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International Investment Agreements: Impacts on Climate Change Policies in India, China and Beyond

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CHAPTER SEVEN

INTERNATIONAL INVESTMENT AGREEMENTS: IMPACTS ON CLIMATE CHANGE POLICIES IN INDIA, CHINA, AND BEYOND

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Introduction

Mitigating and adapting to climate change will require a fundamental reorientation of our global economy as we move away from fossil fuels and transition to a low carbon and climate-resilient world. This reorientation depends on government actions to help catalyze and channel financial flows in new directions and away from business-as-usual practices.

International investment agreements (IIAs)—treaties that now number over 3,000 and have the objective of promoting and protecting cross-border investment flows—could potentially play a key role in these efforts to scale up and (re)direct investments to meet climate change mitigation and adaptation needs. As presently drafted and interpreted, however, these IIAs represent a missed opportunity to advance climate change solutions and, worse, may even frustrate them. Due to the daunting amount of investment needed for mitigation and adaptation, and the consequent mandate for governments to be strategic in closing financing gaps, it is necessary to critically assess the climate-policy consistency of IIAs and (re)shape them accordingly.

This paper examines these issues. Beginning with a brief overview of IIAs and the challenges and opportunities they can pose for climate change policy generally, this paper then highlights particular challenges and opportunities these agreements pose for climate policy in China and India. When analyzing the relationship between IIAs and climate change, these two countries are important to examine because of their significant modern contributions and vulnerabilities to climate change; their active yet divergent approaches to IIAs; and their dual roles as hosts of considerable inward investment and homes to a large and growing cadre of major outward investors. The issues China and India face in terms of the intersections of climate policy and investment law are not entirely unique to them, but are especially visible. This visibility presents important examples of how current legal frameworks may hinder, but could be harnessed to advance, national action on climate change mitigation and adaptation.

IIAs and Climate Change: The Promise and Perils

IIAs have been signed by most countries throughout the world. They typically require states to provide certain standards of protection to foreign investors including obligations to:

- compensate investors for any expropriation of their property,
- provide investors "fair and equitable treatment" (FET), and
- treat covered foreign investors the same as, or better than, domestic investors or investors from other foreign countries.

A growing minority of IIAs also include restrictions on "performance requirements" such as measures requiring or incentivizing use of local goods and services, and those mandating "technology transfer."

To enable easy enforcement of these obligations, most IIAs permit foreign investors to directly sue their host-country government for conduct that allegedly breaches the treaty. Such claims can generally be used to challenge actions or omissions of any branch (e.g., executive, legislative, or judicial) and level (e.g., local, state/provincial, or federal/national) of government. These suits, referred to as investor-state dispute settlement (ISDS) cases, take place before an ad hoc panel of three arbitrators who are appointed and paid by the parties to the dispute. The final awards rendered by tribunals are subject to only minimal review and, as compared to judgments issued by national courts, are easier to enforce around the world. These awards carry powerful consequences as they frequently order states to pay foreign investors millions or even billions of dollars.

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A key reason many governments have agreed to provide foreign investors these substantive protections and grant them access to ISDS is to attract foreign investment. The rationale is that by signing IIAs, countries provide signals to foreign investors that they are attractive and disciplined sites for foreigners to commit their capital. Studies conducted to date, however, indicate that the mere act of concluding an IIA is no guarantee that investment will come (Sachs and Sauvant, 2009). Rather, something more from the would-be host state is required such as a market, a low-cost and/or high quality labor force, or natural resources that the investors are seeking to access. Moreover, it is unclear that the legal guarantees provided by IIAs are adequate to compensate for broader and more systemic weaknesses in a host country's legal and business environment (Sachs and Sauvant, 2009). Thus, despite their objective to promote international investment, IIAs are not sufficient to meet that goal. To the extent that IIAs do attempt to attract investment, they rarely target those types of investments that would be most desirable from a sustainability perspective including, for instance, investment that would facilitate climate change mitigation or adaptation.

Even more problematically, as IIAs have been interpreted by ISDS tribunals, a wide range of government actions and inactions, even those taken in the public interest for purposes such as reducing greenhouse gas (GHG) emissions, can actually run afoul of IIA commitments. When applying the expropriation standard, for instance, ISDS tribunals have required governments to pay foreign investors compensation for legislation, regulation, and court decisions that they consider to have unduly negative impacts on foreign investors' property rights. The fact that a measure is taken in good faith and for public interest aims is generally not considered to protect governments from having to pay compensation. Similarly, the "fair and equitable treatment" (FET) standard has been interpreted to require governments to compensate investors for conduct that interferes with the investors' expectations regarding future business plans and profits. Some interpretations of the FET obligation also declare that governments must pay foreign investors compensation for measures that the tribunals deem "arbitrary" or not proportionate to their purpose. As with the expropriation obligation, the fact that a state may be acting in good faith and in the public interest does not shield it from liability under the FET standard.

The range of climate change-related measures consequently vulnerable to challenge under these IIA provisions is extremely broad. On the mitigation side, it could include (but is by no means limited to) actions by governments to:

- discontinue fossil fuel subsidies or to impose carbon taxes on fossil fuel industries;
- include stricter emissions or other environmental standards in new laws or application of existing laws;
- enact policies or practices denying environmental permits for development, transport or use of coal, gas, or petroleum resources;
- institute planned phase-outs of certain energy sources; and
- implement decisions that require or result in stranding of fossil fuel reserves.

On the adaptation side, IIA claims under the expropriation or FET provisions could be used to challenge actions ranging from court decisions requiring fossil-fuel industry players to compensate individuals and communities for causing climate-change related harms, to zoning restrictions limiting future development in flood-prone areas. Indeed, the potential claims are arguably limited only to the imagination of investors and their attorneys; the IIA system lacks rules that prevent investors from or penalize them for making frivolous claims, much less claims that are unsound from a climate policy perspective.

The non-discrimination standards raise similar issues. Under these standards, host governments may treat *different* investors or investments differently, but must treat foreign investors the same as or better than *"like"* domestic investors or investments or those from other countries. As the provisions have been interpreted by at least some ISDS tribunals, conduct that has the *effect* of treating covered foreign investors less favorably than "like" domestic or other foreign investors may breach a treaty even in the absence of any discriminatory *intent.*

Foreign-owned companies have used these non-discrimination provisions in IIAs to challenge government decisions to enforce laws against them when similar action had not been taken against other firms, or to deny them permits for extractive industry projects when other projects had been approved. These interpretations not only threaten legitimate government exercises of enforcement and prosecutorial discretion (i.e., decisions by officials regarding how to use often scarce resources to promote compliance with environmental or other laws); they also arguably prevent the strengthening of climate change and other environmental restrictions over time. If, for example, a foreign investor's application for a coal-fired power plant were rejected based on concerns about the project's contributions to GHG emissions, the investor could claim it was discriminated against in breach of the IIA if a coal-fired power plant that happened to be owned by a domestic or other foreign investor had previously been proposed and approved before the threats and causes of climate change had been properly understood and incorporated into policy decisions.

Cases interpreting the non-discrimination standards have also successfully challenged government efforts to apply different fiscal regimes to investors involved in producing, using or selling substitutable and non-substitutable products. Ecuador, for example, was held liable for fiscal policies that treated exporters of oil less favorably than "like" exporters of flowers; Mexico was held liable for fiscal policies that treated purchasers of high fructose corn syrup differently than purchasers of sugar. These disputes highlight the potential for IIA-based suits against governments for tax regimes that differentiate among producers or users depending on climate-change considerations such as the type of fuel they produce, energy they use, or adaptation planning they have incorporated. Should a coal-fired power plant receive the same tax treatment as a solar-powered facility? Should a car with relatively high GHG emissions benefit from the same subsides provided for low-emissions vehicles? Should production of a water-intensive crop receive the same fiscal incentives as one appropriate for a drought-prone climate? Are the different groups of power producers, cars, or crops "like"? These questions are not resolved in the texts of IIAs, and previous ISDS cases provide no guarantee that tribunals will consider or respect the distinctions governments draw in order to advance climate policy aims.

Perhaps the most emblematic sign of the threats IIAs pose to climate policies is *TransCanada v. United States,* which was filed in June 2016 under the North American Free Trade Agreement (NAFTA). In that case, a Canadian firm is seeking USD 15 billion in alleged damages from the United States for the Obama Administration's rejection of its proposed Keystone XL pipeline, a project that would transport more than 800,000 barrels of carbon-heavy petroleum each day from Canadian tar sands to refineries in the Gulf Coast. According to the Obama Administration, approving the pipeline would undercut the US's global leadership in the effort to fight climate change. However, according to TransCanada, the government's decision expropriated the company's property, frustrated its expectations, and discriminated against its investment project since previous pipeline projects of investors from the U.S. and other countries had never been rejected on climate-related considerations.

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Even though TransCanada's case clearly contravenes climate policy and the public interest, it may actually have strong claims according to past interpretations of IIAs. Moreover, even if TransCanada were to lose on the merits, its claims illustrate how investors in the fossil fuel industry may use IIAs to discourage or halt climate-friendly policies, or to secure payouts as governments strive to move away from previous, unsustainable policies.

Another area of tension between IIAs and climate policy objectives arises from IIA restrictions on mandatory and incentive-based "performance requirements." Performance requirements are tools governments use to require or encourage companies to source their goods and/or services from domestic providers, or to make certain expenditures in the host country such as expenditures on research and development or on employee education and training. While the advantages and disadvantages of these local content tools are hotly debated, they have been and continue to be used by countries around the world to help develop infant industries and to create and deepen the linkages between foreign investment and the domestic economy (albeit with varying degrees of success). These linkages can help ensure that foreign investment provides coveted capital, jobs, technology and know-how. Local content mandates or targets have also been used to make certain policies—such as government programs to subsidize development of renewable energy generation—more politically attractive by helping ensure that those policies produce measurable domestic benefits for stakeholders. A number of IIAs, however, significantly limit the use of these tools.

Similar local content restrictions are embedded in World Trade Organization (WTO) agreements including the Agreement on Trade-Related Investment Measures (TRIMs Agreement) and the Agreement on Subsidies and Countervailing Measures (SCM Agreement). These have been successfully relied upon to challenge efforts by India and Canada to spur domestic development and production of renewable energy technologies while expanding deployment of renewable energy sources. Thus, restrictions on performance requirements are not entirely new in the international law arena. Nevertheless, when included in IIAs, these restrictions on performance requirements often extend beyond the prohibitions enshrined in WTO agreements and can be challenged under the IIAs' investor-state dispute settlement mechanisms, as well as through the IIAs' state-to-state dispute settlement mechanisms. By permitting investors to challenge performance requirements directly, the number of potential "enforcers"—and the monetary remedies they can access—can therefore be significantly greater under IIAs than through the WTO, which only permits states to raise challenges to the policies of another state.

IIA restrictions on performance requirements also typically prohibit governments from imposing "technology transfer" requirements on foreign investors. While the meaning of "technology transfer" is not defined in IIAs, it is susceptible to broad interpretations encompassing flows of "knowledge, experience and equipment amongst different stakeholders such as governments, private sector entities, financial institutions, NGOs and research/educational institutions" (IPCC, 2000). These flows can occur through a host of formal and informal relationships such as licensing agreements, training programs, collaborative research and development, and demonstration.

IIA provisions restricting "technology transfer" requirements are arguably inconsistent with provisions in climate change agreements seeking to promote technology transfers and placing commitments on state parties to help ensure that they occur. Article 4 of the United Nations Framework Convention on Climate Change (UNFCCC), for example, obliges developed country parties to "take all practicable steps to promote, facilitate and finance, as appropriate, the transfer of, or access to, environmentally sound technologies and know-how to other Parties, particularly developing country parties." Similarly, Article 10 of the Kyoto Protocol states that, "taking into account their common but differentiated responsibilities" all parties must "[c]ooperate in the promotion of effective modalities for the development, application and diffusion of, and take all practicable steps to promote, facilitate and finance, as appropriate, the transfer of, or access to, environmentally sound technologies, know-how, practices and processes pertinent to climate change, in particular to developing countries..."

The arguable tensions between climate change objectives and IIA obligations are made more problematic by the different dispute settlement mechanisms enshrined in the two legal regimes. Comparing the investment regime's standards and enforcement mechanisms with those of the climate change regime highlights the important differences between the two areas of international law. The UNFCCC does not specifically provide for dispute settlement, and indeed avoids prescribing detailed climate policies and specific measures. Similarly, the Kyoto Protocol sets forth clear obligations to reduce greenhouse gas emissions but leaves it to countries themselves to determine the best way to meet their obligations. The most recent Paris Agreement focuses on the actions and investments necessary to hold the increase in the global average temperature to well below 2 degree C above pre-industrial levels, but does so based on an informal system of mitigation pledges on the part of parties. The climate change regime is thus less prescriptive and non-adjudicatory compared to the strict obligations and enforceability of the investment law regime.

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As a result, when a government regulates to meet its commitments under the Paris Agreement, and the regulation is perceived by an investor to violate the government's obligations under an IIA, the measure may be adjudicated by an ISDS tribunal, according to the standards and requirements of investor protection in the treaty. If IIAs were reliably interpreted as instruments designed and applied to protect and promote investment as a means of achieving the broader objective of advancing sustainable development, then IIA obligations could be read in line with and supportive of UNFCCC aims. But IIAs have more commonly been interpreted as having the sole purpose of promoting and protecting international investment, regardless of its impact on sustainability objectives, an approach that can result in government liability for breaching broad investor protections irrespective of the legitimacy for doing so from a climate policy perspective.

Importantly, IIAs could be more actively enlisted to play a catalytic role in advancing mitigation and adaptation. There are a number of things the agreements could do in this respect, including incorporating commitments by state parties to:

- cooperate on sharing and disseminating information on opportunities for investment in relevant projects;
- cooperate on development, deployment, and diffusion of relevant technologies;
- taking into account principles of special and differential treatment, provide technical, financial or other assistance to support investment in adaptation and mitigation; this could include such support as capacity building for investment promotion agencies, provision of risk capital and investment guarantees, and assistance in developing relevant technical, managerial and professional expertise.

In addition to such provisions designed to actively support investment in climate-*friendly* investments, IIAs could also be used by state parties to reduce subsidies and other supports to climate-*unfriendly* investments. Some IIAs, for example, bar or limit the use of certain government subsidies and could therefore be specifically used to eliminate fossil fuel subsidies.

Moreover, as is done by some government-sponsored political risk insurance providers, IIAs could narrow their scope so as to deny protection to investments that are inconsistent with climate policy objectives. In contrast to current practices in which IIAs provide *all* types of foreign-owned investments what is, in effect, free political risk insurance, a climate-consistent approach would deny coverage for projects such as new coal mines and real estate projects in high-risk coastal or flood prone zones. Using this approach, IIAs could seek to encourage investment in climate friendly projects by providing qualifying investors protections against real government abuse, while ensuring that investments exacerbating climate change challenges would not be similarly covered and incentivized.

China and India: Past Practices and Future Options

For countries such as China and India, for whom both the effects of climate change and the contributions of their industries are particularly notable, the challenges and opportunities presented by IIAs are heightened. Data from 2012 show that these two countries together accounted for roughly one-third of the world's annual greenhouse gas (GHG) emissions (World Resources Institute, 2014). Given their development needs, large and ecologically diverse territories, and sizeable populations, these countries' efforts to reduce climate risks will be complex, and likely expensive, tasks (Nadin, et al., eds. 2015).

> *"For countries such as China and India, for whom both the effects of climate change and the contributions of their industries are particularly notable, the challenges and opportunities presented by IIAs are heightened."*

Due to concerns about current levels of emissions, potential costs of climate change, and opportunities to become leading producers of environmentally sound goods and services, both India and China have emphasized the importance of developing and adopting GHG reduction and climate-change adaptation policies and have taken steps to do so. Each country's "Intended Nationally Determined Contribution" (INDC), developed in connection with the Paris Agreement, lists various components of their respective climate-friendly plans. In these texts, initiatives aiming to (re)direct private sector activity figure prominently.

IIAs pose risks to these actions. China and India have both indicated that they will pursue their climate policy objectives through measures such as imposition of taxes, removals of subsidies, and adoption of new zoning restrictions. Notably, in other countries and similar contexts, such actions have given rise to ISDS claims. India and China are therefore likewise vulnerable as each country boasts a significant amount of foreign investment that could be affected by these measures and has signed a large number of IIAs (China roughly 150 and India roughly 95) under which investors could potentially bring challenges.

Not all of these IIAs, however, are the same (Berger, 2008). Up until the late 1990s, China's IIAs provided only a relatively narrow set of protections to investors and limited access to ISDS. Yet over the past two decades, China has embarked on a program of negotiating treaties with stronger investor protections (though it still appears largely resistant to including restrictions on performance requirements), and greater access to ISDS. These shifts reflect China's concern about the treatment of its growing number of investors abroad.

In comparison, India's IIAs have tended to provide broader investor protections and greater means to enforce them through ISDS. After being hit with a number of ISDS claims, however, India adopted a different approach. In 2015, it adopted a new "model" text that, as compared to its previous IIA commitments, narrows investor protections, limits ISDS, and contains a number of provisions recognizing and protecting states' rights to regulate in different policy areas. Despite the preparation of this new model, it is still unclear as of mid-2016 whether India will actually conclude IIAs incorporating the model's more defensive approach. Moreover, irrespective of what India does with its future treaties, the long lives (often multiple decades) and automatic renewal provisions of many IIAs mean that India will be subject to broad obligations under pre-2015 agreements for years to come. Even if India were to terminate those IIAs, their "survival clauses" typically provide that state parties will continue to be bound by the treaties' obligations for a period of 10-20 years. China and India, therefore, will likely be vulnerable to ISDS claims and liability for at least the coming decades, which is the prime time for climate action.

In terms of the opportunities China's and India's IIAs present for advancing climate policy objectives, some of the provisions suggested above by which state parties to an IIA commit to cooperate on investment in sustainable development can already be found in a few agreements concluded by China (Johnson and Sachs, 2015). Yet while promising, both China's and India's IIAs could do much more in terms of specifying relevant commitments and establishing institutions or mechanisms to ensure compliance.

On the issue of excluding coverage for investments that are inconsistent with climate policy objectives, India's model IIA contains analogous provisions denying IIA protections for certain projects based on investor misconduct. Denying coverage based on climate change risks and vulnerabilities is similar, but merely extends the grounds for exclusion. Nevertheless, neither India nor China presently have language in their IIAs that would preclude coverage for projects that exacerbate climate change challenges.

The Future of the Investment Regime

There are fundamental questions about whether IIAs permit appropriate policy space for action on climate change or deter or undermine appropriate government measures. Moreover, there is concern that IIAs are agnostic toward the types of investment they cover, protecting investments irrespective of whether they exacerbate or help ameliorate mitigation and adaptation challenges. Consequently, not only are IIAs missing an opportunity to catalyze badly needed investment in support of climate action, they may also be facilitating—if not encouraging—entrenchment of unsustainable policies and practices.

These issues are especially salient for China and India as countries with significant numbers of IIAs and stocks of foreign investment, as well as a real interest in the climate agenda and important national plans to address climate change. In recent years, both countries have been altering their approaches toward IIAs; and there are some areas in which those new approaches can help reduce exposure to ISDS claims for mitigation or adaptation measures and/or help promote climate friendly investments. Nevertheless, much broader overhauls of IIAs are needed, both for those two countries and the parties to the thousands of other IIAs that exist or that are being negotiated.

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