCCC Annex I countries are the same as Kyoto Protocol Annex B countries except with regard to Belarus which is part of Annex I but not of Annex B. An amendment for Belarus to enter Annex B has not yet entered into force.

<sup>8</sup> Party quantified emission limitation or reduction commitments are listed in Annex B to the Kyoto Protocol. These targets are expressed as levels of allowed emissions or 'assigned amounts' over the 2008–2012 commitment period and divided into 'assigned amount units' (AAUs).

<sup>9</sup> Kyoto Protocol, *supra* note 3, art. 10. For a more elaborate examination of the principle in all its facets, see: Marie-Claire Cordonier Segger & Ashfaq Khalfan, *Sustainable Development Law: Principles, Practices and Prospects* (Oxford, New York: Oxford University Press, 2004), at 132; D. French, *International Law and the Policy of Sustainable Development* (Manchester: Manchester University Press, 2005), at 81ff; Lavanya Rajamani, *Differential Treatment in International Environmental Law* (Oxford; New York: Oxford University Press, 2006), at 176ff; Yoshiro Matsui, 'The Principle of "Common but Differentiated Responsibilities"', in Nico Schrijver & Friedl Weiss eds., *International Law and Sustainable Development: Principles and Practice* (Leiden; Boston: Martinus Nijhoff Publishers, 2004), at 73.

<sup>10</sup> Kyoto Protocol, *supra* note 3, art. 7 and 8.

conducted according to the rules of the Protocol. Parties are required to submit annual emission inventories and national reports. Moreover, a compliance system ensures that Parties are fulfilling their commitments and offers support if they encounter difficulties in doing so. Finally, the UNFCCC and the Kyoto Protocol are also designed to assist Parties in adapting to the adverse effects of climate change by facilitating the development and deployment of techniques which increase resilience to these impacts.<sup>11</sup> To this end, a fund was created to finance adaptation projects and programmes in developing countries that are Parties to the Kyoto Protocol.

Among commentators, the Kyoto Protocol is generally seen as the first major step towards a global emission reduction regime that will stabilise and reduce greenhouse gas emissions, by providing the structural foundations for future international rule-making regarding climate change.<sup>12</sup> States have already embarked on their next negotiations journey to formulate a new international framework by 2012,<sup>13</sup> that is, the end of the first commitment period of the Kyoto Protocol, which should set the necessary rigorous (but currently still very contentious) emission reduction targets called for by the Intergovernmental Panel on Climate Change.<sup>14</sup>

### 2.2.2. Implementation through the 'Kyoto Flexibility Mechanisms'

The Protocol provides that its member States can implement its rules either individually, through national measures, or jointly, by means of the three market-based 'Kyoto Flexibility Mechanisms' via which countries can limit their emissions: first, Joint Implementation, second, the Clean Development Mechanism, and, third, Emissions Trading. The idea is to stimulate 'green' investment and help Parties to meet their emission targets in a cost-effective way.

First, Joint Implementation (JI)<sup>15</sup> means that Annex I countries with emission reduction or limitation commitments under the Kyoto Protocol (Annex B) can participate in emission reduction or removal projects in

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<sup>11</sup> *Ibid.*, art. 10 and 12 (8).

<sup>12</sup> See in general: Chester Brown, 'The Settlement of Disputes Arising in Flexibility Mechanism Transactions under the Kyoto Protocol', *Arb. Int'l* 21 (2005) 361; W. Bradnee Chambers (ed.), *Inter-Linkages: the Kyoto Protocol and the International Trade and Investment Regimes* (Tokyo; New York: United Nations University Press, 2001) [Chambers]; David Freestone & Charlotte Streck (eds), *Legal Aspects of Implementing the Kyoto Protocol Mechanisms: Making Kyoto work* (New York: Oxford University Press, 2005) [Freestone & Streck (eds)]; Edward A. Smeloff, 'Global Warming: The Kyoto Protocol and Beyond', *Env.'l Policy and Law* 28 (1998) 63.

<sup>13</sup> See conference documents COP 13/ CMP3 (3–14 Dec. 2007) at Bali, Indonesia; COP 14 / CMP 4 (2–13 Dec. 2008) at Poznan, Poland. See also Wybe Th. Douma, Leonardo Massai & Massimiliano Montini (eds), *The Kyoto Protocol and Beyond: Legal and Policy Challenges of Climate Change* (The Hague, Netherlands: TMC Asser Press, 2007).

<sup>14</sup> The Intergovernmental Panel on Climate Change (IPCC) is a scientific intergovernmental body set up by the World Meteorological Organization (WMO) and the United Nations Environment Programme (UNEP). The IPCC was established to provide the decision-makers and others interested in climate change with an objective source of information about climate change. The IPCC does not conduct any research nor does it monitor climate related data or parameters. Its role is to assess on a comprehensive, objective, open and transparent basis the latest scientific, technical and socio-economic literature produced worldwide relevant to the understanding of the risk of human-induced climate change, its observed and projected impacts and options for adaptation and mitigation. Information from: <[www.ipcc.ch/index.htm](http://www.ipcc.ch/index.htm)> (last checked 25 Jan. 2009).

<sup>15</sup> Kyoto Protocol, *supra* note 3, art. 6.

other Annex I countries. Moreover, they can also authorise legal entities, such as private investors, to participate in actions leading to the generation, transfer, or acquisition of Emission Reduction Units (ERUs).<sup>16</sup> Each ERU is equivalent to one tonne of CO<sub>2</sub>, which is then counted towards meeting the country's Kyoto targets. The main idea is that this offers industrialized States a flexible and cost-efficient means of fulfilling a part of their Kyoto commitments, while host States benefit from foreign investment and technology transfer. The main eligibility requirement for a JI project to gain approval is that it must create an 'additional reduction', that is, a reduction in emissions by sources, or an enhancement of removals by sinks, that is additional to what would otherwise have occurred.

There exist two procedures for establishing a JI project: Track 1 and Track 2.<sup>17</sup> Track 1 implies that if host States meet all of the eligibility requirements to transfer and/or acquire ERUs, they may assess emission reductions or removals by a JI project on their additionality in comparison to normal occurrences. Upon such verification, States hosting the projects can issue the appropriate quantity of ERUs. The Track 2 procedure on the other hand regulates situations in which host States merely meet a limited set of eligibility requirements.<sup>18</sup> In these cases, assessment of the additionality of emission reductions or removals is done through the verification procedure under the JI Supervisory Committee.<sup>19</sup> Under this procedure, an independent entity accredited by the JI Supervisory Committee has to determine whether the relevant requirements have been fulfilled before host States can issue and transfer ERUs. Currently, 196 projects under JI Track 1 have met with automatic approval while 26 projects under Track 2 fulfilled the relevant requirements to be approved.<sup>20</sup> However, ERUs will only be issued for a crediting period starting after 2008.<sup>21</sup>

Second, under the Clean Development Mechanism (CDM),<sup>22</sup> Annex I countries, or their investors, can participate in projects in non-Annex I countries to create saleable Certified Emission Reductions (CERs). Like an ERU, each CER is equivalent to one tonne of CO<sub>2</sub> and counted toward the country's Kyoto targets. They can be earned either through emission reduction projects, for example, rural electrification projects using solar panels or the installation of more energy-efficient boilers, or through projects that enhance the sequestration of greenhouse gases through the creation of sinks, for example, afforestation or reforestation projects. The operating details of CDM projects function differently from those of JI

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<sup>16</sup> *Ibid.*, art. 6 (3).

<sup>17</sup> See: FCCC/CP/2001/13/Add.2, Decision 16/CP.7.JI Modalities, 5; FCCC/KP/CMP/2005/8/Add.2, Decision 9/CMP.1.

<sup>18</sup> However, host States that meet all the eligibility requirements can nevertheless opt to use the Track 2 verification procedure.

<sup>19</sup> For a case-study of Brazilian practice in this regard, see: R. Sales & B.K. Sabbag, 'Environmental Requirements and Additionality under the Clean Development Mechanism, a Legal Review under the UNFCCC, the Kyoto Protocol, and the Brazilian Legal Framework on Climate Change', Y.B. Int'l Env. L. 16 (2005) 235.

<sup>20</sup> See online: UNFCCC, <[http://ji.unfccc.int/JI\\_Projects/ProjectInfo.html](http://ji.unfccc.int/JI_Projects/ProjectInfo.html)> (last checked 24 November 2010).

<sup>21</sup> Decision 16/CP.7.JI Modalities, 6, para. 5.

<sup>22</sup> Kyoto Protocol, *supra* note 3, art. 12.

projects although 'additional reduction' remains the main requirement. If CDM projects succeed in a detailed public registration and issuance process supervised by the Designated Operational Entity,<sup>23</sup> they will be approved by Designated National Authorities.<sup>24</sup> The mechanism is overseen by the CDM Executive Board, which is ultimately answerable to the countries that have ratified the Kyoto Protocol. However, public funding for CDM activities cannot result in the diversion of official development assistance.

The CDM system has been in operation since 2006 and at the time of this writing, 2,527 CDM projects had been registered with the CDM Executive Board, while registration has been requested for 137 projects, and another 81 are currently under review pending registration.<sup>25</sup> However, most projects are still in the construction phase and have yet to start producing CERs. These projects are anticipated to produce CERs amounting to more than 2.7 billion tonnes of CO<sub>2</sub> equivalent in the first commitment period of the Kyoto Protocol, 2008–2012.

The third Flexibility Mechanism is Emissions Trading (ET)<sup>26</sup>, which implies that Annex I countries, or their investors, that want to emit more than they have been allocated in Annex B to the Protocol, may still fulfil their commitments by buying extra emission rights from countries or investors that have 'excess capacity' because they have emitted less than their allowance, the so-called assigned amount units (AAUs).<sup>27</sup> Since carbon dioxide is the principal greenhouse gas, it is now tracked and traded like any other commodity in the carbon market – although, of course, this is a sale of intangible commodities and emissions never actually change hands.<sup>28</sup> Not only actual emission units are traded under the Emissions Trading scheme, but also removal units (RMUs) based on land use, land-use change and forestry activities such as reforestation, ERUs generated by JI projects, and CERs generated from CDM projects. These unit transfers are tracked and recorded by the Kyoto Protocol's registry system and international transaction log. To avoid 'overselling' of units and

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<sup>23</sup> A Designated Operational Entity under the CDM is either a domestic legal entity or an international organization accredited and designated, on a provisional basis until confirmed by the CMP, by the Executive Board (EB). It has two key functions: it validates and subsequently requests registration of a proposed CDM project activity and it verifies emission reduction of a registered CDM project activity, certifies as appropriate and requests the Board to issue Certified Emission Reductions accordingly. See online at: UNFCCC, <<http://cdm.unfccc.int/DOE/index.html>> (last checked 25 Jan. 2009).

<sup>24</sup> Parties participating in the CDM shall designate a national authority for the CDM. For more specific information, see Decision 3/CMP.1.

<sup>25</sup> For an up-to-date overview of the different status of CDM project activities, see online: UNFCCC, <<http://cdm.unfccc.int/Projects/index.html>> (last checked 24 November 2010).

<sup>26</sup> Kyoto Protocol, *supra* note 3, art. 17.

<sup>27</sup> For an interesting study on emissions trading issues, see: Bernd Hansjürgens (ed.), *Emissions Trading for Climate Policy: US and European Perspectives* (Cambridge; New York: Cambridge University Press, 2005).

<sup>28</sup> As this Paper deals with climate change in relation to foreign investment, it will not address trade issues which may arise. For such matters, see e.g.: S. Murase, 'Trade and the Environment: with Particular Reference to Climate Change Issues', in Harald Hohmann ed., *Agreeing and Implementing the Doha Round of the WTO* (Cambridge University Press, 2008); Sitanon Jesdapipat, 'Climate and Trade: Implications for Post-Kyoto Regimes', in Yasuko Kameyama et al. ed., *Climate Change in Asia: Perspectives on the Future Climate Regime* (New York: United Nations University Press, 2008); Cinnamon Carlarne, 'The Kyoto Protocol and the WTO: Reconciling Tensions Between Free Trade and Environmental Objectives', *Colo. J. of Int'l Envtl. L & Pol'y* 17 (2005–2006) 45; P. Patelin, 'Implementation of the Kyoto Protocol', in Marie-Claire Cordonier Segger & Maria Lechner Reynal eds., *Beyond the Barricades: The Americas Trade and Sustainable Development Agenda* (Burlington: Ashgate, 2005) 115.



subsequently being unable to meet their own emissions targets, member States are required to reserve a minimum level of emission units in their national registry, the so-called 'commitment period reserve'. Emissions trading schemes are also being established at the national level and the regional level, for example, by the European Union.<sup>29</sup>

### 2.2.3. Interaction with International Investor–State Arbitration

One issue that arises as a result of the operation of the three Flexibility Mechanisms outlined above is whether and how private investors should be offered a possibility to appeal against decisions of Kyoto institutions.<sup>30</sup> For example, during the various stages of JI projects, investors might object to certain determinations of the independent entity accredited by the JI Supervisory Committee or against the accreditation or verification decisions of the Supervisory Committee itself. Similarly, in CDM projects, investors might disagree with the registration, monitoring, verification, certification or issuing of credits as executed by the Designated Operational Entity or the CDM Executive Board. However, a number of authors have already dealt extensively with these topics, suggesting appropriate ways to deal with the total lack of dispute settlement provisions that might regulate this type of cases: therefore, these issues will not be further addressed in this Paper.<sup>31</sup> The focus of this Paper hence lies on the problems which the implementation of the Kyoto Protocol could create for the functioning of investor–State arbitration (and *vice versa*). Specifically, foreign investors from both Kyoto and non-Kyoto member States might view a host State's Kyoto-related measures as a violation of its obligations under its international investment treaties. The different standards that could allegedly be violated will be dealt with more in-depth in the next section, but it is useful here to illustrate the type of State conduct that might form the object of litigation.

Examples of claims by foreign investors operating within the Kyoto regime could include disputes about a State Party's assessment of the additionality of emission reductions or removals by a JI project, or the actions of the Designated National Authority in relation to CDM projects. Since international investment treaties do not usually contain rules qualifying what is a 'State' or a 'State act' for the purpose of the treaty, the general international rules on State responsibility apply.<sup>32</sup> According to

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<sup>29</sup> Marjan Peeters, 'Emissions Trading as a New Dimension to European Environmental Law: the Political Agreement of the European Council on Greenhouse Gas Allowance Trading', *Eur. Env'tl. L. Rev.* 12 (2003) 82; Herbert Posser & Stephan Altenschmidt, 'European Union Emissions Trading Directive', *Journal of Energy and Natural Resource Law* 23 (2005) 60; Michael Mehling, 'Emissions Trading and National Allocation in the member States, an Achilles' Heel of European Climate Policy?', *Yearbook of European Environmental Law* 5 (2005) 113; Gerard H. Kelly, 'An Evaluation of the European Union's Emissions Trading Scheme in Practice', *Eur. Env'tl. L. Rev.* 15 (2006) 175.

<sup>30</sup> On the link between sustainable development and investment more general, see: Andrew Newcombe, 'Sustainable Development and Investment Treaty Law', *Journal of World Investment and Trade* 8 (2007) 357.

<sup>31</sup> See *e.g.*: Charlotte Streck & Jolene Lin, 'Making Markets Work: A Review of CDM Performance and the Need for Reform', *EJIL* 19 (2008) 409; Jacob D. Werksman, 'Legitimate Expectations of Investors and the CDM: Balancing Public Goods and Private Rights under the Climate Change Regime', *CCLR* 2 (2008) 95; Charlotte Streck & Thiago B. Chagas, 'The Future of the CDM in a Post-Kyoto World', *CCLR* 1 (2007) 53.

<sup>32</sup> International Law Commission's Draft Articles on Responsibility of States for Internationally Wrongful Acts, art. 4 and 5 adopted and submitted to the General Assembly by the ILC at its 53<sup>rd</sup> session (International Law Commission Yearbook, 2001, vol. II, Part Two), adopted by UNGA

these rules, actions of, for example, a Designated National Authority, could be attributed to the State (regardless of whether this Authority is considered to be a real organ of the State or merely an entity exercising elements of governmental authority) and hence it will fall under the purview of any applicable investment treaty governing the host State's conduct.<sup>33</sup> Foreign investors outside the Kyoto system, on the other hand, could bring claims against host States' legislative and executive changes in national legislation and administration to promote and protect investments under the Kyoto mechanisms. To this author's knowledge, neither type of claim has so far arisen in an investor-State arbitration dispute, but that does not diminish the relevance of the exercise in view of the thousands of projects which are in the pipeline. Moreover, agreements following up on the Kyoto Protocol will most likely build on the current regime and, as this system of promoting specific types of investments in order to implement sustainable development goals becomes more popular, the likelihood that disputes arise will increase.

There are currently about 2,600 bilateral investment treaties (BITs) in force,<sup>34</sup> plus a number of multilateral treaties that include investment chapters such as the North American Free Trade Agreement (NAFTA) or the Energy Charter Treaty (ECT) – all of which resort under the common denominator 'international investment agreements' (IIAs).<sup>35</sup> These treaties establish a number of international investment protection standards that apply to foreign investments in general, including investments made under the Kyoto Flexibility Mechanisms. The main characteristic that sets these international instruments apart from mainstream international treaties is that they provide for private standing for foreign investors in arbitral disputes against States. This innovation in the role of individuals towards a form of recognition as active subjects of international law implies that foreign investors no longer have to rely on receiving diplomatic protection from their home State espousing their claim, with the ensuing loss of control over the settlement and in most cases, the inability to obtain damages.

Instead, by concluding an IIA, the host State is regarded as extending a general offer to submit all foreign investment claims arising under the IIA

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Resolution 56/83 of 12 Dec. 2001 and corrected by document A/56/49(Vol. I)/Corr.4). For the application of these rules in the climate change regime more generally (incl. the responsibility for damage caused by the State), see: Roda Verheyen, *Climate Change Damage and International Law: Prevention Duties and State Responsibility* (Boston: M. Nijhoff, 2005); Christina Voigt, 'State Responsibility for Climate Change Damages', *Nordic J. Int'l L.* 77 (2008) 1.

<sup>33</sup> For the application of the State responsibility rules in the international investment law field, see: James Crawford, 'Treaty and Contract in Investment Arbitration' (22nd Freshfields Lecture on International Arbitration delivered in London, 29 Nov. 2007), online: Lauterpacht Centre for International Law, <[www.lcil.cam.ac.uk/Media/lectures/pdf/Freshfields%20Lecture%202007.pdf](http://www.lcil.cam.ac.uk/Media/lectures/pdf/Freshfields%20Lecture%202007.pdf)> (last checked 25 Jan. 2009); Simon Olleson, 'The Impact of the ILC's Articles on Responsibility of States for Internationally Wrongful Acts', British Institute of International Comparative Law Research Project, online: BIICL, <[www.biicl.org/files/3107\\_impactofthearticleson-state\\_responsibilitypreliminarydraftfinal.pdf](http://www.biicl.org/files/3107_impactofthearticleson-state_responsibilitypreliminarydraftfinal.pdf)> (last checked 25 Jan. 2009); K. Hobér, 'State Responsibility and Attribution', in Peter Muchlinski, Federico Ortino & Christoph Schreuer eds., *The Oxford Handbook of International Investment Law* (Oxford; New York: Oxford University Press, 2008), 549 [Muchlinski et al.].

<sup>34</sup> See online: Eleventh session of the United Nations Conference on TRHAD and Development, <<http://www.unctad.org/templates/webflyer.asp?docid=8270&intItemID=4431&lang=1>> (last checked 26 Nov. 2010).

<sup>35</sup> North American Free Trade Agreement, 1 Jan. 1994, 32 ILM 289 (Parts 1–3) and 32 ILM 612 (Parts 4–8); Energy Charter Treaty, 17 Dec. 1994, 34 ILM 381.

to an *ad hoc* international arbitration tribunal.<sup>36</sup> When a particular foreign investor is of the opinion that the host State has breached the protection standards under the applicable treaty, it can accept this offer of arbitration by initiating a procedure at, for example, the International Centre for the Settlement of Investment Disputes (ICSID) or the Permanent Court of Arbitration (PCA).<sup>37</sup> These institutions serve as registry offices and, if so requested, also provide the procedural rules to arbitrate the dispute. An *ad hoc* arbitration panel is then constituted (usually comprising of three arbitrators), which has to render a decision in accordance with the IIA as the main source of applicable law, the national law of the host State, and other applicable rules of international law.<sup>38</sup>

The essential conflict between the Kyoto system and the investment treaty system stems from the fact that the objectives of each system are different. The objective of IIAs is to promote foreign investment by creating a stable, predictable legal environment in which all investors are treated fairly in a non-discriminatory way. The main idea behind the Kyoto Protocol, in contrast, is that Parties have to change – sometimes drastically – their national investment law in a way that favours certain investments which are considered more desirable for sustainable development. These different underlying goals might come into conflict when advanced before an arbitral panel whose jurisdiction is based on an investment treaty. Thus, this Paper will next outline a number of specific problems arising from this interaction between international norms and will then present a number of proposals on how to reconcile – or even mutually reinforce – these objectives.

### **3. Standards of Investment Protection versus Kyoto Objectives**

First of all, in order for investment protection standards to apply to Kyoto projects,<sup>39</sup> it must be established that these projects in fact qualify as 'investments' for the purposes of the relevant IIA. Although this will depend on their qualification under national law, most investment treaties

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<sup>36</sup> This evidently also depends on the terms of the particular agreement, for example, the IIA might exclude claims regarding dispute settlement clauses or taxation agreements from its scope of application. For more information on the 'offer to arbitrate', see: Christoph Schreuer, *The ICSID Convention: a Commentary on the Convention on the Settlement of Investment Disputes between States and Nationals of Other States* (Cambridge University Press, 2001), at 218–219 and 1286; Christoph Schreuer, 'Consent to Arbitration' in Muchlinski *et al.*, *supra* note 33, at 830ff.

<sup>37</sup> Convention on the Settlement of Investment Disputes between States and Nationals of Other States, 18 Mar. 1965, 4 ILM 524 [ICSID Convention]; for other ICSID rules and regulations, see online: International Centre for Settlement of Investment Disputes, <<http://icsid.worldbank.org/ICSID/ICSID/RulesMain.jsp>> (last checked 25 Jan. 2009); Permanent Court of Arbitration Optional Rules for Arbitrating Disputes between Two Parties of Which Only One Is a State, 6 Jul. 1993, online: Permanent Court of Arbitration, <[www.pca-cpa.org/showpage.asp?pag\\_id=1188](http://www.pca-cpa.org/showpage.asp?pag_id=1188)> (last checked 25 Jan. 2009). Other institutions that similarly act as registry offices include (but are not limited to) the London Court of International Arbitration, the Stockholm Chamber of Commerce and the International Chamber of Commerce in Paris. Also, claimants can opt to use rules of procedure which are not linked to one particular institution such as the United Nations Commission on International Trade Law (UNCITRAL) Arbitral Rules, 28 Apr. 1976, GA Res 98, UN GAOR (99th Plen. Mtg.), UN Doc A/Res/31/98 (1976), 15 ILM 701 (1976).

<sup>38</sup> ICSID Convention, *supra* note 37, art. 4.2 (2).

<sup>39</sup> Which standards of investment protection are provided for, how they are formulated and what their precise scope is, varies from treaty to treaty. However, the standards addressed in this Paper are included in the majority of IIAs.

formulate their scope in such a broad way that they cover 'every kind of asset', sometimes accompanied by a list of non-exhaustive examples.<sup>40</sup> Even if emission reduction projects are not explicitly mentioned in such a list, they fall under the scope of most investment definitions and are thus covered by the IIA's provisions. Hence the interaction of substantive investment protection standards with Kyoto objectives needs to be considered.

### **3.1. The Prohibition on Expropriation without Compensation**

#### *3.1.1. Direct Expropriation*

One standard, found in customary international law and in all investment treaties, is the prohibition on direct expropriation without compensation,<sup>41</sup> which is explained by Lowenfeld as follows:

*Expropriation is lawful and not inconsistent with the BITs [or IIAs in general] if it (i) is carried out for a public purpose; (ii) is non-discriminatory; (iii) is carried out in accordance with due process, and (iv) is accompanied by payment of compensation – in some treaties qualified by the word 'just', in most other recent treaties by the traditional 'Hull formula' – 'prompt, adequate and effective'.<sup>42</sup>*

In the past, investments in the natural resources sector were often expropriated because many developing countries were persuaded to grant foreign investors (especially nationals from their former colonial mother country) long-term concessions at bargain prices. As the position of developing countries grew stronger, their governments began to rely on the principle of permanent sovereignty to end these deals.<sup>43</sup> This could prove to be a particularly relevant lesson for CDM projects which also take place in developing (non-Annex I) countries. If foreign investors gain rights over large parts of territory for long periods of time at very low prices, governments might be tempted to call off the contract after some time and expropriate either the project itself or its revenue, being the emission reduction units that were produced.<sup>44</sup>

#### *3.1.2. Indirect Expropriation*

Arguably, the main risk to investors stems not from direct expropriation but rather from indirect expropriation, which refers to a situation in which the investment's value decreases as a result of regulatory activity of the

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<sup>40</sup> For a number of examples from recent BITs, see UNCTAD/ITE/IIT/2006/5, 'Bilateral Investment Treaties 1995–2006: Trends in Investment Rulemaking' (Geneva: United Nations, 2007), at 4–21[UNCTAD study on Bilateral Investment Treaties]; see e.g.: E.C. Schlemmer, 'Investment, Investor, Nationality, and Shareholders', in Muchlinski *et al.*, *supra* note 33, at 49.

<sup>41</sup> For a number of examples from recent BITs, see UNCTAD study on Bilateral Investment Treaties, *ibid.*, at 44–52; see e.g. August Reinisch 'Expropriation', in Muchlinski *et al.*, *supra* note 33, 407.

<sup>42</sup> Andreas F. Lowenfeld, *International Economic Law* (Oxford University Press, 2002), at 476 (*insertions added*).

<sup>43</sup> Antony Anghie, *Imperialism, Sovereignty and the Making of International Law* (Cambridge University Press, 2005).

<sup>44</sup> Jacob Werksman, Kevin A. Baumert & Navroz K. Dubash, 'Will International Investment Rules Obstruct Climate Protection Policies? An Examination of the Clean Development Mechanism', *International Environmental Agreements: Politics, Law and Economics* 3 (2003) 59, at 75–76 [Werksman *et al.*].

host State, although a transfer of property title from the investor to the host State never actually takes place.<sup>45</sup> Sloane and Reisman distinguish two principal species of indirect expropriation: creeping and consequential expropriations. They define a creeping expropriation as:

*... an expropriation accomplished by a cumulative series of regulatory acts or omissions over a prolonged period of time, no one of which can necessarily be identified as the decisive event that deprived the foreign national of the value of its investment. Moreover, they may be interspersed with entirely lawful State regulatory actions.*<sup>46</sup>

A consequential expropriation, on the other hand, is denoted as: 'the host State's failure to create, maintain, and properly manage the legal, administrative, and regulatory normative framework contemplated by the relevant BIT, an indispensable feature of the "favourable conditions" for investment'.<sup>47</sup> Previously, a claim for indirect expropriation could only be made for 'intentional creeping expropriation' in cases where discriminatory intentions or the precise aim and effect of property confiscation could be proven.<sup>48</sup> However, the 'tantamount to expropriation' clauses commonly stipulated in current IIAs have been interpreted as extending the concept of indirect expropriation to 'an egregious failure to create or maintain the normative "favourable conditions" in the host State'.<sup>49</sup>

In *Metalclad v. Mexico*, for example, it was decided that environmentally based measures that 'effectively and unlawfully' prevented the investor's operation of a landfill amounted to an indirect expropriation under NAFTA.<sup>50</sup> On the other hand, tribunals have not been entirely oblivious to environmental concerns, as evidenced by this statement of the *Feldman v. Mexico* panel:

*[G]overnments must be free to act in the broader public interest through protection of the environment, new or modified tax regimes, the granting or withdrawal of government subsidies, reductions or increases in tariff levels, imposition of zoning restrictions and the like. Reasonable governmental regulation of this type cannot be achieved if any business that is adversely affected may seek compensation, and it is safe to say that customary international law recognizes this.*<sup>51</sup>

### 3.1.3. Potential Conflicts with Kyoto Objectives

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<sup>45</sup> See generally on the shift from overt expropriation to indirect expropriation through the enactment of discriminatory domestic laws: Charles H. Brewer II, 'Case Report: S.D. Meyers, Inc. v. Canada', *AJIL* 98 (2004) 339, at 344; Todd Weiler, '2002 in Review: From Expropriation to Non-Discrimination', *Y.B. Int'l Env. L.* 12 (2002).

<sup>46</sup> Robert D. Sloane & W. Michael Reisman, 'Indirect Expropriation and its Valuation in the BIT Generation', *Brit. Y.B. Int'l L.* 74 (2004) 115, at 128, Boston Univ. School of Law, Working Paper No. 06-43 [Sloane & Reisman].

<sup>47</sup> *Ibid.*, at 129.

<sup>48</sup> *Ibid.*, at 118.

<sup>49</sup> Sloane & Reisman, *supra* note 46, at 119.

<sup>50</sup> *Metalclad Corporation v. United Mexican States* (Award, 30 Aug. 2000) at para. 107.

<sup>51</sup> *Feldman v. Mexico* (Award, 16 Dec. 2002), at 646.

To illustrate how the prohibition on expropriation might cause problems in the context of Kyoto investments, consider the following example. As noted above, one of the main requirements for a project to be approved is that investors have to prove that their project will create additional emission reductions. In order to calculate whether a certain reduction is additional, a reference case or baseline is constructed, although this baseline could be updated and adapted to changing circumstances during the course of the project.<sup>52</sup> The original baseline is developed by the investor in conjunction with the host government and needs to be approved by an independent body, the Designated Operational Entity for CDM projects or the Accredited Independent Entity for JI projects. If the additional amount of emission reductions is lower than initially foreseen because, for example, the host government has taken domestic measures to lower emissions, this will in turn lower the value of the investment and could thus trigger an indirect expropriation claim.

Furthermore, regulatory actions taken by the host government to promote Kyoto friendly investments will also affect foreign investors outside the Kyoto system. Commentators have predicted that the mere existence of Kyoto regulation on the national level lowers the value of all non-Kyoto investments in the same sector.<sup>53</sup> All investors, regardless of whether they are nationals of Kyoto Parties, will have to suffer the possible impact of new national regulations which limit the amount of greenhouse gas emissions allowed in certain economic sectors or territorial regions, or which prescribe the use of certain emission reduction technology for factories.

Some authors, such as Werksman and Gray, also predict that the mere fear of being forced to pay heavy compensation could have the effect of a 'regulatory chill', referring in general to the phenomenon that States 'refrain from enacting stricter environmental standards in response to fears of losing a competitive edge against other countries in obtaining FDI'.<sup>54</sup> As UNCTAD formulates it, the 'prospect of investor-State arbitration arising out of alleged regulatory takings could result in a regulatory chill' on the ground that concern about liability exposure might lead host countries to abstain from the necessary regulation'.<sup>55</sup> This implies that host governments do not adopt any new environmental or other regulations just in case such measures 'would reduce the commercial value of investments and, therefore, be considered

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<sup>52</sup> UNFCCC, Work Program on Mechanisms, Article 12 of the Kyoto Protocol, document FCCC/CP/2000/CRP.2 and FCCC/CP/2000/CRP.2/Add.1, 24 Nov. 2000, section H: 'Validation and Registration'; Werksman *et al.*, *supra* note 44, at 77.

<sup>53</sup> Werksman *et al.*, *supra* note 44, at 77; Bradford Gentry & Jennifer Ronk, 'International Investment Agreements and Investments in Renewable Energy', in Leslie Parker *et al.* eds., *From Barriers to Opportunities: Renewable Energy Issues in Law and Policy* (2006-2007), at 68-70.

<sup>54</sup> Kevin R. Gray, 'Foreign Direct Investment and Environmental Impacts - Is the Debate Over?', RECIEL 11 (2002) 310 [Gray]; See also Kate Miles, 'International Investment Law and Climate Change: Issues in the Transition to a Low Carbon World' (2008) SIEL Working Paper No. 27/28, at 22-26, online at Social Science Research Network, <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1154588](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1154588)> (last checked 25 Jan. 2009 [Miles]).

<sup>55</sup> UNCTAD/ITE/IIA/2007/3, 'Investor-State Dispute Settlement and Impact on Investment Rule-making', 75. UNCTAD adds however that '[t]he use of the negative list approach, combined with the increased sophistication of the annexes, shows that signatories to new generation IIAs have not experienced any regulatory "chilling effect" resulting from the increase in investment disputes over the last decade' (88).

expropriatory'.<sup>56</sup> Although other commentators such as Bjorklund or Douglas seriously doubt the causal correlation between the absence of environmental (or other welfare policy-related) regulation on the one hand and the presence of a strong system of investment protection on the other,<sup>57</sup> the possibility of regulatory chill seems no less real because conclusive negative proof is logically impossible to deliver.

Several scholars have nevertheless examined and found evidence of regulatory chill in national legislative history in several States,<sup>58</sup> relating to the enactment of carbon tax regulation in the US and the EU,<sup>59</sup> the tannery sector in Brazil<sup>60</sup> and the phosphate industry in Morocco and Tunisia.<sup>61</sup> Regulatory chill does not only have an impact on top-level decisions, because regional and local rules, policies and practices regulating government interaction with investors are also challengeable.<sup>62</sup> These effects of regulatory chill on environmental law in general can logically be applied to the implementation of Kyoto objectives. If host countries allowed their policy-making to be influenced by this sort of rationale (whether well-founded or perceived), it would utterly trump the purpose of the Kyoto Protocol, precisely intended to promote this type of domestic legislative change. A particular type of regulatory chill is due to the existence of 'stabilisation clauses' in contracts between private investors and host States which 'aim to guarantee that domestic laws with respect to investments will remain unchanged'.<sup>63</sup> The effect of such a clause could be to impede any Kyoto-based regulation in the host State enacted after the establishment of the investment. However, these clauses are contractually stipulated, while this Paper deals with treaty-based arbitration.

## 3.2. Substantive Standards of Treatment

### 3.2.1. National Treatment, Most-Favoured-Nation Treatment, and Fair and Equitable Treatment

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<sup>56</sup> Werksman *et al.*, *supra* note 44, at 77; see also Eric Neumayer, 'Do Countries Fail to Raise Environmental Standards? An Evaluation of Policy Options Addressing "Regulatory Chill"', *Int'l J. Sust. Dev.* 4 (2001) 231.

<sup>57</sup> Andrea Bjorklund and Zachary Douglas both made remarks to this extent at the LCIL Legal Experts Seminar on 13 Jul. 2008. Also other authors deny the existence of any regulatory chill effect, see *e.g.*: Stephan W. Schill, 'Do Investment Treaties Chill Unilateral State Regulation to Mitigate Climate Change?', *J. Int'l Arb.* 24 (2007) 469 [Schill].

<sup>58</sup> Gray, *supra* note 54, at fn. 45, refers to the study of Johan A.E. Albrecht, 'Environmental Regulation, Comparative Advantage and the Porter Hypothesis', Working Paper 59.98, Fondazione Eni Enrico Mattei (1998).

<sup>59</sup> Daniel C. Esty & Damien Gerardin, 'Environmental Protection and International Competitiveness: A Conceptual Framework', *JWT* 32 (1998) 5; Dawn Erlandson, 'The BTU Tax Experience: What happened and Why it Happened', *Pace Environmental Law Review* 12 (1994) 173.

<sup>60</sup> N. Mabey & R. McNally, 'Foreign Direct Investment and the Environment: From Pollution Haven to Sustainable Development', WWF-UK (1999), at 33.

<sup>61</sup> *Ibid.* at 34.

<sup>62</sup> Gray, *supra* note 54, at fn. 52, refers to Alan Rugman, John Kirton & Julie Soloway, *Environmental Regulation and Corporate Strategy: A NAFTA Perspective* (New York: Oxford University Press, 1999); Gary Horlick & Alicia Marti, 'NAFTA Chapter 11B: A Private Right of Action to Enforce Market Access through Investment', *J. of Int. Arb.* 14 (1997) 43.

<sup>63</sup> Office of the UN High Commissioner for Human Rights, Special procedures of the Human Rights Council, Mandate of the Special Representative of the Secretary-General on Human Rights and Transnational Corporations and Other Business Enterprises, Stabilization Clauses and Human Rights, London, Thursday 22 May 2008, online: Business and Human Rights Research Center, <[www.business-humanrights.org/Documents/Stabilization-clauses-and-human-rightsconsultation-summary.DOC](http://www.business-humanrights.org/Documents/Stabilization-clauses-and-human-rightsconsultation-summary.DOC)> (last checked 25 Jan. 2009).

In international economic law, relating to trade as well as investment, non-discrimination clauses serve to create 'a level economic playing field between foreign and domestic market participants' or between foreigners from different countries.<sup>64</sup> One of the central objectives of investment treaties is to prevent nationality-based discrimination against foreign investors in order to provide a level playing field for all market participants.<sup>65</sup> Whether treatment is discriminatory is determined by way of comparison with treatment accorded to local investors of the host State (the so-called national treatment clause)<sup>66</sup> or with treatment granted to other foreign investors (the so-called most-favoured-nation [MFN] clause).<sup>67</sup> Hence MFN and national treatment standards are 'empty' provisions in the sense that they do not provide an absolute right to a certain treatment but merely an obligation for a State to treat this particular group of foreign investors as favourable as other foreign or domestic investors, respectively. If the host State accords the same abysmal treatment to all foreigners and to all its national investors, foreign investors will not be able to obtain better treatment by invoking the MFN or national treatment standard.

As opposed to these relative provisions, investment law also provides for absolute standards such as the minimum standard of treatment or the fair and equitable treatment clause, which guarantee a certain level of protection regardless of the treatment accorded to other foreigners or nationals.<sup>68</sup> These absolute provisions are intended to protect allegedly weaker-placed foreigners from government abuse and arbitrary, unjust or unreasonable measures in general. The violation of the legitimate expectations of the investor is one of the main grounds on which an investment tribunal can decide that the host State has breached the fair and equitable treatment standard. An often cited definition of legitimate expectations can be found in *Tecmed v. Mexico*:

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<sup>64</sup> Nicholas DiMascio & Joost Pauwelyn, 'Nondiscrimination in Trade and Investment Treaties: Worlds Apart or Two Sides of the Same Coin', *AJIL* 102 (2008) 48, at 82.

<sup>65</sup> Not all IIAs provide for MFN and/or national treatment but these are among the most common provisions to be found in investment treaties, hence the likelihood that a violation of either or both of these standards is invoked in an investor-State arbitration involving Kyoto-projects is very high.

<sup>66</sup> For a general introduction to the meaning and effect of the national treatment standard in international investment law, see UNCTAD, National Treatment, UNCTAD/ITE/IIT/11(Vol.IV) (1999) online: UNCTAD, <[www.unctad.org/en/docs/psiteiid11v4.en.pdf](http://www.unctad.org/en/docs/psiteiid11v4.en.pdf)> (last checked 25 Jan. 2009); Andrea K. Bjorklund, 'National Treatment', in August Reinisch ed., *Standards of Investment Protection* (Oxford University Press, 2008), at 29 [Reinisch, 2008]; Jürgen Kurtz, 'National Treatment, Foreign Investment and Regulatory Autonomy: the Search for Protection or Something More?', in Philippe Kahn & Thomas W. Wälde eds., *New Aspects of International Investment Law* (Boston: Martinus Nijhoff Publishers, 2007), at 311

<sup>67</sup> For a general introduction to the meaning and effect of the MFN standard in international investment law, see: Andreas R. Ziegler, 'Most-Favoured-Nation (MFN) Treatment', in Reinisch, 2008, *ibid.*, at 59; P. Acconci, 'Most-Favoured-Nation Treatment', in Muchlinski *et al.*, *supra* note 33, at 363.

<sup>68</sup> Ioana Tudor, *The Fair and Equitable Treatment Standard in International Law of Foreign Investment* (Oxford University Press, 2008) [Tudor]; Katia Yannaca-Small, 'Fair and Equitable Treatment Standard: Recent Developments', in Reinisch, 2008, *supra* note 66, at 111; Alberto Alvarez-Jiménez, 'Minimum Standard of Treatment of Aliens, Fair and Equitable Treatment of Foreign Investors, Customary International Law and the Diallo Case Before the International Court of Justice', *Journal of World Investment & Trade* 9 (2008) 51; Alexander Orakhelashvili, 'The Normative Basis of "Fair and Equitable Treatment": General International Law on Foreign Investment?', *Archiv des Völkerrechts* 46 (2008) 74; T.J. Grierson-Weiler & I.A. Laird, 'Standards of Treatment', in Muchlinski *et al.*, *supra* note 33, at 259.



*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 and any all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives.*<sup>69</sup>

### 3.2.2. Potential Conflicts with Kyoto Objectives

Conflicts between the Kyoto objectives and the investment protection goals could arise in the application of all these standards, in particular the MFN and national treatment clauses, because the Kyoto Flexibility Mechanisms were precisely intended to differentiate between carbon-friendly and carbon-intensive investments.<sup>70</sup> At least four areas of friction can be identified between investment and Kyoto rules, regarding measures that are encouraged by the Kyoto Protocol but potentially discriminatory under IIA standards. First, it is assumed that projects under the Flexibility Mechanisms are only open to investors from countries that are State Parties to Kyoto, which could be regarded as a violation of the MFN principle. Hence, a US investor (*i.e.* from a non-Kyoto State Party) may feel discriminated in comparison with an EU investor (*i.e.* from a Kyoto State Party) because third countries will probably prefer investments that create emission reductions. Workman argues that 'a rule barring non-Party participation would be justified for enforcement reasons, as a non-Party host country could not be expected to make its investors comply with CDM rules. Moreover, this rule would give potential host countries an incentive to join the Protocol'.<sup>71</sup> He then refers to an analysis by the OECD Secretariat of potential conflicts between the draft Multilateral Agreement on Investment (which has in the meantime failed to be adopted) and Multilateral Environmental Agreements, which include the use of quotas and permits.<sup>72</sup> According to the OECD Secretariat, barring investors from non-Parties to the Kyoto Protocol may not be necessary, as the resulting emission CERs or ERUs would have no value in the legal system of the investor's home State.

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<sup>69</sup> *Tecmed v. Mexico* (Award, 29 May 2003), at para. 154. For an elaborate discussion of investment case law on legitimate expectations, see: Tudor, *ibid.*, at 163–168; Stephen Fietta, 'The "Legitimate Expectations" Principle under art. 1105 NAFTA: International Thunderbird Gaming Corporation v. the United Mexican States', *Journal of World Investment & Trade* 7 (2006) 423.

<sup>70</sup> Miles, *supra* note 54, at 33.

<sup>71</sup> Werksman *et al.*, *supra* note 44, at 71–72.

<sup>72</sup> Werksman *et al.*, *supra* note 44, at fn. 19. For more information on the draft MAI, see: Saman Zia-Zarifi, 'Multilateral Agreement on Investment' in Fiona Beveridge, ed., *Globalization and International Investment* (Burlington, VT: Ashgate, 2005), 279–298; J. Kurtz, 'NGOs, the Internet and International Economic Policy Making: the Failure of the OECD Multilateral Agreement on Investment', *Melbourne J. Int'l Li* 3 (2002) 213; M. Albert & S. Hessler, 'Das Multilateral Agreement on Investment (MAI) in Beispiel für "failed governance"', in Peter Nahamowitz & Rüdiger Voigt eds., *Globalisierung des Rechts II: Internationale Organisationen und Regelungsbereiche*, vol. 2 (Baden-Baden: Nomos, 2002); P. Malanczuk, 'State-to-State and Investor-to-State Dispute Settlement in the OECD Draft Multilateral Investment Agreement', in Eva Constant Nieuwenhuys & Marcel M.T.A. Brus eds., *Multilateral Regulation of Investment* (The Hague: Kluwer Law International, 2001), 137 [Nieuwenhuys & Brus]; Nico J. Schrijver, 'A Multilateral Investment Agreement from a North-South Perspective', in Nieuwenhuys & Brus, *ibid.*, 17.

Although this view is echoed by Gehring,<sup>73</sup> it is submitted that this does not take into account the value of these credits or units on the carbon market of emissions trading. When a developed State Party sets up emission reduction projects either under the JI or the CDM scheme and creates ERUs or CERs, it can offset these against its own commitments to thus increase its own emissions allowance. However, if an investor from such a State sets up a similar project, the credits gained become the property of the investor itself and can thus be sold via Emissions Trading, if the investor so wishes. But, an investor from a non-Kyoto member State is not able to create such credits, even if it set up such a project (either out of goodwill or because the local environmental regulations leave it no choice), which would have resulted in additional reduction units if the investor had originated from a Kyoto Member State. Hence, such an investor misses out on the 'extra' value inherent to Kyoto investments and created on top of the regular profit expected from any investment.

Secondly, even among investors from Kyoto States, a discrimination claim could also be based on a violation of the MFN principle, since, for example, JI schemes are only open to investors from Annex I countries. Hence an Australian investor (*i.e.* a foreign investor from an Annex I Party) could be said to have an advantage over a Brazilian investor (*i.e.* an investor from a non-Annex I Party).

Thirdly, claims could also arise regarding violations of investment standards in the distribution of emissions allocations. Miles found that certain sectors and corporations are framing themselves as particularly 'emissions-intensive' in order to receive a higher allocation.<sup>74</sup> Governments could be accused of (or effectively commit) discriminatory or unfair acts in this distribution process.

Fourthly, the Kyoto Protocol provides for the possibility that States hosting investments set the compliance of the home State of the investor (regardless of any compliance of the investor itself with the national laws of the host State) as a requirement for the investor's ability to participate or continue participating in a project. If a home State does not comply and a host State suspends all ongoing projects by investors from that country – where does that leave the investor? Under Article 6 on JI, for example, an Annex I Party's right to use emission credits towards its treaty obligations can be suspended, if the compliance of either the investor or its home State is in dispute. An investor could argue that this violates the legitimate expectations which it took into account when making the investment, to such an extent that the host State can be said to have acted in breach of the fair and equitable treatment standard. More in general, for investments which were established a considerable time before the entry into force (or even the negotiations) of the Kyoto Protocol, investors could claim that the changes in regulation caused by the Protocol were impossible to foresee and yet significant enough to warrant a finding of a breach of fair and equitable treatment.

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<sup>73</sup> M. Gehring, 'Discussion Session at the Sustainable Development in World Investment Law Legal Experts Seminar' (Lauterpacht Centre for International Law, Cambridge, 13 Jul. 2008).

<sup>74</sup> Miles, *supra* note 54, at 33–34 (see in particular fns. 274–275).

Other potential conflicts between investment rules and Kyoto objectives can be identified. These include situations where countries discriminate between foreign and domestic investors in order to undertake unilateral CDM investment (the so-called infant industry argument) and situations of discrimination in emissions trading (based on the origin of the credits, so that trade in credits generated by, for instance, nuclear energy would be restricted).<sup>75</sup> Since the purpose of this section is to non-exhaustively illustrate a number of potential problems applying MFN, national treatment and fair and equitable treatment standards in relation to Kyoto-projects, other examples will not be discussed further in this Paper.

### **3.3. The Prohibition on Performance Requirements**

#### *3.3.1. Investment Clauses Regulating Performance Requirements*

A final but crucial example relates to the prohibition of performance requirements under a number of IIAs. Performance requirements are conditions imposed by host States on investors relating to the establishment and operation of investments or in exchange for a particular advantage.<sup>76</sup> Historically, many developed and developing States imposed performance requirements on foreign investors as a condition for allowing the investment in their territories. The rationale for this was to attempt to induce certain investor behaviour in pursuance of particular policy objectives, for example, generating employment, increasing the demand for local inputs, boosting exports or augmenting foreign exchange. Hence investors would be required to hire nationals of the host country, to use locally produced raw materials or inputs or to export a portion of the finished product. However, many legal and economic articles and studies have argued that these objectives cannot be achieved via government regulation but rather depend on a complex interaction of policies and variables.<sup>77</sup> Arguably, performance requirements are a disincentive for foreign investors who will refrain from investing under conditions impeding the free management of their investments and forcing them to conduct business in ways that reduce their efficiency.

In a recent UNCTAD study on trends in investment rule-making, six different types of clauses on performance requirements were examined.<sup>78</sup> First, a significant number of BITs which do not contain a specific provision on performance requirements include an 'application of other

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<sup>75</sup> Werksman *et al.*, *supra* note 44, referring in fn 32 to the so-called Pronk's Text, which emerged from the November 2000 COP and specified that 'Annex I Parties will declare that they will refrain from using nuclear facilities for generating certified emission reductions under the CDM.' Werksman analyses that this 'suggests a domestic action by Annex I countries to not use CDM credits from nuclear projects. But the text does not establish nuclear projects as categorically ineligible for earning CDM credits.'

<sup>76</sup> UNCTAD/ITE/IIT/2004/10 (Vol. I), 'International Investment Agreements: Key Issues' (2004), 19, 96, 144-145.

<sup>77</sup> See *e.g.*: Bart Legum, 'Understanding Performance Requirement Prohibitions in Investment Treaties' in Arthur W. Rovine ed., *Contemporary Issues in International Arbitration and Mediation: the Fordham Papers 2007* (Leiden: Martinus Nijhoff, 2008) 54; Bijit Bora, 'Incentives, Performance Requirements and the International Policy Architecture', in Jeremy Streatfeild & Simon Lacey ed., *New Reflections on International Trade: Essays on Agriculture, WTO Accession and Systemic Issues* (London: Cameron May, 2008) 101; UNCTAD, 'Foreign Direct Investment and Performance Requirements: New Evidence from Selected Countries, UN' (2003).

<sup>78</sup> UNCTAD study on 'Bilateral Investment Treaties', *supra* note 40, at 64-69.

rules' provision which aims to ensure that the host State provides the investor with MFN treatment regarding the application of its domestic laws or international obligations, such as those under the Agreement on Trade-Related Investment Measures (TRIMs).<sup>79</sup> Second, several BITs restrict the use of performance requirements while stating that the obligations undertaken in this regard do not extend beyond those assumed in the context of the TRIMs Agreement,<sup>80</sup> whereas a third group of (mostly Finnish) IIAs include a general restriction on the use of performance requirements.<sup>81</sup> A fourth category restricts the use of performance requirements on the basis of an exhaustive positive list, that is, member States will only refrain from those performance requirements explicitly listed.<sup>82</sup> A fifth group comprises agreements with sophisticated and detailed clauses, including additional restrictions on the use of performance requirements, but also preventing the host State from using certain performance requirements as a condition for granting advantages or incentives.<sup>83</sup> The sixth and last group contains the most detailed and far-reaching obligations on this subject, obliging the contracting Parties to refrain from imposing the banned performance requirements not only on each other's investments and investors, but also on investments and investors of any third country in order to ensure a single investment policy.<sup>84</sup>

### 3.3.2. Potential Conflicts with Kyoto Objectives

Under the climate change regime, projects are assessed on their contribution to achieving more sustainable forms of development and to the promotion of real, measurable and long-term benefits in both industrialized and developing countries.<sup>85</sup> Performance requirements are not entirely counteractive to all forms of sustainable development: for instance, a Kyoto windmill project produces environmentally friendly energy whether the windmills are manufactured locally or not. Nevertheless, a host country would be able to provide good reasons for issuing regulations requiring investors to use locally produced goods or services, build domestic capacity by employing local people or transfer technology to local companies. In assessing a project's impact on climate change and its contribution to sustainable development, one should also take into account the energy used for transporting materials and workers

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<sup>79</sup> For example, the TRIMs Agreement Annex provides an illustrative list of the kinds of performance requirements inconsistent with MFN and National Treatment agreement on Trade-Related Investment Measures (signed 15 Apr. 1994, entered into force in January 1995) 1868 UNTS 186.

<sup>80</sup> BIT between Canada and Costa Rica (1998), see online: UNCTAD, <[www.unctadxi.org/templates/DocSearch779.aspx](http://www.unctadxi.org/templates/DocSearch779.aspx)> (last checked 25 Jan. 2009).

<sup>81</sup> BIT between Azerbaijan and Finland (2003), see online: UNCTAD, *ibid.*

<sup>82</sup> Canadian and United States BITs at the end of the 1990s: these clauses limit 'the use of performance requirements both at the pre-establishment phase of the investment and thereafter. Only compulsory performance requirements are restricted; the contracting parties being left with discretion to impose them as a condition for the receipt of investment incentives. Finally, the disciplines apply not only to investment in goods, but also to investment in services'. (UNCTAD study on 'Bilateral Investment Treaties', *supra* note 40, at 66).

<sup>83</sup> For example, the BITs concluded by Japan, see online: UNCTAD, *supra* note 80.

<sup>84</sup> IIAs between Cuba and Mexico (2001), the United States and Uruguay (2005) (see: *ibid.*) and the 2004 Canadian model BIT (see: Andrew Newcombe, 'Canada's New Model Foreign Investment Protection Agreement', online: Investment Treaty Arbitration, <<http://ita.law.uvic.ca/documents/CanadianFIPA.pdf>> [last checked 25 Jan. 2009]).

<sup>85</sup> As outlined in UNFCCC in Preamble, art. 2, art. 3 (4)-(5), art. 4, 1(d) and 2(a); Kyoto Protocol, *supra* note 3, art. 2, 1. (a) (i)-(ii), 10 and 12.

to the project site, the reduction of poverty and the transfer of know-how, in particular from developed to developing States.

Especially the latter impact assessment criteria are not specific to issues concerning climate change, but they are more generally linked to international law relating to the principle of sustainable development. The main goal of this principle is to reconcile and integrate goals of economic development (e.g. poverty reduction) with those of environmental protection (e.g. the reduction of greenhouse gases).<sup>86</sup> The principle of sustainable development does not exactly prescribe how to reform international law in order to balance these different goals, but more precise guidelines are provided in sub-areas of international environmental law, such as the rules on climate change. However, such a balancing act can only be successful if the guidelines and initiatives in one sub-area do not counteract those in other sub-areas. Hence, all areas of international law which aim to promote 'their' aspect of sustainable development ought to be well-aligned so that, for example, the success of projects under the Kyoto Protocol does not impede the implementation of other sustainable development objectives.

## **4. Reconciling and Reinforcing Kyoto and Investment Objectives**

This Paper has explained the different objectives of Kyoto and the investment regime, and has offered some concrete illustrations of investment protection standards, the strict interpretation of which could prevent host States from applying any Kyoto-inspired regulation and implementing any policy favouring Kyoto projects. However, the future of realizing Kyoto objectives via private investment is not entirely bleak. The section below will outline a number of suggestions for the drafting of the follow-up treaty after the expiration of the Kyoto Protocol in 2012, as well as for future investment treaties and contracts. Moreover, this section will also address the existing mechanisms in the international law toolbox which could resolve conflicts between climate change and investment objectives. But, first of all, a number of proposals will be examined which have been put forward in the literature but which have to be rejected for various reasons.

### **4.1. Reconciling Objectives: How *not* to do it**

It has been advocated that the Executive Board in CDM projects or the Supervisory Committee in JI projects ought to receive the competence to adjudicate the disputes between Kyoto and investment objectives.<sup>87</sup> This

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<sup>86</sup> See e.g.: Nico J. Schrijver, *The Evolution of Sustainable Development in International Law : Inception, Meaning and Status* (Leiden: Martinus Nijhoff, 2008); 'World Commission on Environment and Development, Towards Sustainable Development' in Ronald B. Mitchell, *International Environmental Politics*, vol. 4 (London: SAGE, 2008) 282; Nico J. Schrijver, 'Development: The Neglected Dimension in the Post-Rio International Law of Sustainable Development', in Hans Christian Bugge & Voigt, Cristina ed., *Sustainable Development in International and National Law: What Did the Brundtland Report Do to Legal Thinking and Legal Development, and Where Can We Go from Here?* (Groningen: Europa Law Publishing, 2008) [Bugge & Voigt (eds)], 221; Marie-Claire Cordonnier Segger, 'Sustainable Development in International Law', in Bugge & Voigt (eds), *ibid.*, 85.

<sup>87</sup> Werksman *et al.*, *supra* note 44, at 81.

would not be a desirable solution. Firstly, the Kyoto institutions were not created for these purposes, and granting such competence could force them into a position whereby they would be simultaneously both party and judge. For example, the JI Guidelines describe how all project participants have to submit a project design document to the accredited independent entity.<sup>88</sup> After this entity has submitted its report, the involved parties may ask for a review by the Article 6 Supervisory Committee.<sup>89</sup> If the investor claims that the host State has injured the investment project by submitting incorrect data to the accredited independent entity or the Supervisory Committee or has attempted to delay procedures with the purpose of harming the investment (especially for time-sensitive projects), it is submitted that the Supervisory Committee would be too much involved in the procedures which form the object of the claim to be able to function as an impartial and independent judge (or to be seen so).

Secondly, it would not be a solution for disputes involving non-Kyoto member States because foreign investors from these States would probably not have private standing before Kyoto institutions. Under the investor-State arbitral system, foreign investors derive their right to initiate arbitral proceedings from the IIA concluded between their home State and the State hosting their investment. Although it would be theoretically possible that a treaty would grant private standing to nationals of a State which is not a Party to that treaty, it would be – to this author's knowledge – unprecedented in an investment context. Other authors claim that the solution lies in the elimination of investor-State arbitration altogether on the ground that it is ill-equipped to deal with public interests: rather, governments are best placed to balance economic stakes versus sustainable development policies.<sup>90</sup> This solution cannot be subscribed to either: the investment arbitration system was precisely created to promote foreign investment, and thereby development, by giving investors a direct means to settle a dispute rather than having to rely on the highly politicized mechanism of diplomatic protection.<sup>91</sup> For the implementation of the Kyoto goals, international law is specifically making an appeal towards private investors: therefore, it would certainly be counterproductive if, at the same time, their access to dispute settlement were eliminated.

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<sup>88</sup> JI Guidelines, FCCC/KP/CMP/2005/8/Add.2, *supra* note 17, para. 30ff.

<sup>89</sup> *Ibid.*, para 35.

<sup>90</sup> Konrad von Moltke & Howard Mann, 'Misappropriation of Institutions: Some Lessons from the Environmental Dimension of the NAFTA Investor-State Dispute Settlement Process', *Int'l Env. Agreements: Politics, Law and Economics* 1 (2001) 1; Werksman *et al.*, *supra* note 44, at 82.

<sup>91</sup> Alan O. Sykes, 'Public versus private enforcement of international economic law: standing and remedy', *J. Legal Stud.* 34 (2005) 631; On the link between diplomatic protection and investor-State arbitration more generally, see: Sir Frank Berman, 'The Relevance of the Law on Diplomatic Protection in Investment Arbitration', in Federico Ortino *et al.* (eds), *Investment Treaty Law: Current Issues*, vol. 2 (London: British Institute of International and Comparative Law, 2007) 67; Francisco Orrego Vicuna, 'Changing Approaches to the Nationality of Claims in the Context of Diplomatic Protection and International Dispute settlement', *ICSID Review* 15 (2000) 340; D. Tunic, 'The International Convention on the Settlement of Investment Disputes (ICSID) and Diplomatic Protection' in Institutouton Diethnon Demosiou Dikaiou kai Diethnon Scheseon Thessalonikes, *United Nations Decade of International Law* (Thessaloniki : Institute of International Public Law and International Relations of Thessaloniki, 1998) 447.

A clause that has been adopted in a number of Kyoto investment contracts is the stipulation that the project which forms the object of the contract is not to be considered an investment for the purposes of investment arbitration. The validity of this type of clause can be disputed depending on one's view of the identity of the legal rights-holder of investment treaty obligations. Some tribunals have held that, since these obligations derive from an inter-State treaty, they are addressed solely to States: accordingly, the investor would merely act on behalf of the State when initiating an investment dispute.<sup>92</sup> It would then be impossible to waive in a contract what is essentially a right of the home State. A better view, though, is that a host State's obligations under an IIA are owed to the investor itself, but they are such that the investor cannot waive its access to arbitration in advance. It can only do so after a conflict has already arisen.<sup>93</sup> Moreover, regardless of the validity of such a clause, removing a project from the scope of investment protection, thereby barring the investor from arbitral dispute settlement, could well be counterproductive as it risks deterring investors from setting up Kyoto projects.

Other proposals which can be found in the literature include a prohibition on indirect expropriation claims or the exemption of Kyoto-related claims from the scope of application of IIAs.<sup>94</sup> This could be an option for future investment treaties, although the previous argument regarding counter-productivity applies here as well and even if this would only resolve claims from Kyoto investors, not from other foreign investors.

## 4.2. Suggestions for Future Treaties and Contracts

Two groups of treaty-drafters ought to consider the tension between the climate change and the investment protection objectives: States negotiating the Kyoto Protocol follow-up treaty (Kyoto II) and States concluding IIAs. Kyoto II should encompass investment rules, giving a direct right to arbitration to private investors, so that no fallback on the dispute settlement mechanisms of the applicable IIA is necessary. Such a creation of a *lex specialis* for Kyoto Protocol investments would be impossible to ignore for IIA tribunals when assessing their jurisdiction and, thus, it would solve at least those cases in which Kyoto investors attempt to initiate arbitral proceedings. However, it would not provide a solution for claims raised by investors from States that do not participate in Kyoto II – unless it would explicitly provide for private standing for such investors. Another option, which could serve as a solution for non-Kyoto investors who want to participate in Flexibility Mechanism contracts, would

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<sup>92</sup> See e.g.: *The Loewen Group Inc. and Raymond L. Loewen v. United States* (Award 26 Jun. 2003), 7 ICSID Reports 421, at para. 233. For an in-depth discussion, see: Zachary Douglas, 'The Hybrid Foundations of Investment Treaty Arbitration', *Brit. Y.B. Int'l L.* 74 (2003) at 151, 162–163, 175–176.

<sup>93</sup> Zachary Douglas, 'Nothing if Not Critical for Investment Treaty Arbitration: Occidental, Eureko and Methanex', *Arb. Int'l* 22 (2006) 27, at 37–38 [Douglas, 2006]: 'The investor's procedural right to have the host state's conduct adjudged according to the investment treaty standards is only perfected upon the filing of a notice of arbitration. At that point the investor is free to waive its procedural right and this of course is common practice whenever an investment treaty claim is settled and withdrawn'. See also: *Eureko BV v. Republic of Poland* (Partial Award, 19 Aug. 2005), online: Investment Treaty Arbitration, <[http://ita.law.uvic.ca/annulment\\_judicialreview\\_if\\_content.htm](http://ita.law.uvic.ca/annulment_judicialreview_if_content.htm)> (last checked 25 Jan. 2009).

<sup>94</sup> Werksman *et al.*, *supra* note 44, at 82.

be to adopt an approach similar to the Montreal Protocol.<sup>95</sup> This Protocol aims at avoiding potential conflicts with World Trade Organisation (WTO) rules by encouraging compliant behaviour of non-Parties, through the extension of certain Protocol privileges to non-Parties who can demonstrate that they are acting in accordance with the Protocol's provisions. Extending certain privileges (e.g. the possibility for investors from non-Kyoto States to participate in Kyoto projects creating ERUs or CERs and to sell those via emissions trading) could be an idea for future climate change negotiations. Moreover, if foreign investors use this option, it would also serve as a stimulant for their home States to take part in the climate change regime.

The second group of treaty-drafters are those negotiating IIAs. They can explicitly make reference to the social, environmental and human rights goals to which States have committed themselves on the international plane. One example could be the explicit inclusion in treaties that renewable energy is not 'in like circumstances' compared to energy from carbon-intensive sources. Future treaties could also include public welfare carve-outs in treaties not removing Kyoto investments *per se* from investor protection under IIAs but simply providing that non-discriminatory and good faith regulation put in place to encourage or operationalize Kyoto investment will not be seen as expropriatory.

Although the attempt to create a comprehensive multilateral investment agreement failed, more and more attention is devoted to the incorporation of the sustainable development principle in general and climate changes objectives in particular in newly negotiated treaties.<sup>96</sup> One example of a step in the right direction is the Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects which focuses on energy efficiency and conservation.<sup>97</sup> It recognises the need for a variety of tools, including regulation, and it explicitly calls for cooperation and assistance. However, it only emphasises cooperation while remaining subject to the other provisions of the ECT and to trade law. Another example of a changing mentality in treaty-drafting can be seen in the BIT drafted by the Institute for Sustainable Development which clearly influenced, for example, the Norwegian model BIT.<sup>98</sup> This BIT incorporates provisions designed to produce a more balanced investment treaty and protects investment and the regulatory function of host States. It includes provisions on environmental protection measures, developmental needs of the State and social responsibilities of investors.

Finally, investor-State contracts ought to be shaped in a way which takes into account sustainable development goals, for example by explicitly stipulating that the Kyoto Protocol is part of the applicable law and will

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<sup>95</sup> This option was also suggested by Werksman *et al.*, *ibid.*, at fn. 19.

<sup>96</sup> See Markus W. Gehring, 'Sustainable International Trade, Investment and Competition Law', in Marie-Claire Cordonier Segger & Ashfaq Khalfan eds., *Sustainable Development Law: Principles Practices, and Prospects* (Oxford, New York: Oxford University Press, 2004) at 281 *ff.*

<sup>97</sup> Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects, 17 Dec. 1994, 34 ILM 446, as Annex 3 to the Final Act of the European Energy Charter Conference.

<sup>98</sup> A Model BITs is a draft treaty by which a country indicates the policy it is likely to follow when negotiating new investment treaties. Most adopted BITs follow this blueprint very closely and some Model BITs (e.g. the 2004 US Model BIT) can also exert influence on other treaties because third countries copy or paraphrase the template.



prevail in case of a conflict. Another useful contract stipulation would be that there will be, for example, a yearly update of the baseline which cannot form the basis of an expropriation claim even if it results in a decrease of expected credits.<sup>99</sup> As Werksman argued both with regard to IIAs and investor-State contracts, in order to 'promote the security and the predictability necessary for the success' of the climate change regime, the Parties to the Protocol should be explicit in their preference for Kyoto upon investment rules and 'as specific as possible in their articulation and collective approval of those rules'.<sup>100</sup>

However, for the IIAs which are currently in force, these suggestions would mean that the State Parties have to agree upon an *addendum* amending the treaty accordingly. It is doubtful whether this would be valid for investments already in place, because both national and international law are strongly disposed against retro-active application of rules. Under investment law in particular, it could be claimed that this forms a violation of the legitimate expectations of investors although it could also be argued that it is a mere exercise of the States' regulatory power.<sup>101</sup> However, it would not apply to alleged breaches of the IIA based on facts which occurred before the amendment. In any case, it is clear that it would be extremely difficult for States to reach such an agreement in practice. Thus, widespread treaty amendment can be considered unfeasible in practice: a solution should better be found within the parameters of the current investment regime.

### **4.3. Public International Rules on Treaty Interpretation**

#### *4.3.1. The Limits of the 1969 Vienna Convention on the Law of Treaties*

Disputes regarding the application of different international treaties can often be solved by applying the international customary law on treaty interpretation, as evidenced by the 1969 Vienna Convention on the Law of Treaties (VCLT).<sup>102</sup> The VCLT can assist with finding a more mutually supportive interpretation of investment protection and climate change treaties to prevent a potential conflict of norms. Article 31 VCLT states that '[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'. Following provisions offer a number of ways to discover this purpose: other relevant agreements between the State Parties,<sup>103</sup> subsequent State practice in the application of the treaty<sup>104</sup> or other 'relevant rules of international law applicable in

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<sup>99</sup> Since this Paper focuses on international treaty-based arbitration, the possibilities in terms of contract-drafting are only briefly addressed. For a more comprehensive set of proposals relating to Kyoto-contracts, see: Ibibia Lucky Worika & Michael Brown, 'Contractual Aspects of Implementing the Clean Development Mechanism and other Flexibility Mechanisms under the Kyoto Protocol', in Chambers, *supra* note 12, at 215; A. Pogany, 'Negotiating a JI Contract: A Project Developer's Perspective', in Freestone & Streck (eds), *supra* note 12.

<sup>100</sup> Werksman *et al.*, *supra* note 44, at 70.

<sup>101</sup> See discussion in the section below of *SPP (ME) v. Egypt* (Award, 20 May 1992) (1994)19 YB. Comm. Arb. 51 [SPP (ME)], in which the fact that Egypt had signed up voluntarily and after admitting the investment hence causing a significant change in the regulations applicable to the investment, influenced the tribunal's decision against Egypt.

<sup>102</sup> Vienna Convention on the Law of Treaties, 23 May 1969, 8 ILM 679.

<sup>103</sup> *Ibid.* art. 31(3)(a).

<sup>104</sup> *Ibid.* art. 31(3)(b).

the relations between the parties'.<sup>105</sup> The Kyoto protocol could thus serve as an 'interpretative context' of the investment treaties and, as such, 'inform' the interpretation of the relevant investment protection clauses.<sup>106</sup> If the meaning remains 'ambiguous or obscure' or 'leads to a result which is manifestly absurd or unreasonable', Article 32 VCLT refers to supplementary means of interpretation such as 'preparatory work of the treaty and the circumstances of its conclusion'. Other additional interpretative rules include the prevalence of later treaties (*leges posteriori*) or more specific treaties (*leges speciali*).<sup>107</sup>

However, there seem to be limits to the usefulness of these rules in this context. With regard to State intent, first: most IIAs are seen as separate from treaties dealing with 'regular' inter-State matters and hence their 'object and purpose' is limited to the protection and promotion of foreign investment. Although subsequent agreements and subsequent State practice are relevant for the interpretation of a treaty, Article 31(2) and (3)(a) and (b) refer to subsequent agreements between the original parties of the IIA and subsequent practice in the application of the IIA. In other words, other treaties between other parties or State practice in the application of other treaties such as the Kyoto Protocol are not envisaged by this Article. Hence the only useful guideline seems to be Article 31(3)(c), although this article provides at most that the IIA and Kyoto rules could be simultaneously applicable and does not establish which one prevails in case of conflict.<sup>108</sup>

One idea could be to check for 'disappearing footnotes' in the investment treaty draft (as was done in some Free Trade Agreements with regard to the applicability of the MFN clause to dispute settlement provisions), which expressly explains the negotiating Parties' intent regarding Kyoto (or similar) investments. Subsequently, these footnotes are not included in the final treaty text but could provide proof of intent via an application of Article 32 of the VCLT regarding *travaux préparatoires*.<sup>109</sup> As for the rules on later or more specific treaties, they do not provide much guidance at all. Will the Kyoto treaty be seen as the latest evidence of State intent and therefore prevail over IIAs? This might cause the Kyoto Protocol to prevail over some IIAs but not over those other IIAs with near-to-identical

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<sup>105</sup> *Ibid.* art. 31(3)(c).

<sup>106</sup> Gaetan Verhoosel, 'The Use of Investor-State Arbitration under Bilateral Investment Treaties to Seek Relief for Breaches of WTO Law', *J. Int'l Econ. L.* 6 (2003) 493, at 496; Anatole Boute, 'Combating Climate Change and Securing Electricity Supply: The Role of Investment Protection Law', *Eur. Env. L. R.* 16 (2007) 227, at 244.

<sup>107</sup> See also: A/CN.4/L.682, 'Fragmentation of International Law: Difficulties Arising from the Diversification and Expansion of International Law', Report of the Study Group of the International Law Commission, ILC 58th session, 30-114; Harro Van Asselt, Francesco Sindico & Michael A. Mehling, 'Global Climate Change and the Fragmentation of International Law', *Law & Pol'y* 30 (2008) 423.

<sup>108</sup> There are a number of difficulties in applying art. 31(3)(c)VCLT, in particular whether the term 'all Parties' implies that all Parties to the first treaty (the IIA) also have to be Parties to the second one (the Kyoto Protocol) or merely that the Parties to the dispute at hand have to be members of both. The latter interpretation which seems to be the correct one (see e.g.: Campbell McLachlan, 'The Principle of Systemic Integration and art. 31(3)(c) of the Vienna Convention', *I.C.L.Q.* 54 (2005) 279) entails an extra level of complexity for investment arbitration since one of the Parties to the dispute, that is, the investor, is not even a Party to the IIA, let alone to the Kyoto Protocol, although it is argued that the investor does derive direct rights from the IIA (see elaboration above).

<sup>109</sup> This might also be a good suggestion for States currently negotiating IIAs. See Locknie Hsu, 'MFN and Dispute Settlement: When the Twain Meet', *Journal of World Investment and Trade* 7 (2006) 25, at 35-36.

stipulations which were concluded only a few months later. It is also impossible to say whether IIAs are more specific than the Kyoto protocol and should therefore get priority (or *vice versa*). A 'blind application' of these rules would make no sense as they are dealing with State intent regarding very different subject matter.

The international rules of treaty interpretation are confronted with a number of complex new challenges here. For instance, to what extent are rules agreed upon between State Parties applicable to an investor from one of these States? It is submitted that they are, since they form part of the regulatory climate under which the investor operates and with which it must comply as explicitly stipulated in most IIAs. Also, by applying for approval of an investment as being a Kyoto-project, an investor implicitly accepts that the Kyoto rules will govern its investment. However, this situation could be different (and might possibly create far greater problems) for an investor whose home State is not a Party to the Kyoto Protocol. Unless there is a specific agreement between this home State and the Kyoto host State, which is unlikely to happen, or the investor's claim is based on the non-discrimination clauses (in which case it could be considered not to be 'in like circumstances' – see below), the arbitral panel will be inclined to rule against the Kyoto member State.

Moreover, even if an investment panel is willing to take into account Kyoto rules in a dispute between a Kyoto investor and a Kyoto Member State, further interpretative problems may arise regarding the host State's choice of regulatory action to implement Kyoto. Was this measure legally imposed by the Protocol (*i.e.* consented to by all the Protocol Parties, including the Parties to the IIA)? Or, did the host State merely unilaterally decide that this particular measure would be constructive for an effective implementation of the Kyoto rules? This is not merely a theoretical question: in *SPP v. Egypt*,<sup>110</sup> the tribunal examined Egypt's obligations under the applicable IIA in light of the UNESCO Convention noting that the World Heritage Committee registers only protected property following a request submitted by the contracting Parties. Egypt's obligations hence resulted from such voluntary registration and its obligations under the UNESCO convention entered into force after the investment agreements were concluded and the permits were issued. Therefore, the tribunal held that Egypt could not use its obligations under the UNESCO convention as a defence against an alleged breach of the IIA. Although this case did not deal with climate change regulation, an analogy can be drawn with regard to potential claims by investors who established their investment before the entry into force of the Kyoto Protocol in 2005. Werksman suggests that 'the more precise the Parties are in collectively endorsing a measure, the more likely it will be that the measure survives an IIA-based challenge',<sup>111</sup> but this seems difficult to realize for each and every measure in practice.

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<sup>110</sup> SPP (ME), *supra* note 101, at para. 151–157; see M. Hirsch, 'Interactions between Investment and Non-Investment Obligations in International Investment Law', Research Paper No. 14-06, at 16ff, online: Social Science Research Network, <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=947430](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=947430)> (last checked 25 Jan. 2009).

<sup>111</sup> Werksman *et al.*, *supra* note 44, at 70.

#### 4.3.2. Re-interpretation of Existing Standards

Some authors allege that IIAs will not impede regulations to counter climate change because 'the police power exception under the concept of indirect expropriation and the flexibility of the standard of fair and equitable treatment will usually enable States to regulate in the public interest without being liable for damages incurred by foreign investors' as long as 'these measures do not discriminate against foreign investors, impose proportionate burdens nor unreasonably change the regulatory framework'.<sup>112</sup> Although this view at least recognizes the applicability of the police powers exception on climate change regulation, it does not provide any guidance for an investment tribunal which has to decide whether a measure is discriminatory, disproportionate or unreasonable. This opinion simply seems to imply that as long as measures addressing climate change comply with (*i.e.* are subordinate to) investment protection rules, the latter will not be deemed violated.<sup>113</sup> This approach would evidently solve possible conflicts of norms, but it might also cause many legitimate, potentially effective and useful measures to be struck down or to have their scope of application restricted to an extent that their achievements would be rendered negligible.

A number of suggestions have been formulated in the previous section which could largely solve these issues with regard to future investments. For cases arising under the current IIAs, investment tribunals obviously have to apply the IIA as it is, but it is submitted that within their interpretative discretion, they can opt for a more 'Kyoto friendly' attitude. This approach to interpretation is not merely hypothetical but was in fact already applied by the tribunal in the *Methanex v. USA* (albeit not with regard to Kyoto-related measures):

*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 alia, a foreign investor or investment is not deemed expropriatory and compensatory unless specific commitments had been given to the then putative foreign investor contemplating investment that the government would refrain from such regulation.*<sup>114</sup>

The interpretation of the fair and equitable treatment standard could be reframed so as to protect against arbitrary or bad faith conduct but not against legitimate regulation countering climate change.<sup>115</sup>

One final suggestion with regard to the legitimate expectations aspect of the fair and equitable treatment standard is that the tribunal could also

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<sup>112</sup> Schill, *supra* note 57, at 477. See also Todd Weiler & Thomas Waïde, 'Investment Arbitration under the Energy Charter Treat', *Oil, Gas & Energy Law Intelligence* 1 (2003) 26-27.

<sup>113</sup> Miles, *supra* note 54, at 35-36.

<sup>114</sup> *Methanex Corporation v. United States of America* (Final Award, 3 Aug. 2005) at 1456. For an analysis of this case, see R. Rao, 'Facing Arbitration for Environmental Regulation: Arbitration under Chapter 11 of the North American Free Trade Agreement Between Methanex Corporation and the United States of America', *Sustainable Development Law and Policy* 5 (2005) 65.

<sup>115</sup> Miles, *supra* note 54, at 26; Douglas, 2006, *supra* note 93, at 50-1. For an argument to the contrary, see: Courtney C. Kirkman, 'Fair and Equitable Treatment: Methanex v. United States and the Narrowing Scope of NAFTA Article 1105', *Law & Pol'y Int'l Bus.* 34 (2002) 343.

take into account the level of transparency which the host State displayed. Investors are evidently supposed to comply with the existing laws and regulations of the host State, but it could be relevant to ask whether the State did also publicly provide information regarding future measures under consideration. If so, an investor should take this information into account when planning the establishment of a project. If details of these future measures are distributed in a timely manner, it would even allow investors with ongoing projects to refocus their investment, or at least prepare to close the project down, if necessary.

#### *4.3.3. MFN and National Treatment: Narrow Application of the Ejusdem Generis Principle*

International law does possess a concept – the *ejusdem generis* principle – which might solve the problems related to the relative standards of protection, namely the non-discrimination principles of MFN and national treatment. The function of the *ejusdem generis* principle can be summarized as follows: ‘a clause conferring most favoured nation or national treatment rights in respect of a certain matter, can attract the rights conferred by other treaties (or unilateral acts) only in regard to the same matter or class of matter.’<sup>116</sup> Accordingly, there has to be a ‘substantial identity’ to avoid imposing obligations on States to which they never consented, thus violating the primary principles of treaty interpretation. This is as true for investment law as for any other field of international law. Unless there exists a specific reservation to this extent in the agreement, it is no valid defence for the host State to argue that it has ‘better relations’ or a ‘different kind of agreement’ with a third party investor or its home State, because the ‘same genre’ principle (*ejusdem generis*) refers to the subject matter of the investment and not to the relationship of the actors involved nor to the vehicle carrying the rights (treaty, oral agreement, etc.).

As stated above, non-discrimination standards might conflict with the Kyoto Flexibility Mechanisms because the latter are precisely intended to differentiate between investments while taking into account the varying responsibilities of States for historical greenhouse gas emissions and their unequal economic development.<sup>117</sup> The idea of differentiation based on economic development has not come entirely out of the blue. For example, in its 1978 report on MFN clauses, the International Law Commission (ILC) referred to the work of the UNCTAD Secretariat, which had formulated its position as follows:

*To apply the most-favoured-nation clause to all countries regardless of their level of development would satisfy the conditions of formal equality, but would in fact involve implicit discrimination against the weaker members of the international community.*<sup>118</sup>

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<sup>116</sup> ILC Draft Articles on Most-Favoured-Nation Clauses [ILC Draft Articles MFN] in Yearbook of the International Law Commission, 1978, vol. II (Part One), document A/CN.4/309 and Add.1 and 2, art. 9, Commentary (10).

<sup>117</sup> Regarding the limits of what differential treatment can achieve, see: L. Rajamani, ‘The Nature, Promise, and Limits of Differential Treatment in the Climate Change Regime’, Y.B. Int’l Env. L. 16 (2005) 81.

<sup>118</sup> ILC Draft Articles MFN, *supra* note 116, add.1, para. 188.

The ILC concluded that this balance between the trade and development needs of developing countries requires that, for a certain period of time, the MFN clause would not apply to certain types of international trade relations. Hence, for example, the ILC's Draft Article 23 on MFN clauses excludes treatment based on the Generalised System of Preferences (GSP) from their scope of application. The remaining question is whether this provision, drafted with trade in mind, is relevant for investment. It is argued that it is, as the question could easily be rephrased as: 'can an investor invoke the MFN clause to obtain treatment equal to that of a third State investor who obtained its treatment based on the GSP system granted to his country?' Equally, if it is possible to distinguish according to the economic development of third States, why not take into account the development of the home State and subject the application of the national treatment clause to a similar restriction?

The next step of the argument is that if this line of reasoning is followed for trade and investment treaties, maybe it should also be followed for international environmental instruments such as the Kyoto Protocol which call for a different treatment according to countries' different economic development. Arbitral panels could adopt the view that the Kyoto-nature of an investment alters its subject matter to such an extent that it is no longer 'in like circumstances' as a non-Kyoto investment. Hence, the investments not being comparable, non-Kyoto investors cannot complain that host States have breached their non-discrimination obligations. However, this approach ought to be taken with the greatest level of caution as it could possibly result in the loss of effectiveness of non-discrimination clauses. Once it is established that clean energy and other projects are not 'in like circumstances', States can take specific measures to protect and promote clean energy investment, for example by taking proactive steps towards pre-establishment rights for these projects, but also by according benefits to investments which are already in place. On a global level, the market in clean energy ought to be liberalized – a process that has already started at the WTO by the elimination of trade barriers to environmental goods and services after the Doha Ministerial Declaration.<sup>119</sup> These possibilities will, however, not be further examined in this Paper.

## 5. Conclusion

International economic law in general and investment law in particular are evolving in a manner that causes overlap with other areas of law, such as international sustainable development regimes. The Kyoto Protocol shows proof of an innovative trend in thinking about international law among other because it explicitly provides for the involvement of private entities such as foreign investors, to achieve its goals of limiting and reducing greenhouse gas emissions. This Paper has explored how the international rules on foreign direct investment interact with, obstruct or support the

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<sup>119</sup> Updates online: World Trade Organization, <[http://www.wto.org/english/tratop\\_e/envir\\_e/envir\\_neg\\_serv\\_e.htm](http://www.wto.org/english/tratop_e/envir_e/envir_neg_serv_e.htm)> (last checked 24 November 2010).

objectives of the international climate change regime, and how international law mechanisms could reinforce sustainable investment in climate change-related projects.

This Paper has also addressed potential problems that may arise with regard to the application of investment protection standards such as (in)direct expropriation, MFN and national treatment, fair and equitable treatment, and the prohibition on performance requirements. Of course, it could happen that a State would treat foreign investors in a discriminatory or unfair manner, thereby violating its investment obligations, and attempt to avoid responsibility by presenting the whole operation as an implementation of Kyoto standards. Such a situation needs to be sanctioned by international law. However, the argument made here is that the wording, interpretation and application of the current investment protection rules are not conducive to the taking into account of legitimate environmental rules by arbitral panels. Most relief will have to come from future treaty and contract drafters, although a number of proposals made in the literature have to be rejected. Drafters of the agreement following-up on the Kyoto Protocol should consider the option of providing a dispute settlement system for private claims relating to Kyoto projects. Future IIAs should include references to the social, environmental and human rights of the State Parties. Investment contracts should address possible tensions with other fields of regulation and determine a hierarchy of norms, so that foreign investors can assess the feasibility of their project based upon as much information as possible – and this includes a duty for the State to divulge details of planned as well as current measures.

Using the international rules on treaty interpretation, a number of suggestions were made which also revealed the restrictions inherent to these rules when applied to inter-field interaction of standards as was the case here. Nevertheless, the toolbox of international law does possess a number of mechanisms to address these issues: the concept of interpretative context and the *ejusdem generis* principle. A greater awareness of these issues among *ad hoc* investor-State tribunals will also enable them to adopt a more 'Kyoto friendly' approach by taking other than purely investment related factors into account when examining whether an unlawful expropriation, discrimination or violation of the fair and equitable standard has taken place. However, tribunals cannot be expected to solve all problems. For example, prohibitions on performance requirements are usually so clearly formulated that they need no interpretation. Moreover, it is not ideal that the development of this important part of international law depends on the goodwill of an *ad hoc* panel to consider objectives outside the purely investor related context – after all, this is the context from which it derives its jurisdiction. Beyond the purely legal aspect, if, with regard to current IIAs and contracts, consideration of Kyoto rules and objectives does solely depend on the goodwill of *ad hoc* arbitral panels, then it is unclear how this could be enhanced. Many (but not all) of these issues are still in the hypothetical stage, however, it is crucial that this debate is opened and these problems addressed – if possible before they arise – as it is in the global interest that the objectives of climate change rules and investment protection are reconciled.





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