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Environment Defenders Office

Submission

in response to

Senate Foreign Affairs, Defence and Trade Legislation committee inquiry into the Trade and Foreign Investment (Protecting the Public Interest) Bill 2014.

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Introduction

The Victorian and Tasmanian EDOs welcome the opportunity to participate in the inquiry. For the reasons set out below the Trade and Foreign Investment (Protecting the Public Interest) Bill 2014 preventing the inclusion of ISDS mechanisms in international agreements should be strongly supported.

Investor State Dispute Settlement (ISDS) also sometimes referred to as Investor State Arbitration fulfilled a particular purpose at a particular time in a particular context. The contemporary reality in Australia and for Australians is that it is unnecessary and inappropriate. Criticisms of ISDS are many, well publicised, and made by a wide range of groups in the community.

The use of ISDS has experienced extraordinary growth over the last 2 decades, particularly in the last 10 years. Prior to 1997 the most cases lodged in any year with the International Centre for the Settlement of Investment Disputes (ICSID) was 4. In 2012 there were 50 and in 2013 there were 40, which was still the second highest ever.[1] In the context of this increase and with the benefit of the large number of arbitral decisions now available, the impacts of ISDS in practice can be said with confidence to be overwhelmingly negative. There are certainly examples where ISDS has delivered just outcomes for corporations who were unfairly treated; however these decisions have been far outweighed by the negative impacts for affected communities collectively.

Australia is party to many bilateral and multilateral treaties that contain an ISDS mechanism. To date the only example of ISDS being used against Australia has been by Philip Morris in relation to the tobacco plain packaging laws.[2] No ISDS awards have been made in favour of Australian companies in dispute with foreign governments.[3] There is little to no evidence that any economic gains have been made in Australia as a result of ISDS in investment treaties.

It is important to note that whilst ISDS is a common part of investment treaties and there is almost a standard text used, they are by no means an integral part of any trade agreement and investment treaties can achieve their aims without the inclusion of ISDS.

International trade undoubtedly brings benefits to the Australian community and equally there are examples where foreign investment has contributed positively to the wellbeing of Australians. However it definitively cannot be said that foreign investment is always in our national interest. The Australian Parliament has recognised this reality in the *Foreign Acquisitions and Takeovers Act 1975* Part II which creates a 'national interest' test for certain foreign investments.

Australian Parliaments have also recognised that a range of commercial activities and investments undertaken largely by foreign companies is contrary to the public interest. The most notable example in this context is

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1 International Centre for the Settlement of Investment Disputes, *The ICSID Caseload – Statistics* (2014 – 1) available at https://icsid.worldbank.org/ICSID/FrontServlet?requestType=ICSIDDocRH&actionVal=ShowDocument&CaseLoadStatistics=True&language=English51.

2 *Philip Morris Asia Limited v. The Commonwealth of Australia*, UNCITRAL, PCA Case No. 2012-12.

3 Productivity Commission, *Bilateral and Regional Trade Agreements*, Canberra: Research Report, 2010, p267 available at http://www.pc.gov.au/__data/assets/pdf_file/0010/104203/trade-agreements-report.pdf. Since 2010 it has been reported that Australian companies have been involved in ISDS disputes but to our knowledge no awards have yet been made.

tobacco plain packaging laws but this would also include state moratoriums on genetically modified organisms and the process of hydraulic fracturing for unconventional gas.

Intrinsic in the design of ISDS mechanisms is an intention to limit the ability of domestic governments to interfere with the trading activities of foreign corporations in a way that affects their profits. Certainly some of this protection is legitimate and serves basic notions of fairness and non discrimination that are entrenched in both the Australian Constitution and Acts of the Australian Parliament. The problem arises because ISDS goes much further than the protections that the Constitution and the Parliament has deemed appropriate for Australians. There could be little objection if all ISDS provided was a mechanism to guarantee the same standards as we otherwise enjoy under section 51(xxxi) of the constitution, however that is not the case. The protections go much further and invade the space of legitimate public interest regulation.

By its very design ISDS operates to restrict government action and is only enlivened by government action. In a modern democracy that has a constitutional protection against the unjust acquisition of property it is odd to think that a government could agree to such a provision which can only operate to restrict what the government would otherwise see as action in the national interest.

The obvious question is how can it be appropriate to give foreign investors additional guarantees that the Parliament does not consider that it is appropriate to extend to Australians, which necessarily come at the expense of Australians?

The Mechanics of Investor State Dispute Settlement

International Arbitration between individuals and Nation States is primarily undertaken under two agreements which are then activated by the various bilateral and multilateral investment treaties. The need for these mechanisms was primarily because of unjust expropriations by domestic governments and weaknesses in domestic judicial systems.
ISDS protections broadly cover four areas or provide four different protections:

- Most favoured nation
- Fair and Equitable treatment
- Full protection and security
- Expropriation

Most utilised in ISDS cases are the requirements for fair and equitable treatment and against expropriation.

Fair and Equitable Treatment
Fair and equitable treatment is a customary international law principle. Whilst a protection against discrimination seems reasonable and it most circumstances it is, there is no shortage of examples where we openly recognise that it is appropriate to favour domestic companies or products. The most obvious is television broadcast content but there are a range of others. One particular example is responding to crisis situations where “the ability to treat domestic and foreign creditors differently is a necessary policy option for governments in a

financial crisis"[4] Logically enough a response to a financial crises that allowed stimulus spending to move swiftly overseas rather than staying in the Australian economy would be of far less benefit.

Expropriation – direct and indirect.
Section 51(xxxi) of the constitution provides a limitation on the ability of the government to acquire property from its citizens. To exercise the power to acquire property the acquisition must be on 'just terms'. "The condition "on just terms" was included to prevent arbitrary exercises of the power at the expense of a State or the subject."[5] However the scope of the application of section 51(xxxi) limitation is itself limited and does not apply to various exercises of power under section 51 where it would be an inconsistent or incongruous notion (for example the imposition of taxation or penalties for unlawful conduct),[6] or where no proprietary benefit accrues to the Commonwealth.[7] In effect this means that the limitation typically does not apply to government action that regulates certain practices or products.

Unlike section 51(xxxi) ISDS covers both direct and indirect expropriation. Indirect expropriation is characterised as action that amounts to an acquisition; that is regulatory action that may deprive a company of the use of a product etc. This is perhaps the most problematic part of ISDS because it operates to prevent legitimate government regulation in the best interests of the community.

Arguments in favour of ISDS

The paucity of public argument in support of ISDS underlines the fact that there is no public purpose served by these mechanisms. Set out below are common arguments in support of ISDS and responses to each.

Firstly the general justification used in favour of ISDS is that encouraging foreign investment and increased access to capital is a good thing for the Australian economy. It is beyond dispute that there are many examples where economic and even significant social and environmental gains have been made because of foreign capital investments in Australia. The problematic part of the argument is that ISDS can in some way contribute to this. Already in Australia "foreign investors make up around half of the investor base for the combined value of Australian equities and bonds".[8] Whilst it would be very difficult to identify the proportion of this investment that is covered by ISDS protection, the shear scale of foreign investment demonstrates that international investors view Australia very favourably.

Even in the absence of ISDS there is clearly no reticence to invest here. One particular example is the Archer Daniels Midland attempt to buy GrainCorp. A US company was happy to invest a reported $3.4 Billion to purchase GrainCorp and had also undertaken to spend a significant amount in upgrading rail infrastructure; without any ISDS protection. The only reason this didn't happen was because of a decision by the Treasurer that it was contrary to the national interest. In fact from the time the current government took office until 29

4 Gelpern and Setser, *Domestic and External Debt: The Doomed Quest for Equal Treatment*, Georgetown Journal of International Law (2004) Vol. 35(4) 796.
5 *Grace Brothers Pty Ltd v The Commonwealth* (1946) 72 CLR 269 at 291.
6 *Theophanous v The Commonwealth* [2006] HCA 18.
7 *JT International SA v Commonwealth* [2012] HCA 43.
8 Susan Black and Joshua Kirkwood, "Ownership of Australian Equities and Corporate Bonds" Reserve Bank of Australia Bulletin, September Quarter 2010, available at *www.rba.gov.au/publications/bulletin/2010/sep/pdf/bu-0910-4.pdf.*

November 2013, 130 significant foreign investment applications were approved under the *Foreign Acquisitions and Takeovers Act 1975*.[9]

In considering the economics of ISDS the Productivity Commission found that, "There does not appear to be an underlying economic problem that necessitates the inclusion of ISDS provisions within agreements. Available evidence does not suggest that ISDS provisions have a significant impact on investment flows."[10]
Not only does ISDS not promote investment flows, it also hampers countries' ability to respond to financial crises. This reality has been noted by the UN[11] and born out by the extensive litigation against Argentina in the wake of their response to the debt crisis in the early 2000s.[12]

In debate on pending and recently concluded trade agreement negotiations the Minister for Trade has made the following statements in support of ISDS.

Noting that Australia is already party to agreements which contain ISDS Mr Robb observed that "the roof hasn't fallen in" and that "They [ISDS] have been to the benefit of Australian Companies".[13] In the context of the South Korean Free Trade Agreement he said that ISDS provide a "safeguard in countries with unreliable legal and political systems".[14]

It is the case that so far Australia has only been party to one ISDS dispute, brought by Philip Morris in response to the tobacco plain packaging laws. However the facts that things haven't gone too badly so far (although arguably the potential limitation on the ability of the Australian Government to save the lives of thousands of Australians is quite a significant impact) shouldn't mean that we continue to expose ourselves to the unnecessary risks.

In terms of the benefit to Australian investors it is important to note that ISDS has not been used by any Australian company. "As far as the [Productivity] Commission is aware, no ISDS arbitration case has been brought... by an Australian company against a foreign government"[15] Additionally it is hard to see how the potential benefit to a very small number of companies could justify the costs to the community collectively.

In arguing that the benefit to Australian investors overseas necessitates the need for reciprocal arrangements in Australia and that this offsets the broader risk to the community, the Minister is effectively arguing that the community should collectively insure those who have the capacity to make significant international investments

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9 Joe Hockey Media release "Foreign investment application: Archer Daniels Midland Company's proposed acquisition of GrainCorp Limited" available at http://jbh.ministers.treasury.gov.au/media-release/026-2013/.

10 Productivity Commission, *Bilateral and Regional Trade Agreements*, Canberra: Research Report, 2010, finding 14.1 p271 available at http://www.pc.gov.au/__data/assets/pdf_file/0010/104203/trade-agreements-report.pdf.

11 United Nations Conference on Trade and Development, *Sovereign Debt Restructuring and International Investment Agreements*, Issues Note No 2, July 2011, available at unctad.org/en/Docs/webdiaepcb2011d3_en.pdf.

12 *Giovanna a Beccara and others v. Argentine Republic*, ICSID Case No.ARB/07/5; *Giovanni Alemanni and others v. Argentine Republic*, ICSID Case No. ARB/07/8; *Giordano Alpi and others v. Argentine Republic*, ICSID Case No. ARB/08/9.

13 James Massola, *Free trade deal with Japan took priority over whaling dispute, says Trade Minister Andrew Robb*, The Sydney Morning Herald, 10 February 2014.

14 Sharon Beder, *History shows the heavy price of free trade*, The Canberra Times, 21 February 2014, available at http://www.canberratimes.com.au/comment/history-shows-the-heavy-price-of-free-trade-20140220-3347y.html.

15 Productivity Commission, *Bilateral and Regional Trade Agreements*, Canberra: Research Report, 2010, p267 available at http://www.pc.gov.au/__data/assets/pdf_file/0010/104203/trade-agreements-report.pdf.

against the risk of, possibly quite legitimate, government action. Surely this should be factored into the decision of those making the investment rather than imposed on the Australian community more generally. As noted by the Productivity Commission there are a range of other insurance mechanisms for Australian Companies investing in developing countries.[16]

It is also argued that it is possible to overcome the limitations created by ISDS by excluding particular types of public purpose regulation for the scope of ISDS coverage and the examples of public health and environmental protections are often given.[17] Whilst the proposition seems reasonable in theory in practice it has proven not to be the case.

Firstly, even accepting that the exclusions may work, the implication in excluding certain subject matters is that there may be examples where the government does not act for a public purpose in the collective best interests of the nation in regulating other subject matters. By the same logic that a democratically elected government should be able to pass laws about the protection of public health and the environment free from the risk of ISDS surely this should equally apply to all other laws passed by the parliament.

Secondly the idea that three arbitrators of questionable independence (see discussion below) are an appropriate forum to test the appropriateness or proportionality of measures passed by democratic parliaments is also questionable. So much so that Juan Fernández-Armesto an arbitrator from Spain has been quoted as saying:

> "When I wake up at night and think about arbitration, it never ceases to amaze me that sovereign states have agreed to investment arbitration at all [...] Three private individuals are entrusted with the power to review, without any restriction or appeal procedure, all actions of the government, all decisions of the courts, and all laws and regulations emanating from parliament."[18]

Finally the reality is that the proportionality analysis engaged in by arbitral tribunals means that it is simply not possible to have any confidence that the exclusions will be effective. For example, in *Occidental Petroleum Corporation and Occidental Exploration and Production Company v. The Republic of Ecuador*,[19] Occidental Exploration and Petroleum Company (OEPC) and Ecuador came to an agreement where OEPC would undertake mining exploration and works and then be entitled to a portion of the oil extracted. The agreement expressly stated that OEPC could not assign any rights to any other entity without the express approval of Ecuador, doing so was expressly grounds for the immediate termination of the contract.[20] OEPC proceeded to sell 40% of their stake in the venture without the agreement of Ecuador in contravention of the agreement. On the basis of the breach Ecuador terminated the agreement. It was alleged by OEPC that even if a termination event had occurred, which they disputed but which was fairly plain on the facts and found by the tribunal to indeed be the case,[21] the termination by Ecuador was unlawful "because it was unfair, arbitrary, discriminatory

16 *Ibid* p270.
17 AAP, *Legal safeguards in Korea FTA: Andrew Robb*, The Australian, 17 February 2014 available at http://www.theaustralian.com.au/national-affairs/legal-safeguards-in-korea-fta-andrew-robb/story-fn59niix-1226829396173.
18 Perry, *Arbitrator and counsel: the double-hat syndrome*, *Global Arbitration Review,* STOCKHOLM (2012) Volume 7 - Issue 2, 15 March.
19 ICSID Case No. ARB/06/11.
20 *Ibid* at [119]-[120].
21 *Ibid* at [306] and [662].

and disproportionate".[22] Ultimately the tribunal agreed concluding that the termination was 'disproportionate' and found Ecuador liable to pay approximately US$1.8 billion.[23]

The case illustrates the real risk that even in the face of an explicit recognition of capacity for State action arbitral tribunals will look beyond these exclusions and impose their own views on the appropriate outcome. It is also worth noting that for example the leaked text of the environment chapter of the TPP article 2(3) provides:

> The Parties further recognize that it is inappropriate to set or use their environmental laws or other measures in a manner which would constitute a disguised restriction on trade or investment between the Parties.

This argument, that an environmental measure was in fact a disguised restriction on trade, was used in *Ethyl Corporation v. The Government of Canada*, UNCITRAL 24 June 1998 (which was ultimately settled in the applicant's favour) and demonstrates that there is a capacity to get around prima facie exclusions.

Arguments against ISDS

There are a wide range of problems with ISDS both on a broader principled level and in its practical application. The most common criticisms are the favouring of foreign over domestic investments and the limitation on States' ability to regulate in their national interest. In relation to the distinction between foreign and domestic investors, even proponents of ISDS clauses struggle to justify the advantage given to foreign investors over their domestic counterparts. An arbitration tribunal has justified the differential treatment as follows:

> "The different treatment applied to foreign and domestic investors is a natural consequence of the Treaty. However, this unequal treatment is not without justification: justice is not to grant everyone the same, but *suum cuique tribuere* [to give each their own]. Foreigners are more exposed than domestic investors to the sovereign risk attached to the investment and to arbitrary actions of the host State, and may thus, as a matter of legitimate policy, be granted a wider scope of protection."[24]

The obvious response is that foreigners investing in Australia incur no such risk of arbitrary actions. In the limited range of circumstances where differentiation is well recognised as appropriate, putting in place a limitation to stymie action in those circumstances is necessarily at odds with the national interest. In all other cases where discrimination is inappropriate there are a range of domestic protections against arbitrary action by governments in Australia and we have a robust judiciary to enforce them. Judicial independence is guaranteed by Chapter 3 of the Constitution and there is no question that the Australian Judiciary will treat any party to litigation exactly the same irrespective of their nation of origin.

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22 *Ibid* at [206].
23 *Ibid* at [825].
24 *Vito G. Gallo v. Government of Canada* (North American Free Trade Agreement Chapter 11 Arbitral Tribunal, 15 September 2011) PCA 55798, p67.

Arbitrator independence

Another well recognised major shortcoming of the system is that arbitrators are not independent and the system does not have the safeguards of an independent judiciary that we expect to be exercising judicial power to determine facts and make binding decisions over rights and liabilities.

Arbitrators are paid by the hour and can jump from being an advocate one week to an arbitrator the next. They depend on the corporations that use the system for work. The situation is aptly captured as:

> "To put it simply, if a doctor is sponsored by a pharmaceutical company, we might question whether the medicine prescribed is the best for our health; if a public servant receives money from a lobbyist, we might question whether the policies they promote are in the public interest. In the same vein, if an arbitrator's main source of income and career opportunities depends on the decision of companies to sue, we should wonder how impartial their decisions are."[25]

Expense

Another major problem with the ISDS system and a significant part of the reason why ISDS creates what is referred to as 'regulatory chill'[26] is the enormous expense involved in the arbitration. A report prepared for an OECD roundtable found that "recent ISDS cases have averaged over USD 8 million with costs exceeding USD 30 million in some cases."[27] The United Nations Conference on Trade and Development in a 2010 report found that "*costs involved in investor–State arbitration have skyrocketed* in recent years."[28] (emphasis in original) They also found that legal fees amount to an average of 60 per cent of the total costs of the case.[29]
Unlike in Australia there is no presumption that the unsuccessful party pay the legal costs of the matter.[30] As such it is often the case that even where a State successfully defends a matter they are required to pay there own costs in that defence and as set out above these costs can be very significant.[31]

Lack of appeal mechanisms

Depending on the particular treaty and forum for the arbitration there may or may not be a mechanism for the appeal of an arbitration decision. Even where there is such a mechanism these have proven to be problematic.

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25 Corporate Europe Observatory, *Chapter 4: Who guards the guardians? The conflicting interests of investment arbitrators*, 27 February 2012 available at http://corporateeurope.org/trade/2012/11/chapter-4-who-guards-guardians-conflicting-interests-investment-arbitrators.

26 For discussion on this phenomenon see Productivity Commission, *Bilateral and Regional Trade Agreements*, Canberra: Research Report, 2010, pp271-274 available at http://www.pc.gov.au/__data/assets/pdf_file/0010/104203/trade-agreements-report.pdf.

27 David Gaukrodger and Kathryn Gordon, *Investor state dispute settlement: A scoping paper for the investment policy community*, OECD Working Papers on International Investment, No. 2012/3, OECD Investment Division, (2012) p19 available at www.oecd.org/daf/investment/workingpapers.

28 United Nations Conference on Trade and Development, *Investor - State Disputes: Prevention and Alternatives to Arbitration*, UNCTAD Series on International Investment Policies for Development UNCTAD/DIAE/IA/2009/11 (2010) at p16 available at http://unctad.org/en/docs/diaeia200911_en.pdf.

29 *Ibid* p17.

30 UNCITRAL rules Article 40(2); ICSID Rules Article 61(1).

31 See for example *Vito G. Gallo v. Government of Canada* (North American Free Trade Agreement Chapter 11 Arbitral Tribunal, 15 September 2011) PCA 55798; *Chemtura Corporation v. Government of Canada*, UNCITRAL 2 August 2010 where the respondent was successful and received a partial costs award but still had to pay nearly CAD $3 million in legal costs; *Commerce Group Corp. and San Sebastian Gold Mines, Inc. v. The Republic of El Salvador*, ICSID Case No. ARB/09/17.

For example since 2011 only 1 of the 8 ICSID annulment applications (appeals) have been allowed.[32] In contrast of the 120 appeals heard by the High Court of Australia in 2011-12 and 2012-13, 66 were allowed.[33]

Forum shopping

Another systemic concern is the ability to forum shop. This is illustrated most notably in the Phillip Morris case against Australia, but it has also been as in issue in a number of other cases, for example *Azpetrol International Holdings B.V., Azpetrol Group B.V. and Azpetrol Oil Services Group B.V. v. The Republic of Azerbaijan*, ICSID Case No. ARB/06/15 and *Libananco Holdings Co. Limited v. Republic of Turkey*, ICSID Case No.ARB/06/8.[34]

A one way street

ISDS can only be instituted by corporations. Unlike specific contractual arbitration measures where both parties agree to an arbitration mechanism in the context of the bargain that they both believe to be in their interests, ISDS operates like a floating charge over all investments covered by the treaty irrespective of the utility of the particular investment. Further the State receives nothing beyond the immediate and *temporary* economic activity of that capital in return for the security. There is no mutual obligation on the investor to act reasonably in return, no protection against rent seeking or profiteering, nothing to stop them crowding out competitors and reducing competition nor any mechanism for redress when the company makes decisions that ultimately cost the Australian economy.

Similarly the limitation only operates one way; governments are free for example to reduce environmental protection facilitating greater profit making by investors but then subsequently constrained from reinstating or otherwise improving protections where doing so would then diminish company profits.

Perhaps even worse, and contrary to the argument that ISDS is a mechanism for attracting new investment is that the scope of the protected investments can extend beyond those made subsequent to the implementing treaty. For example in the draft TPP investment chapter leaked in 2012 it is proposed that:

> **"covered investment** means, with respect to a Party, an investment in its territory of an investor of another Party in existence as of the date of entry into force of this Agreement or established, acquired, or expanded thereafter…"[35]

One has to ask why we would contemplate giving additional protection to investor corporations when they have already made their investments and for which Australia will gain no additional benefit.

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32 International Centre for the Settlement of Investment Disputes, *The ICSID Caseload Statistics* (2014-1) p17.

33 High Court of Australia, Annual Report 2012-2013 p 32.

34 See generally David Gaukrodger and Kathryn Gordon, *Investor state dispute settlement: A scoping paper for the investment policy community*, OECD Working Papers on International Investment, No. 2012/3, OECD Investment Division, (2012) p18 available at www.oecd.org/daf/investment/workingpapers.

35 Draft investment chapter released June 2012 available at http://aftinet.org.au/cms/trans-pacific-partnership-agreement/leaked-tppa-trade-chapter-australia-says-no-investor-rights-sue-.

Conclusion

Why should the world stand still for foreign investors? The premise of the ISDS mechanism and the protections it includes is to ensure stability and certainty. This denies the reality that often times the world is uncertain and unstable and governments have a responsibility to respond to these changes. It is for this very reason that parliaments generally cannot bind future parliaments and law making is left to the elected representatives of the day to respond to the contemporary views and values of the community they represent. By its very nature ISDS denies this and seeks to privilege foreign investors over domestic citizens.
The ISDS mechanism creates the very real risk that countries are effectively forced to pay corporations in order to protect things that the community values. There is no shortage of examples where this has occurred around the world.[36]

Across Australia many laws require decision makers to adopt the precautionary principle and respect intergenerational equity. The ISDS system is fundamentally at odds with these principles. It operates to prevent government action when the precautionary principle dictates that it should act.

Irrespective of one's political views, ISDS operates at the expense of responsive government. For example if a relevant ISDS mechanism were in place the creation or the repeal of a carbon tax could *equally* give rise to grounds for compensation under the traditional ISDS model. Surely if neither side can fulfill its agenda without having to pay a foreign corporation to do so, something must be awry.

36 See for example *Metalclad Corporation v. The United Mexican States*, ICSID Case No. ARB(AF)/97/1 where Mexico was effectively required to pay $16 million not to have a waste dump that the local community vehemently opposed.