

# Changing Climate in Climate Change Investment An International Law Perspective

*Francesca Romanin Jacur*  
NYU Global Research Fellow

## I. EVOLUTION OF THE TWO REGIMES

### 1. The Climate Change Regime

States, international organizations and private actors are engaged in a great variety of initiatives to tackle climate change but the only comprehensive treaty devoted to this environmental challenge is the United Nations Framework Convention on Climate Change (UNFCCC). Within the framework of the UNFCCC, states have negotiated the Kyoto Protocol.

While under the Kyoto Protocol industrialized parties committed to quantified greenhouse gas (GHG) emission reductions, under the UNFCCC developed and developing States Parties have engaged in voluntary national appropriate mitigation actions (NAMAs).<sup>1</sup>

These two treaties have created treaty bodies to ensure the implementation of their obligations and a large quantity of decisions, rules and guidelines. In this paper, I will refer to this institutional and normative complex as the ‘Climate Regime’. One of the fundamental principles at the heart of this regime is the principle of common but differentiated responsibilities,<sup>2</sup> whose concrete content is vague and contested.

Negotiations have been – and still are – struggling to find a balance between commitments of developed and developing countries.

The Industrialized countries have more stringent quantified economy-wide emission reduction targets to implement within 2020 and, where available, beyond that date.<sup>3</sup>

Developing Countries agreed to undertake NAMAs in order to achieve “a deviation in emissions relative to ‘business as usual’ emissions in 2020”,<sup>4</sup> and on a voluntary basis to communicate to the Conference of the Parties their national objectives for reducing emissions, including reference to specific mitigation actions to be implemented in order to meet those objectives, and

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<sup>1</sup> Chung ch 19 climate finance book

<sup>2</sup> Principle 7 of the Rio Declaration on Environment and development: “States shall cooperate in a spirit of global partnership to conserve, protect and restore the health and integrity of the Earth's ecosystem. In view of the different contributions to global environmental degradation, States have common but differentiated responsibilities. The developed countries acknowledge the responsibility that they bear in the international pursuit to sustainable development in view of the pressures their societies place on the global environment and of the technologies and financial resources they command.”

<sup>3</sup> Subsidiary Body for Implementation, Compilation of economy-wide emission reduction targets to be implemented by Parties included in Annex I to the Convention (FCCC/SB/2011/INF.1/Rev.1, 7 June 2011).

<sup>4</sup> FCCC/2010/7/Add.1, para.48.

the associated context, conditions and other relevant considerations.<sup>5</sup> The rationale behind NAMAs is to engage developing countries in designing their own climate strategies, to have these strategies communicated to the relevant bodies of the UNFCCC and to have them monitored and verified periodically.

The main results of the last Conference of the Parties in Durban are the agreement on a second commitment period of the Kyoto Protocol, the creation of a Green Climate Fund to finance climate mitigation and adaptation initiatives in developing countries and the manifestation of a common intention to reach a legal agreement in the near future.

Behind the political impasse of reaching a comprehensive agreement to curb GHG emission, fears of losing competitiveness and protection for carbon intensive industry should be taken into consideration.

While the international negotiations proceed at a very slow path, seeking to build trust among all the various subjects involved, climate change is not waiting so other climate initiatives are being undertaken at the domestic and regional level and private investment in climate-related initiatives is increasing.

## **2. The Investment Regime**

The Investment Regime is a fragmented network of investment treaties, mainly concluded on a bilateral basis between States (Bilateral Investment Treaties, or BITs). The origin of the current legal framework governing international investment lies in the failure of a global multilateral agreement on investment protection. Under these treaties, Parties recognize reciprocally certain guarantees and standards of treatment (for example, compensation for expropriation, fair and equitable treatment) for investors of the nationality of the counterparty and give investors access to a direct dispute settlement mechanism, namely international arbitration. The main objective of these treaties is to provide foreign investors with an effective protection under international law from potential discriminatory treatments in the countries where the investments are implemented. Data show the rapid growth of foreign direct investment from \$50 million per year in the 1980s to \$1.9 trillion per year record in 2007. Parallel to the rise in investment volumes, the number of disputes and investment arbitrations has also increased from 5 cases per year in the 1980s to 40 in 2003.<sup>6</sup>

However, these numbers should not lead to think of international investment law and arbitration as only a great successful story. Criticisms of this legal regime come from many sources – developing countries, civil society, and investors – and cover substantive, procedural and institutional aspects. Mainstream targets are the “race to the bottom” effect of investment law on public interest policies of host countries, lack of adequate transparency and participation in

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<sup>5</sup> NAMAs may assume three different declinations: unilateral NAMAs are carried out and finance entirely by the developing country; supported NAMA are financed by international finance, and credited NAMAs, which generate carbon offset credits.

<sup>6</sup> See UNCTAD, FDI Statistics; Karl P. Sauvant (ed.), *The rise of international investment, investment agreements and investment dispute*, in Appeals mechanism in International Investment disputes (Oxford University Press, Oxford 2008) 8-9.

arbitration procedures, the fragmented arbitral governance that produces inconsistent and unpredictable awards.

Eventually, these suggestions have not remained unheard and the investment regime through its main players, the States, as we shall see, has started to react.

## II. THE INTERACTIONS BETWEEN CLIMATE MEASURES AND INVESTMENT LAW

### 1. Standards of Investor Protection

Before reviewing how climate policies are considered under Investment Law, it is useful to briefly describe the main rights granted to foreign investors under bilateral and multilateral investment treaties.<sup>7</sup>

The first two defences against discriminatory actions undertaken by host governments are the right to be treated not less favourably compared to domestic (National Treatment) and other foreign investors (Most Favoured Nation Treatment).

Moreover, a fundamental commitment of States under bilateral and multilateral investment treaties is the right to expropriate a foreign investors' property only for public purposes, in a non-discriminatory basis and respecting due process. When these conditions are met, the expropriation will be considered legitimate, and the investor will receive compensation. As we will see, expropriation is not limited *stricto sensu* to the deprivation of the title, but includes also situations of 'indirect expropriation' where the assets, although remaining in the possession of the investor, are tangibly reduced in their value.

Another pillar of investment treaties is the standard of fair and equitable treatment, a procedural standard requiring proportionality and due process in the implementation of national regulations. It has a broad and abstract nature and its precise content is highly disputed among scholars.<sup>8</sup>

Although now less in *vogue*, stabilization clauses are another legal tool used to protect investors by "freezing" the law applicable to the investment at the time the investment started, and thereby excluding the applicability of regulatory changes introduced subsequently. This static approach has generally been replaced by more flexible approaches balancing the various interests at stake. However, it has not been superseded<sup>9</sup> and may in certain cases contribute positively to stability and predictability.

The enforcement of these rights is ensured by the right of foreign investors to take the host government to arbitration. Disputes can be referred by the investor to a number of fora, generally including the International Centre for the Settlement of Investment Disputes (ICSID), the Permanent Court of Arbitration (PCA), according to the arbitration rules of the United Nations Commission on International Trade Law (UNCITRAL) arbitration rules.

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<sup>7</sup> For present purposes we will not enter in the on-going and profound debates regarding each of them in the literature and in the decisions of arbitral tribunals. REFERENCE

<sup>8</sup> REFERENCE

<sup>9</sup> Cameron argues that this tool represents a "conventional wisdom" but has not yet been superseded by the flexible approaches, and moreover might also have overall positive effects. See Peter D. Cameron, *Stability in the Context of Environmental and Human Right Issues*, in *International Energy Investment Law. The Pursuit of Stability*, Oxford, 2010, at 368.

## 2. The Challenges to Environmental Measures under Investment Law

A lead on how climate measures might be considered in future disputes is provided by the significant number of arbitral decisions on the relationship between environmental regulations and investment law. These mainly deal with the legitimacy of environmental measures challenged by the investor for allegedly constituting indirect expropriation or for being in violation of the obligation to ensure a fair and equitable treatment.

Arbitral tribunals seized with these cases have extensively dealt with issues such as: can a State adopt a regulation in the public interest objective if in so doing it impairs a foreign investor's assets? According to which criteria should the regulation be evaluated? Even if the State action is justified, does the investor nonetheless have a right to compensation? How is an act constituting "indirect expropriation" distinguishable from one exercised in the State regulatory autonomy? What relevance has to be given to the purpose of the measure, and to its effects?

Deciding these various matters has important impacts on the state and on investors' behaviour. While the immediate practical consequence of these determinations is whether to pose the burden of the costs of pursuing environmental policies on the investor or on the host country, arbitral awards impact is not limited to investors' rights and the host State regulatory power in the specific case at stake, but expands on future national policies and investment flows.<sup>10</sup> States indeed, for fear of losing their foreign investment 'appeal', may decide to lower their environmental standards.<sup>11</sup>

In order to be aligned with investment law, environmental measures have to successfully go through a number of tests.

First of all, with regard to expropriation, even though a direct expropriation claim is not likely to arise as long as the control over the investment remains with the investor, there are several claims challenging environmental measures as amounting to "indirect expropriation". There is a deep divide among scholars and investment tribunals on how to determine if a certain measure falls in the category of indirect expropriation - and consequently entails the duty of the State to compensate the investor - or in the category of regulatory autonomy of the host State for which no right to compensation is recognized.<sup>12</sup>

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<sup>10</sup> In this regard, it has been convincingly argued that the current investor-State arbitration system exercises "far-reaching governance functions". Kingsbury and Schill

<sup>11</sup> Commentators commonly refer to this effect as the 'regulatory chill'. Tienhaara, 80, Bernasconi-Osterwalder and Brown Weiss, and others. *Contra waelde?*

<sup>12</sup> Even this distinction is not plainly accepted by international law scholars and by tribunals. One side argues for the recognition as a general principle of international law that "a State is not liable for economic injury which is a consequence of bona fide 'regulation' within the accepted police power of states", as endorsed by the Iran-US Claims Tribunal, in the *Sedco Incv. National Iranian Oil Co.* Conversely, Professor Higgins argues that "Under international law standards, a regulation that amounted (by virtue of its scope and effect) to a taking, would need to be 'for a public purpose' (in the sense of in the general, rather than for a private, interest). And just compensation would be due." (Rosalyn Higgins, *The Taking of Property by the State: Recent Developments in International Law*, 176 *Recueil des Cours* 259, 324 (1982).

For sake of simplification, the interpretative solutions of scholars and tribunals can be divided in two main trends: the ‘sole effect’ doctrine and the ‘purpose and effect’ doctrine.

According to the first view, the purpose of a certain environmental measure negatively affecting an investment, even if legitimate, is not an element that exempts the State from the duty to provide compensation.<sup>13</sup>

In contrast, the approach leaving ‘legitimate’ regulatory measures outside the scope of indirect expropriation holds that the purpose is significant and requests that the following factors be considered: the effect of the measure on the investors’ assets, the extent to which the possession of the investor has been impaired, the purpose of the measure and the way it is designed and implemented. If these requirements are positively met, the regulatory action should be considered as a legitimate exercise of the state regulatory autonomy and would not give rise to the obligation to compensate damages.

A further specification is, however, necessary: if specific assurances have been given by the State to the investor with regard to the implementation of the investment, having generated its legitimate expectations, the State will be liable and required to pay compensation.<sup>14</sup>

We consider the ‘purpose and effect’ doctrine to be preferable under many aspects. Firstly, it allows the interpreter to take into account the different relevant interests involved and the specific circumstances of the case. Moreover, and importantly, by so doing, these factors can be put in perspective and eventually allow to reach a more balanced solution. On the contrary, the ‘sole effect’ doctrine, by following a too narrow approach, loses sight of the regulatory framework in which the measure has its origins and that is relevant to assess its scope and objectives. This is clearly shown in the *Santa Elena v. Republic of Costa Rica* where the ICSID tribunal held that:

“While an expropriation or taking for environmental reasons may be classified as a taking for public purpose, and thus be legitimate, [this] [...] does not affect the nature of the measure or the compensation to be paid for the taking [...]. The international source of the obligation to protect the environment makes no difference.”<sup>15</sup>

The ‘purpose and effect’ doctrine, on the other side, allows to properly keep environmental measures in perspective and to consider their international origin when relevant.<sup>16</sup>

Favour for this doctrine is further strengthened by the express reference in recent BITs of exceptions allowing interferences with property by certain public interest regulations without

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<sup>13</sup> “Expropriatory environmental measures – no matter how laudable and beneficial to society as a whole – are in this respect, similar to any other expropriatory measures that a state may take in order to implement its policies: where property is expropriated, even for environmental purposes, whether domestic or international, the state’s obligation to pay compensation remains.” ICSID Award *Compania del desarrollo de Santa Elena, SA v. Republica of Costa Rica*, 17 february 2000, 5 ICSID reports 153, at 192. See also *Azurix Corp v. Republic of Argentina*, 14 July 2006, ICSID case No. ARB/01/12, para 310; *Tecmed v. The United Mexican States, NAFTA Award*, 29 May 2003, 43 ILM 133 (2004).

<sup>14</sup> *Metalclad corp. v. United Mexican States*, iCSID Case No. ARB(AF)/97/1, Award of august 30, 2000.

<sup>15</sup> ICSID Award *Compania del desarrollo de Santa Elena, SA v. Republica of Costa Rica*, para 71.

<sup>16</sup> See *infra*, paras 3.1. and 3.2.

necessarily recognizing a correspondent right to compensation. This seems the option supported by the majority of scholars and of arbitral decisions.<sup>17</sup>

Once having successfully passed through the test of indirect expropriation, environmental policies will still need to meet the requirements of fair and equitable treatment (FET) in order to be in line with investment law.<sup>18</sup>

To this end, it should be implemented in a non-discriminatory way and be proportionate. In contrast to expropriation, discrimination and proportionality are relative standards. The discriminatory nature should be assessed mainly by considering the treatment of national and other foreign investors in ‘like circumstances’.

In case this particular aspect of the measure is found discriminatory, this does not lead *ipso facto* to the violation of the fair and equitable treatment. The State, as recognized in the *Saluka* case, will have to demonstrate that there is a ‘rational justification’ for this differential treatment.<sup>19</sup>

As for proportionality, a balance should be found between the relevance of the public interest pursued and the concrete impact on the investor. This latter should be assessed in terms of its legitimate expectations and the effects of the measure in the specific case. When are expectations considered “legitimate”? A relevant dimension of the implementation of a regulation is the time factor. Firstly, the interpreter should look back at the time when the investment was made: “any legitimate expectations, in order to be protected under the FET standard, must have existed at the time the investment was made.”<sup>20</sup> However, it should also be reminded that “where investments are made through several steps over a period of time, such expectations must be assessed at each “decisive step”.<sup>21</sup> In order to meet the proportionality test and not impose an excessive burden on investor, regulatory changes should be announced in due time. Moreover, they should be implemented gradually in order to allow the investor to adopt the necessary adjustments to absorb the impact of increased costs and other changes.

A telling precedent of an investor challenging an environmental regulation as being a violation of its right to fair and equitable treatment is the first case brought under the Energy Charter Treaty. In *Vattenfall AB, et al. v. Germany*<sup>22</sup> a Swedish investor, owner of a coal-fired power plant near Hamburg, has initiated arbitration against Germany to an ICSID tribunal. The Swedish investor claims that additional environmental restrictions to reduce the plant pollution in the Elbe River were imposed after the provisional approval of the project in 2007 and that they constitute a violation of its right to a fair and equitable treatment. These measures, implemented by Germany

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<sup>17</sup> *Saluka Investments BV v. The Czech Republic* (nota 107 Boete, p.351)

<sup>18</sup> In *SD Myers, Inc v. Government of Canada*, for example, the arbitral tribunal found that the temporary export prohibition on waste from Canada to the USA did not amount to an indirect expropriation, but held that it violated the fair and equitable treatment and the national treatment standards.

<sup>19</sup> *Saluka Investments BV v. The Czech Republic*, at 460.

<sup>20</sup> (*Lemire v. Ukraine, Frontier Petroleum Services*, 285...297, *Tecmed, Duke Energy Electroquil Partners v. Ecuador, Continental Casualty Company v. Argentine Republic*, vedi nota 145 a p.89 Yb on Intl inv Arb 2010)

<sup>21</sup> *Frontier*, at 297 citing *Schreuer, liber amicorum Waelde* at 265.

<sup>22</sup> *Vattenfall AB, Vattenfall Europe AG, Vattenfall Europe Generation AG &Co. KG v. Federal Republic of Germany*, ICSID Case No. ARB/09/6 (Mar. 30, 2009).

in accordance with the Water Framework Directive, allegedly rendered the original project economically unsustainable.<sup>23</sup>

Despite the many disputes decided, there is no unambiguous interpretation of the substantive content of these standards. Moreover, due to the lack of a coherent legal framework and of *stare decisis* linking the various arbitral tribunals, it is difficult to predict how investment arbitrations will decide analogous disputes in the future.

### **3. Climate measures affecting Carbon-Intensive Investments**

#### *3.1. Unilateral Climate Measures*

States introduce stricter standards on certain industries and may even ban or limit the production or consumption of certain products or services to reduce greenhouse gases (GHG) emissions. An example of this kind of measure is the Australian legislation setting a fixed carbon tax starting in July 2012 that will then become an emissions trading scheme from July 2015.

Similarly, California has adopted legislation to establish a comprehensive regulatory scheme, which includes a cap and trade mechanism, aiming at reducing its GHG emissions to 1990 levels by 2020.<sup>24</sup>

The affected industries will bear additional costs to comply with these measures, or in extreme cases, might even be forced to close down their business if they are no longer profitable. When the owner of these activities is a foreign investor, and if there is an investment treaty between his country and the host country, he can challenge the regulatory measures for violation of rights and standards under investment law and bring the host government to arbitration.

Although no unilateral climate measure has been challenged yet, such a case may soon arise considering the recent trend of enacting climate policies at the domestic level while waiting for a future international global regulatory framework.

#### *3.2. Multilateral Climate Measures*

While unilateral policies autonomously adopted in the exercise of the State regulatory power are more likely to be challenged as protectionist in favour of domestic industries and therefore discriminatory towards foreign investors, multilaterally agreed rules and standards or regulatory measures adopted to comply with a supranational obligation may have at least *prima facie* a favourable presumption of being in good faith.

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<sup>23</sup> See Bernasconi. The case, registered in April 2009, was suspended in August 2010 pursuant to a settlement agreement. In March 2011 an Award on agreed terms has been rendered. Parties agreed to several conditions upon which the investment will be continued. The documents available don't allow at present a comprehensive assessment of these conditions.

<sup>24</sup> The implementation of this climate legislation has been suspended by the California Supreme Court for inadequate environmental review of its implementation and consideration of alternative options, such as direct carbon taxes. See Daniel M. Firger, Michael B. Gerrard, *Harmonizing Climate Change Policy and International Investment Law: Threats, Challenges, and Opportunities*, Yearbook on International Investment Law & Policy 2010-2011, Karl P. Sauvant (ed.), Oxford university press, 2012, p.517-565, at 536.

Further, with regard to climate measures, it can be convincingly argued that their ‘legitimate’ purpose is inferred being based on scientific findings as recognized by the great majority of the scientific community and by several authoritative international institutions.<sup>25</sup>

The ‘outsourcing’ and internationalization of responsibility for stricter environmental or climate measures has beneficial outcomes in terms of stability and predictability, because it links the climate measure to rule-making entities or processes that are not directly dependent and under the control of the host country.

For example, energy efficiency standards with a ‘multilateral matrix’ derive from criteria mutually agreed by international standards setting organisations, or established by industry or other private associations. Standards could also be set by treaty.<sup>26</sup>

Also carbon taxes could have a multilateral origin, such as the tax on GHG emission from aviation that European States are implementing at the domestic level starting from January 2012 in accordance with the European Emission Trading Directive.<sup>27</sup>

*a) An Example of a Multilateral Climate Regulation: The European Trading Scheme*

A more complex structure has to be put in place when States, in order to comply with regional or international commitments, implement cap & trade regulatory schemes.

Back in 2005, European law established a scheme for GHG emission allowance trading within the European Community, in order to promote reductions of such emissions in a cost-effective way, in line with the requirements of the Kyoto Protocol.

According to EU ETS Directive, installations covered by the scheme<sup>28</sup> shall account for their carbon emissions and hold a permit (emission allowance) for each tonne of emissions they emit. Each year, they have to surrender an amount of allowances equal to their total emissions.

The implementation of this scheme is proceeding in phases and is gradually broadening its scope, by including other sectors such as aviation, becoming more ambitious by setting new targets and by replacing the free allocation of allowances with an auctioning system.

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<sup>25</sup> As for the scientific community, consider the IPCC Reports, Marcos A. Orellana, *The Role of Science in Investment Arbitrations Concerning Public Health and the Environment*, Yearbook of International Environmental Law, vol.17, 2006, p.48-72. Climate change has become a recurring theme in the agenda of several international institutions: Security Council, Un General Assembly, HR Committee. See Thomas Waelde and Abba Kolo, *Environmental Regulation, Investment Protection and ‘Regulatory taking’ in International Law*, 50 International and Comparative Law Quarterly, 2001, p.811, at 846: “It is unlikely that courts or arbitrators will find a compensable expropriation in cases where governments issue environmental regulation for legitimate purposes, in accordance with the state of scientific knowledge and accepted international guidelines.”

<sup>26</sup> Reference to international climate-related standards has other potential benefits that go beyond the host country regulation, for example, when they are included in investment contracts upon request of the investor to create stability or for reputational purposes. Also States when negotiating BITs could consider including substantive provisions on climate change.

<sup>27</sup> DIRECTIVE 2009/29/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 23 April 2009 amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading scheme of the Community. See also the judgment of the Court of Justice of the European Union Case C-366/10.

<sup>28</sup> The sectors covered by the scheme are listed in Annex I of the Directive.

This legislation curtails significantly the activity and consequently reduces the profitability of emissions-intensive industries.

There are already a certain number of disputes challenging different aspects of the European ETS. They involve States and the European Commission on both sides, either for matters relating to the implementation of the scheme or for non-compliance by States with their obligations.<sup>29</sup>

Besides these disputes, more interesting for our purposes, are the disputes brought to the European Court of Justice by private investors against EU institutions challenging the ETS scheme *inter alia* for infringing their right to property and for being in breach of the principles of proportionality and equal treatment.

In the *Arcelor* case a steel manufacturer claims that the restrictions imposed by ETS violate his property rights. Moreover, in the applicant's view "[...] the Community legislature was under a duty, pursuant to the principles of proportionality and equal treatment [...] to take into account the very serious consequences of the contested directive for its particular situation."<sup>30</sup>

Although this claim has arisen under EU law and not under an investment treaty, if we assume that the applicant, instead of a European investor is the subsidiary of a Brazilian company and we further assume that there is a BIT between Brazil and the European country where the factory is based, the following contestations of the applicant such as the violation of the right to property and the principle of equal treatment, the disproportionate burden, could equally be raised in an investment dispute:

"The applicant takes the view that the contested provisions encroach disproportionately on the substance of its right to property and its freedom to pursue an economic activity because they require the applicant to operate its plants under economic conditions which are unsustainable. First, those provisions have the effect of placing the applicant in a position of a 'net buyer of allowances' [...] given that, in spite of its reduction efforts in the past, and unlike companies in other sectors, it has no technological potential to reduce further its CO2 emissions in the near future [...]. Second, in view of the particular competitive conditions in the steel sector [...], the applicant will no longer be able to pass on the increased production costs to its customers [...]. Consequently, its production will become loss-making, and it will therefore be obliged either to continue to operate unprofitable and inefficient plants within the internal market or to close them and relocate them to countries which have no emission reduction obligations under the Kyoto Protocol."<sup>31</sup>

In my view, here lies one of the Achilles' heel of cap & trade schemes. In fact, the European scheme and others alike, provides that 100 % of allowances free of charge should be allocated to

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<sup>29</sup> Chester Brown, "International, Mixed, and Private Disputes Arising Under the Kyoto Protocol", *Journal of International Dispute Settlement*, vol. 1, No.2, 2010, pp.447-473.

<sup>30</sup> Case T-16/04, *Arcelor SA v. European Parliament and Council of the European Union*, 2010 E.C.R. 00000, para.146. Another case *Arcelor Atlantique et Lorraine and Others*, 2008 E.C.R. I-9895, para. 75. Thus, by failing [...] to include other sectors in Annex I to the contested directive – in particular the competing non-ferrous metals and chemicals sectors – the Community legislature infringed the principles of equal treatment and undistorted competition.

<sup>31</sup> Case T-16/04, *Arcelor SA v. European Parliament and Council of the European Union*, 2010 E.C.R. 00000, para.147. Another case *Arcelor Atlantique et Lorraine and Others*, 2008 E.C.R. I-9895.

certain energy intensive sectors or subsectors.<sup>32</sup> This kind of exemption is expressly based on the protectionist intention to safeguard these sectors from the economic disadvantage due to the competition with industries of third countries that are not implementing comparable schemes (carbon leakage).<sup>33</sup>

Even if this particular aspect of the scheme is considered discriminatory, the State could still defend the scheme by providing the difficult proof that there is a rational justification for such differential treatment.

Cap and trade schemes, if adopted on a global scale involving all State would be a very effective tool to tackle GHG emissions,<sup>34</sup> however, at regional and national levels they are likely to create potential for carbon leakage and discriminatory issues relating to alleged disguised restrictions to trade and investment.

#### *b) The Clean Development Mechanism (CDM)*

The CDM is established by article 12 of the Kyoto Protocol, which indicates its three main objectives: contribute to the sustainable development of the host State, facilitate the achievement of compliance with quantified emission reduction commitments of industrialized States and contribute to the ultimate objective of reducing GHG emissions overall. Through the CDM private investors of industrialized countries parties to the Kyoto Protocol finance GHG emission reduction projects in developing countries parties to the Protocol. The former receive certified emissions credits (CERs) that can be used to offset their commitments or sold in the carbon market, and the latter receive low-carbon technology and financial flows that contribute to their sustainable development.

The CDM provides for an interesting precedent on the interaction between private investment and climate change law and shows a culture clash between the UN ‘public interest’ negotiating process and the private sector stakeholders operating within the process.<sup>35</sup>

The CDM is a hybrid model that combines top-down regulation coming from the treaty bodies of the KP and bottom-up strategies, provided by developing countries hosting the projects. Acting

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<sup>32</sup> DIRECTIVE 2009/29/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 23 April 2009 amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading scheme of the Community, Preamble, para.24.

<sup>33</sup> ETS Directive, art. 10b. Similar concerns are raised by Bonnell with regard to the New Zealand’s scheme. (Max Bonnell, “Protecting Investments and Protecting the Environment: Can Emissions Trading Schemes Create Liability under BITs?”, Paper on file with author)

<sup>34</sup> Although “In principle, a global cap-and-trade system covering all countries with significant emissions, with allowance allocations to ensure equity for developing countries would be the best solution for all if fully workable, but establishment of such an arrangement is not likely in the near term.” Stewart, Kingsbury, Rudyk, *Climate Finance for Limiting Emissions and Promoting Development. Mechanisms, Regulation, and Governance*, in Richard Stewart, Benedict Kingsbury and Bryce Rudyk (eds), *Climate Finance. Regulatory and Funding Strategies for Climate Change and Global Development*, New York, 2009, p.3-34, at 6.

<sup>35</sup> The tensions have arisen in many ways, such as in the slow and complex approval process of the projects, in the composition of the CDM EB, understaffed and underfunded to carry out its mandate. The CDM is facing many challenges and will have to face in the near future because of the sharp instability of its market.

through their respective DNAs, host countries determine autonomously the sustainable development criteria that CDM projects should meet in order to be authorized on their territory. The preliminary question that needs to be answered is whether CDM activities fall under the definition of “investment” of investment treaties. In our view, the answer is in the positive, considering the broad interpretation given to this definition under BITs. In this view, not only projects implemented according to CDM rules but also the CERs resulting from them will fall under this definition.<sup>36</sup>

The CDM being an outcome of the climate change regime is based on the principle of common but differentiated responsibilities and in observance of this principle it differentiates countries according to their historical contribution to GHG emissions and their stage of economic development. This founding principle at its basis is the main source of potential discriminations challengeable under investment law.

A first discrimination under the Most Favoured Nation treatment arises between developing countries parties to the Kyoto Protocol hosting CDM projects and investors of non-Parties to the KP or of developing countries, even if Parties to the protocol. This discrimination finds its origin in the fact that the CDM has been designed and is intended as a means to facilitate compliance by industrialized countries with their obligations under the Kyoto Protocol.

For example: Benin (developing country party to the Protocol) issues a public tender for a solar plant. A Brazilian (developing country, party to the protocol), an American (non-party to the protocol) and a Japanese (industrialized country, party to the protocol) investor are participating to the bid. Under the CDM rules, only the Japanese company will be eligible to participate in the CDM and own CERs. Could the other investors claim that they suffered discrimination under the Most Favored Nation Treatment? How would an arbitral tribunal decide with regard to these potential discrimination disputes?

As disputes on these matters have not yet occurred, our hypothetical answer assumes and suggests that the arbitral tribunal will take the approach of the “purpose and effect” doctrine and accordingly give due consideration to the climate regime that is at the basis of the challenged measures.

In this view, the tribunal albeit acknowledging the existence of discrimination would be able to justify it by considering and giving relevance to the fact that the measure was implemented in compliance with the climate treaty.<sup>37</sup>

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<sup>36</sup> Werksman 8, e Bennett, Brown at 18.

<sup>37</sup> A further potential discriminatory aspect is the suspension by the Compliance Committee of the Kyoto Protocol of parties participating in CDM projects when they are found to be in non-compliance with their commitments. This situation has occurred in 2008, when Greece was suspended for a few months from taking part to the flexibility mechanisms. What tools could Greek investors use to protect their investment? They could only address their claim to the treaty bodies of the climate regime? What if a host country in observance of Kyoto rules refuses to recognize CERs? Could this measure be challenged under investment arbitration? There is here a gap and a lack of coordination for investors likely to find themselves without effective protection under both the climate and the investment regime. This interaction between investment law and CDM shows a gap that needs to be addressed.

Other discriminatory aspects arise from the EU legislation that allows in the European market only CERs produced by projects in least-developed countries or in countries that have concluded an agreement with the EU. Moreover, with regard to the recent withdrawal of Canada from the Kyoto Protocol, discriminatory treatment may arise towards Canadian investors: are they still entitled to own and trade CERs? Could an investor challenge the measure of a State that doesn't recognize his entitlement to CERs or bans him from participation in the carbon market?

If a CDM investor goes to arbitration, after having asked clarification to the Kyoto Protocol treaty bodies, what relation would there be between the two procedures? And what if inconsistent outcomes are issued?

These questions show that problematic aspects relate not only directly to CDM projects implementation, but also with regard to the trading of CERs. Here again, non-Parties to the KP and developing countries are not entitled to participate in carbon markets where CERs are traded. Some of these matters might be further clarified in the recent dispute between an investor and a host government agency arising from a Kyoto Protocol project. The case, is the first dispute to be arbitrated under the Permanent Court of Arbitration's Optional Rules for Arbitration of Disputes Relating to Natural Resources and/or the Environment.<sup>38</sup>

#### **4. Climate Measures Favouring Low-Carbon Investment**

Several countries have created, or are in the process of establishing, incentives for the promotion of renewable energy and of energy efficiency. These policies, as shown by the European experience, entail investment opportunities but also significant regulatory risks for investors. The profitability of clean energy projects is often dependent on governmental subsidies and feed-in tariffs and consequently requires that those be maintained stable during the life-cycle of the investment. This has not always been the case and unexpected changes in the incentives have created an atmosphere of negative uncertainty and fear that "once investments are made, public authorities will be tempted to reconsider their commitments".<sup>39</sup>

In this regard, the fair and equitable treatment is a relevant standard that States should respect. As already highlighted, this standard calls for consideration of the legitimate expectations of investors and requires balancing the State interest to introduce regulatory changes with the investors' expectations. Moreover, these changes should be informed to due process principles, such as transparency, reasonableness and proportionality.<sup>40</sup>

Moreover, with regard to clean energy investment, stabilization clauses could have beneficial effects in terms of stability and predictability, for example, by reducing the investors' risk with regard to future changes in the incentives granted for implementing renewable energy projects.

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<sup>38</sup> The case regards a Joint Implementation project of Cyprus-based Company in an Eastern European country. Although not a CDM project, the issues of discrimination are analogous.

<sup>39</sup> Anatole Boute, "The Potential Contribution of International Investment Protection Law to Combat Climate Change", *Journal of Energy & Natural Resources Law*, vol.27, n.3, 2009, pp.333-376, at 342.

<sup>40</sup> Stephan W. Schill, "Do Investment Treaties Chill Unilateral State Regulation to Mitigate Climate Change?", *Journal of International Arbitration*, 24 (5), 2007, pp. 469-477.

As these projects still need to be incentivized to compete on the energy market, the stabilization of the tariff to a defined amount would work as a risk guarantee.<sup>41</sup>

It should also be kept in mind that these measures are likely to be challenged by carbon-intensive investors as discriminatory as they subsidize certain energy sectors to their detriment. These challenges raise questions already known under Trade Law of whether low-carbon energy and carbon-intensive energy are ‘like’ products.<sup>42</sup>

### III. NARROWING THE GAP BETWEEN CLIMATE AND INVESTMENT LAW

Recent years have witnessed a growing criticism and some commentators refer to a deep crisis of investment arbitration.<sup>43</sup> Concerns have been raised, to name a few, with regard to the legitimacy of the system, the inadequate involvement of non-state actors, such as multinational enterprises and civil society, the differences among investors and host countries.

With specific regard to environmental and climate change matters, recipes for reform mainly aim at including sustainable development within the objective and purpose of investment law.

The main ways in which sustainable development and environmental principles are being integrated are through express ‘carve-outs’ provisions for environmental regulations in investment treaties and by interpreting investment law in light of environmental principles.

#### 1. Towards Express Reference of Environmental Values

##### 1.1. *The Energy Charter Treaty*

The Energy Charter Treaty (ECT) is a multilateral treaty counting fifty-one signatories that could play a major role in facilitating low-carbon investment. Although being a treaty that follows the traditional pattern of investment treaties, with the peculiarity of focusing on energy investment, it is the first treaty of this kind that contains an express reference in its preamble to the climate change regime and has comprehensive consideration of other environmental agreements:<sup>44</sup>

“Recognizing the necessity for the most efficient exploration, production, conversion, storage, transport, distribution and use of energy; Recalling the United Nations Framework Convention on Climate Change, [...] and other international environmental agreements with energy-related aspects; and Recognizing the increasingly urgent need for measures to protect the environment, including the decommissioning of energy installations and waste disposal, and for internationally-agreed objectives and criteria for these purposes[...].”

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<sup>41</sup> It may be particularly relevant for large-scale projects in which the capital is provided by international lending institutions, eager to make sure that the repayment of their debt will not be undermined for a certain period allowing them to be reimbursed.

<sup>42</sup> REFERENCE

<sup>43</sup> M. Waibel, A. Kaushal, et al., *The Backlash against Investment Arbitration. Perceptions and Reality*, Kluwer Law International, 2010; Jose E. Alvarez, Karl P. Sauvant, Kamil Girard Ahmed, and Gabriela P. Vizcaino, *The Evolving International Investment Regime: Expectations, Realities, Options*, Oxford, 2011.

<sup>44</sup> Edna Sussman, *The Energy Charter Treaty’s Investor Protection Provisions: Potential to Foster Solutions to Global Warming and Promote Sustainable Development*, *Sustainable Development in World Investment Law*, M-C. Cordonier Segger, M.W. Gehring, A. Newcombe (eds), The Netherlands, 2011, p.515-432.

Notably, the interaction between the ECT and the UNFCCC is not limited to the Preamble but has further been taken into account during its 2009 Review Process.

Moreover, the ECT is complemented by the Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects (PEEREA) that was signed together with the ECT in 1994. The Protocol requires its participating states to formulate clear policy aims for improving energy efficiency and reducing the energy cycle's negative environmental impact. Through the implementation of PEEREA, the ECT provides transition economies with a menu of good practices and a forum in which to share experiences and policy advice on energy efficiency issues. Within this forum, particular attention is paid to such aspects of a national energy efficiency strategy as taxation, pricing policy in the energy sector, environmentally-related subsidies and other mechanisms for financing energy efficiency objectives. The meeting of the parties produces concrete recommendations for individual governments concerning ways of improving their national energy efficiency strategies.<sup>45</sup>

This legal regime of investment protection in the energy sector provides an interesting model that shifts from the pure procedural content of classical investment treaties towards a hybrid model that considers also substantive aspects of the relevant sector in which investments are to be enhanced and protected.

### *1.2 Bilateral Investment Treaties*

The traditional objective of BIT to plainly promote and protect foreign investment seems to have broadened its scope with the inclusion in recent BITs of consideration for public interest matters, such as the environment.

Recent BITs, such as the US model, after referring in the preamble to the importance of the stability in the investment regulatory framework,<sup>46</sup> state that they desire

“to achieve these objectives in a manner consistent with the protection of health, safety, and the environment, and the promotion of consumer protection and internationally recognized labor rights;”

The statement in the preamble that economic development brought through the flow of private capital has to be consistent with the protection of the environment and other public interest values and can be used as an interpretative tool as provided by the Vienna Convention on the Law of Treaties.

Furthermore, many countries have included general exceptions for measures taken to protect environmental interests also in the treaty texts. These express carve-outs allow the parties to adopt measures to protect human, animal and plant life or health as well as for conserving natural

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<sup>45</sup> To date such in-depth reviews have been conducted in Denmark, the Czech Republic, Slovakia, Estonia, Moldova, Lithuania, Poland, Hungary, Turkey, Bulgaria and Romania.

<sup>46</sup> “Agreeing that a stable framework for investment will maximize effective utilization of economic resources and improve living standards;” (Treaty between the United States of America and the Oriental Republic of Uruguay concerning the Encouragement and Reciprocal Protection of Investment)

resources and ensure that environmental policies are not watered down to attract more investment.<sup>47</sup>

Examples are the renegotiated BIT between Canada and Czech Republic providing in Art. II that

“[t]he Contracting Parties recognize that it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures. Accordingly, a Contracting Party should not waive or otherwise derogate from, or offer to waive or otherwise derogate from, such measures as an encouragement for the establishment, acquisition, expansion or retention in its territory of an investment.”<sup>48</sup>

Moreover, Art. IX allows parties to adopt measures necessary “to protect human, animal or plant life or health”, “to ensure compliance with laws and regulations” and “for the conservation of living or non-living exhaustible natural resources.”

Other useful and welcomed additions found in recent renegotiated BITs consist in clarifications regarding the interpretation of the standard of indirect expropriation and in certain cases, even a specification of its content. These interventions provide a sort of authoritative interpretations of substantive rights and standards under the treaty thereby providing clarity to investors and states with regard to the kind of commitment that they are undertaking. Foremost, they reduce the discretion of arbitral tribunals eventually asked to interpret the treaty provisions and provide them with a more specific mandate. In the present case, the treaty clearly intends to take position in the divide between the “sole effect” and the “police powers” doctrines,<sup>49</sup> by espousing the latter:

Annex A: Clarification of the standard of indirect expropriation: determining whether an indirect expropriation occurred is a fact-intensive inquiry that requires consideration of, *inter alia*, the economic impact of the measure taken, the extent to which the measures interferes with investment expectations, and the character of the measures.

Moreover, as further evidence of BIT increased focus on protecting “public welfare objectives”, the treaty specifically excludes from its scope measures that are designed to protect “health, safety and the environment”.

“non-discriminatory measures of a Contracting Party that are designed and applied to protect legitimate public welfare objectives, such as health, safety and the environment, do not constitute indirect expropriation.”<sup>50</sup>

These amendments to recent renegotiated BITs show a clear trend towards a balanced approach that in protecting foreign investments takes into consideration public interest values, such as the environment, and consequently climate change matters.

This approach has evident similarities with the general exceptions recognised under trade agreements, such as article XX of the GATT.

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<sup>47</sup> Kate Miles, p.26: “In this way, the ability of states to take domestic action necessary to address climate change without triggering foreign investor compensation requirements would be greatly enhanced.”

<sup>48</sup> Agreement between Canada and Czech Republic for the Promotion and Protection of Investments, May 6, 2009, IC-BT 1157: Art. II. Similar provisions are found in Canada- Latvia BIT, art.II.5.

<sup>49</sup> See *supra*

<sup>50</sup> See Canada –Czech Republic, Annex A; Canada- Latvia BIT, annex B (3).

## 2. Integration of Environmental Norms Through Interpretation

As international investment law does not exist “in a vacuum”, arbitral decisions on disputes ‘concerning the interpretation or application’ of the underlying investment treaty should ‘be in accordance with the applicable rules of international law’.<sup>51</sup>

It follows that principles of international environmental law that have become custom will also be applicable to investment disputes.

Environmental impact assessment (EIA) is now generally considered as a general principle of law, both at the domestic<sup>52</sup> and international level,<sup>53</sup> as recently recognized also by the ICJ.<sup>54</sup>

Similarly to EIA, other procedural principles of environmental law are relevant and could be eligible to be integrated in investment law. These are the principles constituting the three pillars of the Aarhus Convention on Access to Information, Public Participation in Decision-Making and Access to Justice in Environmental Matters.<sup>55</sup> These procedural norms, at the crossroads between environmental and human rights, have been broadly recognized and adopted in international fora and are increasingly used as benchmarks to assess performance also in the implementation of energy projects.

The main aim pursued by these norms is to link government accountability and environmental protection, involve stakeholders in an early stage of authorization procedures, enhance transparency and strengthen the environmental integrity of projects.

Recourse to these procedural mechanisms contributes to establish more inclusive consultation platforms and to strengthen dialogue among the population potentially affected, investors and government representatives.<sup>56</sup> In the framework of these procedures, the State should notify if relevant regulation are been considered and in so doing would allow the investor to calculate in advance the impact on his business and better absorb the impact of regulatory changes and facilitate a pacific adaptation to them.<sup>57</sup>

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<sup>51</sup> United States- Argentina (1994)BIT, article VIII

<sup>52</sup> Fertilisation of investment law with environmental law principles is not only taking place through the interpretation given by arbitral tribunals but is also happening through integration in investment contracts. Practice shows that investment contracts often contain a mandatory requirement to carry out an independent and comprehensive EIA, which will then be included in the environmental management plan and will be considered as an integral part of the investor commitments.

<sup>53</sup> The Espoo Convention on Environmental Impact Assessment in a Transboundary Context, 25 February 1995, in force 10 September 1997, 45 Parties. The Convention requires State Parties to establish a national EIA procedure with public participation (article 2.2), and its obligations have been specified through the adoption of the Strategic Environmental Assessment (SEA) Protocol, Kiev, 21 May 2003, in force 11 July 2010, 28 Parties, 38 Signatories, (Doc. ECE/MP.EIA/2003/2.) regulating environmental impacts within a State Party.

<sup>54</sup> PULP MILLS

<sup>55</sup> Aarhus, Denmark, 25 June 1998, 45 Parties.

<sup>56</sup> As noted by Cameron, these procedural steps would “limit the appearance of potential unilateral action, with the inevitable risk of litigation [...]. There would also be a lower risk of such a procedure being used by a host state as an excuse for removing the contractor from the project.” At 384.

<sup>57</sup> Cameron, 379: “Progress made in this area suggests that a pragmatic, conflict-free approach to the adaptation of investment agreements to increasingly rigorous environmental standards is a viable option.”

Beside these procedural principles, other principles of international environmental law such as sustainable development, the polluter-pays principle, and paradoxically even the principle of intergenerational equity and of common but differentiated responsibility could be useful tools to re-orient investment law towards a more ‘qualitative’ model of investment protection.<sup>58</sup>

Looking through the lens of these concepts, arbitrators could be able to justify measures that discriminate between low-carbon and carbon intensive sources of energy, or might better assess national regulations adopted in developing countries, taking into account their level of institutional and administrative development.

Beside the important role that can be played by general principles of law, also environmental treaties, and in particular for our present purposes the UNFCCC and the Kyoto Protocol, could be taken into account in investment disputes, provided that the host country and the state of nationality of the investor are parties to them. According to article 31.3(c) of the Vienna Convention on the Law of Treaties, the tribunal in adjudicating a case relating to an alleged discriminatory climate measure shall take into account also ‘any relevant rules of international law applicable in the relations between the parties’.<sup>59</sup> In this view, the tribunal could consider the host state obligations under the Kyoto Protocol as a justification for the adoption of discriminatory measures.<sup>60</sup>

#### IV. TOWARDS MUTUAL SUPPORTIVENESS

##### 1. “Stabilizing” Host Countries: The Complementary Role of the UNFCCC

Past experience shows that foreign investments alone do not bring a real economic growth in developing countries if they are not coupled with an improvement of the domestic economic, legal and institutional framework.<sup>61</sup>

In a bottom-up perspective, it is crucial therefore to intervene with reforms in key sectors, such as tax, employment, environment, contract law, and to strengthen institutions and procedures at the domestic level. These improvements would allow developing, emerging or industrialized countries to create a stable and trustworthy investment environment, identify their climate priorities and engage in significant national strategies.<sup>62</sup>

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<sup>58</sup> See remarks of Sarianna M. Lundan at the Second Columbia International Investment Conference, October 30-31 2007.

<sup>59</sup> Article 31 ‘General rule of interpretation’: “[...] 3. There shall be taken into account, together with the context: [...] (c) any relevant rules of international law applicable in the relations between the parties.”

<sup>60</sup> But see Brown: “There are limitations to the possibility of using article 31.3(c) as a means of reaching a Kyoto-friendly interpretation of BIT obligations; it is suggested that it would be extremely difficult for an investment treaty tribunal to reconcile directly conflicting obligations under a BIT and the Kyoto Protocol.”

<sup>61</sup> Rumu Sarkar, *A “Re-Visioned” Foreign Direct Investment Approach from an Emerging Country Perspective: Moving from a Vicious Circle to a Virtuous Cycle*, 17 ILSA J. Int’l & Comp. L., 2010-2011, pp. 379-392, at p.386: “If systemic problems in the underlying economic and legal framework are not addressed by the host country, it may continue to be vulnerable to boom and bust cycles, thus making sustainable economic development all the more illusory.”

<sup>62</sup> DUBASH, cap 18 Climate Finance book Developing countries, in particular, have a huge potential to achieve relatively cheap GHG emissions, as they often have high energy intensity productions and obsolete energy

The need to “allow greater flexibility for states to mitigate climate change in their own terms”<sup>63</sup> is the very similar and most important lesson learned from the experience of the climate change regime: developing and developed countries are reluctant to assume legal obligations if these are not in line with their respective national interests and necessities, which may greatly vary from country to country, depending on their economy, their development stage, their geographic location and many other factors. The recent trend of investment law goes in the same direction of allowing more flexibility and discretion to national policy makers in the implementation of their environmental policies.<sup>64</sup>

The UNFCCC contributes significantly to build capacities in climate change matters through reporting obligations since its entry into force, and recently by engaging all countries in NAMAs, it has gathered valuable information on domestic climate policies of developed and developing countries.<sup>65</sup>

By engaging in these activities, the UNFCCC plays a highly complementary role with regard to investment regimes. Indeed, traditionally, as already pointed out these regimes provide for standards and procedures to ‘rescue’ the investor from the complexities of the host countries, rather than dealing with their economic and institutional development situation.

The engagement of developing countries in climate change action is at an early stage and many problematic aspects still need to be addressed<sup>66</sup> in order for NAMAs to represent a credible and coherent body of rules on which investors can rely upon, but I think that this is a constructive way to go.

It seems to me that information on national climate strategies and these commitments, although still relatively weak and in part voluntary, could improve the transparency and predictability of domestic climate-related regulatory policies and thereby reduce risks of unexpected changes.

Their effective contribution to create a stable and predictable level playing field for climate-related investments will, however, be conditioned by the way NAMAs are monitored, verified

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infrastructures. On the other side, however, their weak institutional and administrative capacity often combined with corruption, unpredictable regulatory changes, nationalizations constitute relevant obstacles to foreign capitals.

<sup>63</sup> Daniel Bodansky, *The Future of Climate Governance. Creating a more Flexible Architecture*, p.48-52, at 48.

<sup>64</sup> The relevance of a host-country centred perspective has been underlined also by UNCTAD in one of its recent report on “The Role of International Investment Agreements in Attracting Foreign Direct Investment to Developing Countries”.

Also investor associations are engaged in building capacities in host countries. For example the UNEP Financial Initiative, a global public-private partnership with over 200 signatories, is focusing on the link between financial performance and Sustainable Development and has built regional task forces in Africa, Latin America, Asia, and India over the last 10 years.

<sup>65</sup> This is of crucial importance because, as recognized by the High-Level Advisory Group on Climate Change Financing, one of the main drivers for the transition to a low-carbon economy is how much climate finance developing countries themselves will demand from the private market in the coming years.

<sup>66</sup> There are, for example, drawbacks to NAMAs implementation related to lack of capacity of developing countries to manage technical requirements, such as the definition of the emission baselines, the measurement of emissions reductions, their reporting and verification. Optimistically as it may seem, it should not be forgotten that many developing countries have hosted CDM projects and at this time should be familiar with dealing with this kind of issues and requirements, as they are very similar to the ones required under the CDM.

and reviewed. This set of measures shall be supported by appropriate compliance review mechanisms. In a credible and robust bottom-up approach, host countries should design their own climate strategies and sustainable development priorities, declare them and be held accountable for their implementation.<sup>67</sup>

This kind of monitoring and compliance review requiring complex and challenging technical and legal aspects is already in place under the Kyoto Protocol where Compliance Bodies are currently reviewing emission reduction commitments of industrialized State parties and reporting obligations of developing countries.<sup>68</sup>

A sort of ‘virtuous circle’ could be created in which the more credible are NAMAs and their review, the less regulatory measures adopted accordingly are likely to be challenged and found illegitimate under investment arbitration.

Along with this substantive dimension of building capacities in host countries, this ‘virtuous circle’ would also involve the respective compliance and dispute settlement procedures of the climate and investment legal regimes, and establish a constructive and complementary dialogue between them.

Climate-related regulatory policies would be periodically monitored, reviewed and verified by the Compliance Mechanism of the climate change regime. The compliance approach significantly differs from traditional dispute settlement procedures as it deals in a preventive way with situations of non-respect, is amicable, non-confrontational and adopts a problem-solving approach rather than a punitive one. In this view, compliance bodies mainly assist countries facing difficulties in order to help them return to comply.

Practice under compliance mechanisms in other environmental treaties shows that generally states, in particular developing countries, are willing to receive assistance and often ‘trigger’ the procedure on their own initiative.

This on-going and periodic review process would strengthen the environmental integrity of regulatory climate policies, and make them less challengeable from investment arbitration. In the event of a dispute brought to arbitration, the tribunal, according to the abovementioned article 31.3(c) of the Vienna Convention would be able to take into account, for good or bad, the outcome of the compliance proceedings under the climate regime.

Linking these procedures would have an extensive impact, considering the almost global participation to the UNFCCC (192 States). The idea of establishing a dialogue between dispute settlement, or dispute avoidance, procedures is not new in international law and interestingly,

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<sup>67</sup> J. Werksman and K. Herbertson, *The Legal Character of National Actions and Commitments In a Copenhagen Agreement: Options and Implications*, WRI Working Paper, November 2009, p.4. The author also notes that other advantages potentially coupled with the adoption of credible NAMAs are that countries adopting them could be eligible to access carbon markets and avoid trade sanctions.

<sup>68</sup> REFERENCE TO KYOTO NCP

investment tribunals have already referred to decisions of other dispute settlement bodies, such as, for example, the European Court of Human Rights.<sup>69</sup>

In this vision, the facilitative review procedures under the climate regime could constitute a sort of ‘previous exhaustion of environmental remedies’, or a preliminary test that could reduce recourse to arbitration.

### **Concluding Remarks**

The climate and the investment regime story starts with two independent bodies of law pursuing different objectives, combating climate change and protecting foreign investors’ assets in host countries, with opposite nature: the former being a common concern of the international community, the latter a purely private economic concern.

Their assumptions are also radically opposite: while the climate regime struggles to achieve mutual trust among developing and developed countries, and private actors, the investment regime is built on the lack of trust towards the legal systems of host countries, and indeed provides for recourse to international arbitration.

Even the tools the two regimes use to pursue their purposes are opposite: the climate regime differentiates between countries according to their economic development and their contribution in terms of GHG emissions; while on the other hand, investment law’s main mantra is non-discrimination.

Possibly the only aspect common to both regimes was the fact that they had to deal, albeit in different ways, with the challenge of the North versus South issue and probably the very fact that this divide is now blurring has brought these two regimes closer one another.

Looking at the recent evolution of the climate and investment regimes some common elements, even though not always aligned, emerge.

Both regimes may be said to have now at least a partially overlapping common goal: create a stable and predictable legal regime governing sustainable investments around the world.

Moreover, both regimes, one sooner one later, are realizing that the approach to achieve this goal is by creating solid institutions and reliable procedures in host countries, able to effectively decide on their own economic priorities, hopefully towards a sustainable development path.

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<sup>69</sup> Reference has been made to the First Protocol of the 1950 European Convention for the Protection of Human Rights and Fundamental Freedoms with regard to individual property rights and the amount of compensation due in case the State interferes in the enjoyment of property for public interest objectives.