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Right of the Host State to Regulate the Environment and Investment Protection - A Changing Landscape

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Abstract - The increase in investment flows is one of the newest challenges in the pursuit of sustainable development. Generally, investors establish their operations in countries that have less stringent environmental regulations to reap maximum benefits from the investment. It has been estimated that a 1% increase in foreign direct investment contributes to a 0.04% increase in environmental pollution. In response to this challenge, countries have revisited and re-framed their Bilateral Investment Agreements (BITs) in a manner to balance the host state's regulatory power concerning its commitments to protect the environment with investment protection. Accordingly, environment-related language has been used by different states within the BITs to preserve the regulatory power of the host state. Such language can be identified mainly in seven ways; i) referring to the environment in preambles of BITs, ii) reserving policy space for the regulation of environment in general, iii) reserving policy space for environmental regulation for the specific subject matter, iv) exceptional clause to indirect expropriation, v) none-lowering environmental standards to attract investments, vi) environmental matters and investor-state disputes and vii) general promotion of progress in environmental protection and cooperation. The effect of each way is different and therefore, this research purposes to explore the legal implications of each way by highlighting the most appropriate method to incorporate environmental concerns in the texture of the BIT.

Keywords—Bilateral Investment Agreements, Regulatory power, Policy Space, Indirect Expropriation, Non-Lowering Standards, investor-state disputes

I. INTRODUCTION

International Investment Law (IIL) and International Environment Law (IEL) are two distinct regimes that resulted from the fragmentation of international law(Koskenniemi,2006). Until the principle of sustainable development emerged environmental concerns were not integrated into the International Investment Agreements (IIAs)(Vinules,2012; Footer, 2009). Significantly, Part I of the Brundtland Commission Report of 1987 and Principle 4 of the RIO Declaration recognize sustainable development as a way-out to reconcile the tension between development and environment and accordingly affirmed that environmental protection should be integrated into all development process to achieve the sustainable development. As a part of IIAs, BITs are vitally important as more than 180 countries of the globe are a party to at least one BIT(Footer,2009).

The UNCTAD and various scholars have identified many existing BITs as the first generational BITs since they reflect mostly the demands of the capital-exporting countries in the developed world. They are not detailed in nature. (World Investment Report,2015: Salacuse, 2015) One of the main criticisms against these first generational BITs is that they are drafted in a way of hampering the State's sovereign right to regulate the matters relating to the environment, national security, public health, employment, and economic development. (Harten and et al,2010: Spears, 2010). When environmental state measures which are taken to comply with the international environmental obligations of the host state negatively affect the protection of

investment, investors tend to make claims against the host state. If the policy space for environmental concerns of the host state is not expressly stipulated in the BIT, non-commercial concerns become less important in the eye of the investor-state dispute settlement mechanism(ISDS) and many state measures get halted at the arbitration. ((Beharry and Kurutzky,2015; Vinules,2012: Spears, 2010).

With the realization of the fact that BITs are not harmless political declarations and they 'bite' state measures, countries like Venezuela, Bolivia, and South Africa have rendered to terminate their BITs while other states like Canada, United States, China, France, Norway, and the United Kingdom tended to reframe the policy space in their BITs.

The Second generational BITs preserve more regulatory autonomy and flexibility for host countries to adopt non-discriminatory measures having a bonafide intention for the general welfare. Such BITs have adopted the principle of sustainable development *inter alia*, providing an explicit reference to the protection of the environment to restrain the discretionary power of the arbitral tribunals. This approach has not only been followed by OECD members. Countires such as Ghana, India, Brazil, Azerbaijan, and Serbia have also followed the same approach. These BITs purpose to balance the state's environmental concerns with its investment protection commitments and also assist the tribunals with precisely drafted BIT in interpretation.

Even according to Article 31.1 of the Vienna Convention of the Law of Treaties(VCLT), the ordinary meaning of the treaty is paramount important in treaty interpretation and potential conflicts between environmental concerns and investment protection can be considerably mitigated through the incorporation of explicit reference to the environmental concerns. By now, more than 50 countries have revisited their BITs and revised their model BITs.

In this backdrop, the purpose of this study is to explore the ways in which environmental concerns have been integrated into modern BITs. Each way of reference is different and the implication of them varies with the textual formation of the BIT. The subsequent sections of the paper are dealt with it. The study concludes by suggesting the most appropriate way of including environmental concerns within the texture of BIT.

Reseach Methodology

Due to the analytical nature of the study, this research is primarily based on the qualitative research approach. BITs signed by the countries were used as the primary sources and books, refereed journal articles, arbitral decisions, statements of the officials, conference papers, and documents of non-governmental organizations were used as secondary sources.

RESULTS AND DISCUSSION

According to a study done by the Organization for Economic Cooperation and Development (OECD) in 2011, although only 6.5 percent of the BITs concluded till 2010 contained the environment-related language in overall, an essential dimension of the newly concluded IIAs from the 1990s is that 89 percent of them include environmental concerns. However, there are variations in the inclusion of environmental language in IIAs from BIT to BIT. For instance, Egypt, Germany, and the United Kingdom have less than 1% of the propensity of inclusion of environmental concerns. Nonetheless, 83% of IIAs of Canada, 75% of IIAs of New Zealand, 61% of IIAs of Japan, and 34% of IIAs of United States contain environmental concerns in their BIT. Moreover, the modern state practice has rapidly increased this tendency and the author of this research found that all the BITs concluded in 2017,2018, and 2019 contain environment-related language.

As the OECD study has pointed out, the way of inclusion of environment-related language can be identified mainly in seven ways; i) general language in preambles of BITs, ii) reserving policy space for the regulation of environment in general, iii) reserving policy space for the

environment regulation for the specific subject matter, iv) exceptional clause to indirect expropriation, v) none-lowering environmental standards to attract investments, vi) environmental matters and investor-state disputes and vii) general promotion of progress in environmental protection and cooperation(Gordan and Phol,2011). This expression proves that environmental concerns have come forward in treaty negotiations in the contemporary world. A BIT may use one or multiple references to the environment in any of the ways mentioned above.

General language in preambles of BITs

The preamble mainly deals with the objective and purpose of the investment agreements. It recognizes that the promotion of investment can be achieved *inter alia* without relaxing environmental measures. Reference to environmental concerns or sustainable development in the preamble does not create any right or obligation between the parties; it only appears hortatory and inspirational nature (Beharry and Kurutzky,2015). However, according to Article 31 (1) and (2) of the VCLT, the preamble helps in interpreting the object and purpose of the treaty.

Reserving policy space for the regulation of the environment in general

The most used expression on the environment in second-generation BITs is reserving policy space for regulating the environment. This is famously identified as an exception clause. This clause is significant as it purposes to exempt certain transactions or people or situations from the applicability of the commitments in an investment agreement to protect the interests of the host state. In some agreements, this clause is referred to as the general exception, as environmental concerns, as beneficiaries of the protective norms as human, animal, plant life, or health and some to sustainable development and environmental protection or right to regulate.

A state measure within the meaning of this exception clause would be legal, irrespective of its non-compliance with other provisions of BIT(Salacuse,2015: Dolzer,2012; Ranjan,2012). The effectiveness of this provision has been further strengthened in some BITs specifying the nexus between the state measure and the policy objective. For instance, the phrase 'as *it considers appropriate to'* in Article 9 of Rwanda-Arab BIT is having self-judging nature and does not as strict as the phrase 'as it considers.' It gives policy space for the host state to decide the limitations and legitimize its state measures which purpose to regulate the environment. Extending this flexibility further, Article 12(6) of the US Model BIT has provided the procedure for any party to consult the other party regarding any matter relating to the exception clause. This provides an opportunity for the parties to negotiate their differences in a flexible manner.

Reserving policy space for environmental regulation for specific subject matter

Moreover, a limited number of treaties reserves policy rights for a particular purpose on the environment in the performance requirement clause or national treatment clause. Performance requirements allow states to take measures necessary to protect the environment and natural resources(Ex-US model BIT, Article8(3)(c): Canada- Moldova BIT, Article 9.2). Occasionally, some BITs might include provisions that give retrospective effect to the exceptions of national treatment, including the environmental measures(Ex- Article 3.3 of Russia-Sweden BIT). In Congo-US BIT of 1990, Congo has reserved its right to make limited exceptions in *inter alia* drinking water supply. These provisions further provide latitude for the host state to validate the state regulation.

Exceptional clause to indirect expropriation

Moreover, explicit recognition of environmental concerns that tighten the scope of expropriation is also a well-known way to reduce the tension between regulatory power and promotion of the investment(Gordon and Phol 2001:

Ranjan,2012). When the text of the BIT does not differentiate non-compensable regulation with compensable expropriation, the tribunal adopts three tests to determine the case; namely, the sole effect test, police power test, and proportionality test. However, famous arbitral awards such as *Metalclad v Mexico, Tecmed v Mexico* and *Santa Elena v Costa Rica* are evidence of the heavy burden placed on the government to ensure legal certainty. Furthermore, the police power test has been confused with the well-settled right of the State to expropriate foreign investment under customary international law lawfully(Ranjan,2012). Hence, to avoid these confusions the second generation BITs have exempted bona fide and non-discriminatory state measures that purpose to ensure environmental protection from the indirect expropriation(Ex-Article 6.8 of Argentina-Arab BIT, Annex B10 of Canada-Mongolia BIT and Article 5.5 of India's Model BIT). Further, BITs have provided precise limitations to the indirect expropriation stipulating the proper criteria viz. economic impact of the state measure, the intervention of the reasonable expectations of the investors, and character of the state action which requires a case by case, fact-based inquiry. This criterion has been followed in the US Model, Canada-Mongolia BIT, and Japan-Argentina BIT. Moreover, this approach lessens the discretionary power given to the arbitrary tribunals to decide upon the disputes.

None-lowering environmental standards

Non-lowering measures are purposed to avoid lowering environmental standards of the host state to attract investors. This provision came as a response to the 'pollution heaven hypothesis' whereby, the host state purposes to attract investors by lowering environmental or labour standards(Footer,2009) Most of the recent BITs include none lowering environmental standards with the phrase that *'it is inappropriate to encourage the investment by relaxing..'*. The scope of the clause may be varied with a treaty to treaty. For instance, Article 17 (2) of Brazil-Guyana BIT has provided a procedure for the parties to settle their issues relating to lowering standards by consultation. However, in order to reap the maximum benefit from this non-lowering environmental standard, a country has to incorporate this standard into it's all the BIT commitments including the most favored nation's (MFN)treatment. Otherwise, the MFN treatment would enable investors to attract more favorable substantial protection given under another BIT of the host state.

Environmental matters and investor-state disputes

ISDS mechanism is the most effective international remedy available for the investor, and also it facilitates attracting more foreign investors from the viewpoint of the host state. As Vinuales points out, approximately 40 claims with environmental components have been brought before arbitral tribunals from 2000-2010. Second generation BITs have attempted to avoid the criticisms made on the ISDS mechanism against its democratic deficit. For instance, Model BIT of Canada and Model BIT of USA have accepted *amicus curiae* briefs in their BITs. In *Biwater v Tanzania* the tribunal accepted the significance of the *amici's* contribution as it affirmed public interest in the investor-state dispute, convincing the tribunal about sustainable development, right to water and international corporate social responsibility. Moreover, Both in *Methanex Corporation v United States* and *United Parcel Service of America Inc. v. Government of Canada* the tribunal granted amicus standing to NGOs and public interested groups to submit written submissions.

In Addition to this, Brazil- Guyana BIT and the US Model BIT have excluded the application of environmental concerns from the dispute settlement mechanism. Further, Article 12.5 of the US Model BIT has introduced exhaustion of local remedies as a precondition to ISDS and it provides a forum for both the parties to have a compromise. Further, US-Rwanda BIT,

Argentina-Arab BIT, and India Model BIT have allowed consultation of experts on environment-related matters without prejudice to the arbitration procedure with the approval of other disputing parties. More importantly, India's Model BIT provides direction for the tribunal to consider the damage caused to the environment by the investor as a factor to mitigate the compensation when monetary damages are awarded.

General promotion of progress in environmental protection and cooperation

Furthermore, some BITs contain clauses that promote the furtherance and corporation of environmental objectives calling states to strengthen environmental standards. This expression is important when the treaty is interpreted according to the holistic approach by the tribunal.

In addition to these seven ways, the recent BITs have identified the voluntary responsibility of the parties to internalize the standards of corporate social responsibility and OECD Guidelines for Multinational Enterprises. It is evident in Article 17 of Argentina- Brazil BIT, Article 12 of India Model BIT, Article 17 of Japan-Argentina BIT, Article 10of Serbia Model BIT. The Brazil-Guyana BIT is progressive in this regard as matters relating to corporate social responsibility have been excluded from arbitration. More importantly, the Morocco-Nigeria BIT has provided standardization for the companies in areas of resource exploitation and high-risk industrial enterprises that they should maintain their certification to ISO 14001 or an equivalent environmental management standard. If the investors are not obliged to prescribe standards, the host state can take action against the investors. This further obliges parties to comply with the international environmental obligations that the host states or home states are parties. Furthermore, unlike other BITs, conducting environmental impact assessment prior to the establishment of the investment has also been recognized under this BIT. Consequently, the text of the BIT has legitimized the right to regulate the environment of the host state.

CONCLUSION

One of the vibrant features in the second generation BIT is the inclusion of environment-related language for the protection of the environment within the BIT. Accordingly, the conflicting nature of environmental regulation and investment promotion can be minimized by explicit reference to the environment. Since the investment treaty is the primary source in an investment dispute, if the treaty provisions are precisely drafted concerning the rights of both the host state and investors, the tribunal will be able to strike an appropriate balance between the two. However, whether both parties have a similar bargaining power to finalize a BIT depends upon the circumstances.

Linking environmental concerns explicitly with the expropriation clause and general exception clause would generate more latitude for host states to legitimize their state measures without violating the treaty provision. Reference to the environment in the preamble is significant when the purpose and object of the treaty are questioned. However, the preamble alone would not be able to regulate the environmental concerns of the host state. Similarly, the clause relating to the general promotion of progress in environmental protection and cooperation alone does not provide sufficient policy space for the host state to legitimize its state measures on environmental protection. Moreover, none-lowering environmental standards prevent degrading the environmental quality of the host state by its state measures and also by the investors. The effect of this provision is less influential than the exception clause. Multiple references can be made in a BIT to properly balance environmental protection with investment promotion. The US Model BIT and Morocco-Nigeria BIT of 2016 are more progressive in this regard as they contain environment impact assessment and environmental management standards in BITs

extending the common ways of including environment-related language. However, such expression would not unilaterally enable the state to legitimize their arbitral or political decision. The state bears the burden of proof of these clauses and hence, investors' rights will not be jeopardized.

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