Kluwer Arbitration Blog

PAW 2024: Evolving Perspectives on the Right to Regulate: Shaping Investment Treaty Arbitration

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On the second day of the 2024 Paris Arbitration Week ("PAW"), Addleshaw Goddard hosted another roundtable event titled "Evolving Perspectives on the Right to Regulate: Shaping Investment Treaty Arbitration." The firm had assembled a five-star panel comprising Dr. Crina Baltag (Professor, Stockholm University), Marcin Kaldunski (Professor, Nicolaus Copernicus University), Nico Leslie (Barrister, Fountain Court Chambers) and Leyou Tameru (Arbitration Expert, Tameru Wondm Agegnehu & Partners). The discussion was moderated by Addleshaw Goddard's Frankfurt-based partner Dr. Markus Perkams and jointly introduced by its International Arbitration partners, Dr. Ioana Knoll-Tudor (Paris) and Dr. Felix A. R. Dörfelt (Hamburg).

The event centred on the dynamic perspectives on the state's right to regulate ("RTR") within investment treaty arbitration. The panel navigated the complexities of the RTR from state perspectives, implications of the new Africa Investment Protocol (the "Protocol"), interpretations in recent case law, and potential consequences and solutions, offering valuable insights into the evolving landscape of the RTR.

The Right to Regulate in Treaties: A State's Perspective

Marcin Kaldunski opened the discussion by recalling the nature of the RTR, a customary principle derived from the inherent sovereignty of states and their inherent power to create policy, which encompasses all regulatory measures in the public interest (extending to areas such as welfare, anti-corruption, environmental protection, and labour laws, etc.).

However, Kaldunski noted a fundamental tension between the RTR and investor protection under Bilateral Investment Treaties ("BITs"). When states assume obligations under BITs, they often find themselves in a precarious balancing act: on one hand, they must provide a degree of predictability and security to investors who, understandably, seek stability and clear rules; on the other hand, states must retain their regulatory power to manage investments and to respond to changing circumstances and public interest needs.

This tension often leads to conflicts with investors who may perceive regulatory changes as infringements on their rights under BITs. The challenge, as Kaldunski pointed out, is to strike a balance between investor protection and the state's RTR, a task that is far from straightforward

given the complexity and diversity of modern investment relationships. In response to this challenge, states have evolved in their approach to the RTR from a regulatory perspective. Kaldunski explained that, in an effort to secure regulatory autonomy, states have transitioned from a customary rule to specific treaty formulations to protect the RTR. This transition is evident in the drafting of modern BITs, with states increasingly referencing the RTR in treaty preambles, general clauses, as well as specific non-precluded measures clauses (which serves as tools for states to carve out regulatory space within the framework of BITs).

Kaldunski finally noted a shift in treaty practice towards the reciprocal obligations of states, with the RTR evolving from a defensive shield to potentially also being an offensive sword – due to the need for states to address regulatory challenges such as climate change. This shift is reflected in the inclusion of both soft and hard law obligations in recent treaties, and the imposition of obligations on investors to comply with state regulations. While this trend is visible in areas such as investor obligations and the regulation of investor activities, it is yet to be considered a general obligation.

The New Africa Investment Protocol

Illustrating this latest trend, Leyou Tameru offered a comprehensive overview of the Protocol, often dubbed as the "largest treaty in the world" due to its extensive reach across the African continent (approximately 54 countries and over a billion people). She outlined the primary aim of the Protocol as an effort to bolster trade among African countries (only 15-18% of Africa's business is conducted intra-regionally).

The Protocol stands out for its robust enforcement of investors' obligations, particularly in the areas of labour and environment protection. It also addresses previously unaddressed issues by incorporating specific definitions and notably abandons the fair and equitable treatment standard, replacing it with a new standard of fair administrative and judicial treatment. This protocol, Tameru noted, is in line with the new generation of treaties, embodying a clear departure from the traditional language of BITs and marking a shift towards more specific and comprehensive regulatory measures.

As such, one of the unique features of the Protocol is its codification of a specific right to regulate. The Protocol's preamble reaffirms the sovereignty of each state party and their right "to regulate investments within their territories and to introduce measures to achieve their national public policy objectives", underscoring the balance between investor rights and state sovereignty. It is a clear and specific provision that aligns with the new generation of treaties.

Clarifying that its dispute resolution mechanism has yet to be finalized, Tameru concluded that, in essence, the Protocol represents a significant evolution in investment treaty arbitration, reflecting a growing recognition of the need for a balanced approach that respects both investor rights and the state's right to regulate.

The Right to Regulate in Practice: A Review of Relevant Case Law

Nico Leslie subsequently brought to the fore an insightful analysis of case law, focusing on the wave of renewable energy arbitrations in Europe. He underscored that the resulting interpretation

of the RTR is primarily defined by three key elements: the provisions of the treaties, the express guarantees within the host states' domestic legislation, and the alignment of the state's intent to regulate with these provisions and guarantees.

In the context of renewable energy arbitrations, Leslie introduced a distinction between two types of RTR:

- Unqualified RTR, which pertains to the debate surrounding how states have tried to bring regulatory actions in the ambit of domestic actions, like tax measures. He pointed out that several arbitral tribunals have analysed the tax levy in relation to the RTR, but conclusions regarding its legitimacy have varied. For instance, the Czech Republic recurrently argued that the changes it implemented to its regulatory framework were made for the purpose of tax regulation, and thus outside the scope of the relevant treaty (the Energy Charter Treaty ("ECT")) – an argument that was, however, consistently rejected by arbitral tribunals, illustrating the complexities involved in interpreting and applying the RTR in practice; and
- Qualified RTR, which follows long established case law that states will always have the RTR so long as regulation is valid under domestic law. As Leslie noted, the question then becomes: when does the exercise of the RTR by a state trigger an obligation to compensate foreign investors? In answering this question and seeking to draw the line, arbitral tribunals have looked at two considerations: assurances given by the State, and the legitimate expectations of the investors.

Shifting the perspective to Africa, Leyou Tameru highlighted the fascinating and landmark *Foresti v. South Africa* ICSID case, which triggered a wave of anti-ISDS sentiment across Africa. In this case, European-based investors in South Africa claimed that the country's post-apartheid Black Economic Empowerment ("BEE") mining regime violated the terms of investment protection treaties concluded by South Africa with Italy and Luxembourg, resulting in the expropriation of their rights to minerals, or, alternatively, that their shares in the company had been expropriated by South Africa because they had refused to comply with the BEE and sell their shares. This case led to South Africa reviewing its BITs and further terminating some of these BITs, and advocating for the new Protocol to exclude ISDS.

Consequences and Potential Solutions

Building on, Crina Baltag then provided an in-depth analysis of the consequences and potential solutions related to the RTR. She emphasised that the RTR in itself is not problematic; the issue lies in its inconsistent applications by arbitral tribunals in practice. This inconsistency, she noted, often results in unpredictability for both states and investors.

As a recent development, Baltag drew attention to Canada's 2021 Model Foreign Investment and Protection Agreement. This agreement reaffirms in its Article 3:

> "*the right of each party to regulate within its territory to achieve legitimate policy objectives, such as with respect to the protection of the environment and addressing climate change; social or consumer protection; or the promotion and protection of health, safety, rights of Indigenous peoples, gender equality, and cultural diversity*".

However, and despite such treaty's clear affirmation of the RTR, Baltag highlighted that there is no standardised test on how the RTR must be assessed in practice, revealing an ongoing struggle for a uniform approach.

Further delving into the complexities of the RTR, Baltag elaborated on the question of compensation, a key issue in the discussion of the RTR. According to her, the "million-dollar question" is whether compensation is owed when there has been a lawful exercise of the RTR, or if there is no right to compensation because there was no breach of treaty? Citing as an example the *Eco Oro v. Colombia* ICSID case relating to biodiversity regulation, she explained that the tribunal decided that compensation was owed even if there had been a legitimate exercise of the RTR by Colombia. A conclusion similar to that was found by the *Infinito Gold v. Costa Rica* tribunal, but this can be contrasted with *David Aven v. Costa Rica* where compensation was denied to the investors, whose rights were deemed subordinate to the state's RTR.

Baltag hence proposed that when a state is claiming to exercise its RTR, the question for tribunals should be to seek to establish whether that state is trying to prevent harm. In a case which a state is trying to prevent harm, no compensation should be awarded to investors. If the scenario in which that state is trying to maintain or increase public welfare, no compensation should be awarded. In practice, however, there is no uniform approach to these questions.

Baltag also touched upon the ongoing ECT modernisation and the solutions currently discussed in the UNCITRAL Working Group III, which had discussed the possibility of having a draft provision on the RTR, amid the uncertainty of RTR's procedural or substantive nature, but, so far, have also failed to provide any test to assess the legitimacy of the RTR.

Addressing a question to the panel, both Baltag and Leslie underscored the relevance of the proportionality test in determining whether a state's regulatory measures are justifiable and in line with its obligations under investment treaties – i.e., whether measures taken by a state are proportionate to the legitimate public policy objectives. Baltag also highlighted the critical role of the burden of proof in this context, suggesting that if the RTR is used as a defence by the state, then the burden of proof should fall on that state to demonstrate that its regulatory measures were justified and proportionate.

Conclusion

As stressed by each of the speakers, the challenge lies in striking a balance between providing predictability to investors and preserving the state's right to regulate. New generation BITs – including the Protocol – and initiatives such as the ECT modernisation and under the ambit of UNCITRAL Working Group III, indicate a promising path towards achieving this balance. This challenge, as they noted, will continue to shape the landscape of investment treaty arbitration in the future, underscoring the need for a more uniform and balanced approach to the RTR, and calling for continued dialogue and exploration in this crucial area of international law.

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This entry was posted on Monday, March 25th, 2024 at 8:43 am and is filed under Paris Arbitration Week, right to regulate
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