ECT Modernisation Perspectives: Reforming the Fair and Equitable Treatment Protection

Kluwer Arbitration Blog
July 23, 2020

Ylli Dautaj (Assistant Editor for Investment Arbitration) (University of Edinburgh) and Per Magnusson (Magnusson Minds)

Please refer to this post as: Ylli Dautaj (Assistant Editor for Investment Arbitration) and Per Magnusson, 'ECT Modernisation Perspectives: Reforming the Fair and Equitable Treatment Protection', Kluwer Arbitration Blog, July 23 2020, http://arbitrationblog.kluwerarbitration.com/2020/07/23/ect-modernisation-perspectives-reforming-the-fair-and-equitable-treatment-protection/

The investment protection mechanism in the Energy Charter Treaty (ECT) is meant to, among other things, promote, attract, and protect foreign investments in the member states' energy sectors. In 2018, the Energy Charter Conference announced its list of approved topics for the modernization of the ECT. The list included several substantive investment protection provisions. This post focuses solely on the fair and equitable treatment (FET) standard. The crux of the matter breaks down to: (1) what level of protection does the current FET standard provide (*de lege lata*), and (2) what level of protection should it generate subsequent to the ECT modernization process (*de lege ferenda*)?[fn]For an elaborate discussion on this topic, the reader is advised to consult Professor Schreuer's seminal chapter and Professor Hobér's ECT Commentary.[/fn]

Why Reform the FET Standard?

Article 10(1) of the ECT contains an FET standard, providing that:

> *"Each Contracting Party shall, in accordance with the provisions of this Treaty,*

> *encourage and create stable, equitable, favourable and transparent conditions for Investors of other Contracting Parties to make Investments in its Area. Such conditions shall include a commitment to accord at all times to Investments of Investors of other Contracting Parties fair and equitable treatment." (emphasis added)*

It soon became apparent through arbitration that scholars and practitioners had to clarify whether the FET standard was a reference to the minimum standard of treatment under customary international law. Another issue was whether the FET obligation in Article 10(1) was a stand-alone provision or connected to other substantive protections. The latter proved rather cumbersome given the lumping together of several protections in Article 10 (1) of the ECT. Adding to this, the inherent ambiguity in "fair" and "equitable" has not made things more certain, especially pertaining to host State rights to regulate without breaching the standard of protection. As a result, the interpretation and application of the obligation contained in Article 10(1) has not been easily discernable and the lack of clarity has produced inconsistent and divergent arbitral awards.

The main reasons for FET reform seem to be a lack of clarity and a possibility of a "regulatory chill". Adding fuel to the overall reform debate is the allegation of an "investor-bias". Therefore, some statistics may be necessary to encapsulate current affairs: (i) there have to date been 130 ECT arbitrations; (ii) 12 EU States have been respondents; (iii) most claimants are EU nationals; (iv) most claimants are small and medium enterprises; (v) the outcome of final awards (65) break down as follows: 43% (finding of breach of ECT and award of damages), 15% (finding as to a lack of jurisdiction), 31% (finding of no breach), 6% (settlement agreement embodied in award), 3% (finding of breach but no award of damages), and 3% (outcome is unknown). Out of the final awards that are publicly available (64), the FET standard was invoked in 24.3% of the cases. A substantive breach of investor protection was found in 32 cases, out of which a breach of the FET standard constituted 64% of the successful claims. Statistically speaking, therefore, there seems to be no systematic favoritism ("investor-bias") embedded in the ECT ISDS regime. However, investors do win and have mostly been successful when invoking the FET protection. In this light, several states, NGOs, and some scholars now emphasize that the current FET standard creates a "regulatory chill" and is in need of reform.

De Lege Lata and *De Lege Ferenda*

Initially, some considered the FET standard a "catch-all" provision (encapsulating e.g. constant protection and security, non-discrimination, etc.). However, nowadays most experts treat it as a stand-alone standard that generates a negative right, i.e. a duty on the host State to refrain from certain prohibited actions. Through arbitral practice and scholarly work, several sub-standards have been considered to constitute part of FET protection. States have engaged in (re)defining the FET standard in new IIAs in order to reflect these developments and provide more clarity. Most strikingly, in the Comprehensive Economic and Trade Agreement (CETA) the EU has proposed a list definition of measures that constitute a breach of the FET obligation. To similar effect, several ECT members have proposed revising Article 10(1) of the ECT to reflect different policy options meant to *clarify* the FET standard. The main policy considerations are whether:

1. the FET standard should include a *list of measures* that constitute a breach of the FET obligation?
2. the list should be *closed* or *open-ended*?
3. the FET provision should offer protection for *legitimate expectations*?
4. the legitimate expectations sub-standard should only be breached if there has been a *specific representation and reliance* (i.e. a form of promissory estoppel)?
5. the FET provision should be narrowed to align with the *minimum standard treatment* under customary international law, or whether it should offer more robust protection?

ECT member states disagree as to the way forward. For example, Azerbaijan and Georgia advocate in favor of the minimum standard treatment alignment. Further, the EU advocates for a closed list approach (e.g. denial of benefits, manifest arbitrariness, duress and harassment, etc), and for legitimate expectations to be narrowed to situations where a party has made a specific representation which the investor relied on when making or maintaining the investment, whereas Switzerland proposes an open-ended list of FET obligations, and Japan does not believe that any amendment is necessary.

It is the sub-standard of legitimate expectations that has been the most

controversial in reform discussions, as it represents one of the main features underpinning the so-called "regulatory-chill" argument. In this light, we must ask a fundamental question: is it inherently unreasonable that an investor should be able to argue that a high level of transparency could form part of a legitimate expectation under FET, giving rise to a right to expect their investment to benefit from foreseeable laws, regulations, administrative rules, and policies? In fact, investor compliance with domestic law demands foreseeability and State actions in a coherent and consistent manner. The value of stability and predictability should not easily be substituted, not even for supposedly very noble purposes. The ancient wisdom in "the means does not justify the ends" deserves some attention in this part of the reform debate. FET protection should protect investors' reliance on reasonable transparency and consistency in the host State's legal framework.

Finally, a central part of the FET reform debate asks whether the current standard leads to a widespread "regulatory chill". To address this issue, member states have to determine how to protect investors while also ensuring that the State is able to regulate in order to preserve public policies. Some States have opined that a separate provision stipulating a "right to regulate" may be necessary. The EU is of the opinion that reforms are needed to ensure that "governments' right to regulate for public policies such as the protection of health, safety, or the environment is fully preserved". We believe that this debate will unfold through a narrowing of the material scope of the FET obligation in the ECT. The EU is paving the way for such an approach through its proposal to clarify that the investment protection provisions should not be interpreted as undermining State rights to "change their laws in the future, even if that may negatively the investor's expectation of profits".

A "Hush and Rush Reform" is Intellectually Lazy and Divorced from Reality

We are much in favor of a modernization process that is driven by well-intended, justified, and substantiated reform proposals, i.e. such that align with furthering the object and purpose of international investment protection. The underlying focus should be, as Graham Coop put it, on "how the ECT could be improved in order to become more attractive as an instrument for settling major—that is, critical—international energy disputes".

If, however, there is a hidden agenda among some overly influential stakeholders (e.g. several NGOs not engaging in regime interaction considerations or reasonable balancing between investor protection and obligations) for a total transformation of international investment law and ISDS as we know it, we ought to proceed with serious caution. Any reform that is rushed at the backdrop of the recent backlash and in light of the current legitimacy debate must be strenuously scrutinized.

This post has zoomed-in on the FET standard because it is such a controversial standard of treatment that in turn underscores much of the overall criticisms of ISDS – primarily *vis-á-vis* the balancing between states' right to regulate and investor protection. The regulatory-chill and alleged investor-state bias arguments have been driving factors in pushing for a transformation of the content of international investment law and for reforming the ISDS system. However, as things stand, both the alleged investor-bias and the supposed regulatory-chill argument have not been substantiated. At the end of the day, the FET standard in the ECT has helped promote a global rule of law with respect to a nowadays transnational energy sector. Reforming the FET standard without taking thorough account of its strengths risks undercutting its achievements.

As transnational scholars and lawyers, we must not forget the deeply entrenched post-WWII and post-Cold War mission to facilitate interdependence and interconnectivity through cross-border trade, commerce, and investments. There is no better way to facilitate these transactions than through the elaboration of favorable IIAs with ISDS clauses. Internationally recognized substantive protection with the option of procedural redress in a neutral venue elevates these treaties to instruments of trust. Let us also not forget that ISDS promotes a global rule of law, which assists to hold states accountable for breaching laws and regulations of global concern. By way of illustration, the FET protection in the ECT has recently been relied on by investors when host States have interfered with their investments in the renewable energy sector. Thus, holding States accountable can indeed prove to promote a common global cause, apart from the obvious *bona fide* and *pacta sunt servanda* element in adhering to its international obligations. It is important that arbitrators get this balance between investor protection and regulating for public purposes right. Several mechanisms for doing so have been proposed, including the doctrine of proportionality as a tool for arbitrators in achieving this. Thus, striking a balance between the right to regulate (e.g. redressing the supposed "regulatory chill" argument) and the right to expect

regulatory stability is an important one, but unfortunately a large part of the current criticism risks throwing out the baby with the bathwater. Small and medium enterprises must be able to rely on a host State refraining from actions that *de facto* constitute systematic violations of their reasonable and justified expectations with respect to stability and transparency of the legal environment. Multinational corporations have their ways of negotiating outside default regimes.

To read our coverage of the ECT Modernisation process to date, click here.