Kluwer Arbitration Blog

The Implications of Koch v. Canada for Emissions Trading Schemes

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Following our previous post on dispute resolution in carbon markets, the ICSID Tribunal in *Koch Industries, Inc. and Koch Supply & Trading, LP v. Canada*, ICSID Case No. ARB/20/52 ("Koch v. Canada") recently dismissed the Claimants' USD 31.3 million claims arising out of a cap-and-trade emissions programme on jurisdictional grounds.

The Tribunal's key findings included that the emission allowances held by Koch Supply & Trading, LP ("KS&T") under Ontario's Cap-and-Trade Program ("OCTP"), and KS&T's trading business in emission allowances, did not constitute an "investment" under Chapter 11 of the North American Free Trade Agreement ("NAFTA"). It also found that KS&T's parent company, Koch Industries, Inc. ("Koch Industries"), did not have a qualifying investment.

This post discusses the Award and its implications for emissions trading schemes with a cross-border nexus.

Background

OCTP was an emissions trading scheme ("ETS") established under the Climate Change Mitigation and Low-Carbon Economy Act (Ontario Cap-and-Trade Act or "OCTA") and related regulations. The Program commenced in January 2017 and was linked with similar programs in California and Québec.

Both KS&T and its parent company, Koch Industries, are US companies. KS&T was a market participant in OCTP with tracking accounts for emission allowances in Ontario and California. KS&T bid in auctions in Ontario and consistently transferred emission allowances to California for trading.

In 2018, following changes within Ontario's government, OCTP was abruptly ended. The repeal legislation stipulated that no proceedings could be brought against the government in respect of the cancellation, and that market participants would not receive compensation for any unused allowances remaining in their tracking accounts.

In December 2020, the Claimants commenced ICSID arbitration against Canada, alleging that these matters "wip[ed] out KS&T's carbon allowances trading business" in Ontario in breach of investment protections under NAFTA.

In the course of the ICSID proceedings, Canada contended that the Tribunal lacked jurisdiction on the grounds that the Claimants did not have a qualifying investment in Canada under NAFTA Chapter 11.

The Tribunal's Jurisdictional Findings

The arbitration proceeded to a final hearing on both jurisdiction and the merits, and the Tribunal found that neither of the Claimants had a qualifying investment in Canada under NAFTA Chapter 11. As the Tribunal declined jurisdiction, it did not consider the merits issues.

KS&T Did not Have a Qualifying Investment

<u>NAFTA Article 1139(g)</u>

NAFTA Article 1139(g) defines "investment" as "real estate or other property, tangible or intangible, acquired in the expectation or used for the purpose of economic benefit or other business purposes." Relying on this definition, the Claimants argued that KS&T's emission allowances constituted "property" and therefore qualified as an investment under NAFTA.

The Tribunal noted that NAFTA does not define the term "property," and it also had regard to the established principle that "[p]ublic international law does not create property rights. Rather, it accords certain protections to property rights created according to municipal law." Accordingly, the Tribunal decided that it "must first find the definition of that term in the law of the host State and determine whether the object in question satisfies that definition." As there is no rule in Ontario or Canadian law expressly providing that emission allowances constitute property, the Tribunal's core enquiry was: did the emission allowances created by the OCTA constitute property under Ontario common law?

In this regard, the parties' experts on Ontario law agreed that "the element of "exclusive control" is an essential attribute to find property under general common law in Ontario." On this basis, the Tribunal considered that holders of emission allowances under the OCTA did not have "exclusive control" over those allowances because:

- emission allowances under the OCTA were part of a strict regulatory scheme designed to curb greenhouse gas ("GHG") emissions over time; and
- the OCTA imposed significant limitations on participants' use and control of allowances. In particular, it attributed broad powers to the government regarding their allocation, creation, and removal without compensation.

Although the Tribunal considered this "a very close case," it concluded that KS&T's emission allowances were not an "investment" in Canada under the NAFTA.

<u>NAFTA Article 1139(h)</u>

NAFTA Article 1139(h) defines "investment" as:

"interests arising from the commitment of capital or other resources in the territory of a Party to economic activity in such territory, such as under

- contracts involving the presence of an investor's property in the territory of the Party, including

turnkey or construction contracts, or concessions, or
- contracts where remuneration depends substantially on the production, revenues or profits of an enterprise."

The Tribunal found that:

- the *chapeau* of Article 1139(h) requires that there be a cognisable interest resulting from capital commitment or other resources *within* the territory of the host State towards economic activity *within* that territory; and
- to demonstrate an "investment," a party must show that its activities have some resemblance to the examples in sub-paragraphs (i) and (ii).

The Tribunal held that KS&T's emission allowances did not grant it a legal share in any asset or resource, or qualify as "interests" under Article 1139(h).

According to the Tribunal, KS&T's trading business in Ontario also did not satisfy Article 1139(h). The Tribunal noted that "KS&T's economic activities primarily involved purchasing allowances in Ontario and then transferring them to California for resale in the secondary market." These cross-border purchase and sale transactions neither constituted economic activity in the territory of the host State nor resembled the examples in Article 1139(h).

KS&T also had a negligible physical or corporate presence in Ontario. Accordingly, it was insufficient that KS&T had purchased allowances in Ontario auctions with an Ontario tracking account. In the Tribunal's view, even if Ontario had used the proceeds from KS&T's purchases to fund green projects in the province, that would not satisfy NAFTA Article 1139(h).

Koch Industries Did not Have a Qualifying Investment

The Tribunal also found that Koch Industries could not establish jurisdiction under NAFTA, because: (i) Koch Industries could not rely on its ownership of KS&T, which had no qualifying investment, to establish jurisdiction; and (ii) Koch Industries' ownership of Canadian entities was immaterial, because the Claimants' claims did not relate to those entities.

Having found that neither Claimant met the jurisdictional requirements under NAFTA, the Tribunal did not determine Canada's other jurisdictional objections (such as the objection that neither Claimant could establish jurisdiction under Article 25 of the ICSID Convention) or the merits issues.

Significance of the Award

As observed in a research report of the Central University of Finance and Economics, the harmonisation of emissions trading schemes across borders (via linkages or regional schemes) is projected to increase, as harmonised schemes are better positioned to: (i) address liquidity and volume problems; (ii) have consistent carbon prices; and (iii) generate public revenue that supports the development of climate-friendly projects. The *Koch v. Canada* Award will have implications for cross-border participation in these mechanisms.

Emission Allowances as "Property"?

"Property" is commonly included in the definition of "investment" in investment treaties, but many treaties do not expressly define "property."

Switzerland's bilateral investment treaties ("BITs") are apt to consider for this issue given the Swiss ETS and the EU ETS are linked. "Movable and immovable property" is not expressly defined in many of Switzerland's BITs with EU Member States, such as with Croatia, Czechia, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, and Slovakia.

In light of the *Koch* Tribunal's reasoning, future tribunals faced with the question of whether emission allowances are considered "property" in disputes arising under these treaties are also likely to have regard to the law of the host State.

Although this approach reflects established public international law, it has the potential to fragment the availability of investment protections for ETS-related activities, contrary to efforts at harmonisation. That fragmentation is because local laws differ significantly on the legal characterisation of emissions allowances. For example, the legislative framework of the EU ETS defers to Member States' national legislation, resulting in a plethora of legal characterisations (including property, administrative authorisations to emit, and *sui generis* administrative rights). This may also increase the complexity of arbitrations, necessitating extensive expert evidence on local laws even at a jurisdictional stage.

Implications for Emissions Trading Businesses

The Tribunal's application of NAFTA Article 1139(h) may affect the threshold for activities that emissions trading businesses must undertake in the host State to qualify for investment protection. For example, the Tribunal considered the words "commitment of capital" to set "specific requirements for an expenditure of funds to qualify for protection." Importantly, similar language appears in other investment treaties.

Singapore's treaties are particularly relevant, noting: (i) its popularity as a jurisdiction for investment structuring; and (ii) its envisaged role as a regional hub for carbon trading. Like the *chapeau* of NAFTA Article 1139(h), Singapore's recent BITs (such as the Indonesia-Singapore BIT and Myanmar-Singapore BIT) consider "commitment of capital" as a necessary element of an "investment." Therefore, a future tribunal applying one of these BITs may be more likely to find that a business model like KS&T's does not qualify.

The Importance of Certain and Clear Investment Protections

Actions inconsistent with international efforts to reduce GHG emissions can adversely affect emissions trading schemes. The Tribunal noted that the way OCTP was terminated, alongside the lack of compensation to market participants or access to local courts, was counteractive to encouraging private actors' contribution towards mitigation of climate change. Economist Mr. Tom Tietenberg similarly notes that if permits are insecure or at risk of arbitrary withdrawal, market participants are less likely to partake in these mechanisms. Moreover, as we previously noted, insufficiency of market participants can cause emissions trading schemes to suffer from volume and liquidity issues and ineffective pricing determinations. For these reasons, it is important that international investment protections are certain and clear.

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