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Protecting Investments in Carbon Credits through Investment Treaties

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by Mark Mangan[1] *and Lukas Lim.*[2]

Abstract

Foreign investments in decarbonization can be fraught with sovereign risk as states grapple with the tension that sometimes arises between efforts to achieve ambitious climate goals and other public interests. Investment treaties can provide foreign investors with valuable protection against government overreach and an effective means for seeking relief through international arbitration should the treaty guarantees be violated.

I. Introduction

Carbon sequestration and trading play an important role in efforts to reduce carbon emissions in the atmosphere to help avoid the worst effects of climate change. However, those participating in the industry will typically have investments or operations outside their home country, thereby exposing them to a degree of sovereign risk. For instance, a state hosting an investment in natural carbon sinks such as forests, mangroves, peat, and soil[3] or man-made reservoirs such as former oil wells could respond to pressure from other segments of society by abruptly changing its laws, withdrawing licensing permits, revoking subsidies intended to attract foreign investment, seizing property or allowing its destruction through unrestrained civil unrest. Some states have also introduced retroactive taxes and other financial impositions to increase their share of the profits or discriminated directly or indirectly against foreign nationals or companies. These and other forms of state interference could erode the value of a foreign investment, frustrate climate objectives, and potentially breach international law.

The principal means by which a foreign investor can protect itself against sovereign risk is to ensure its foreign investments fall within the terms of one or more investment treaties. Investment treaties provide foreign investors with valuable protection against arbitrary regulations and government overreach and, importantly, a means for seeking compensation and other forms of relief should the treaty be violated.

Consider a typical carbon sequestration project in which an investor acquires or leases large parcels of land in a developing country (referred to as the 'host state') to plant and conserve trees and mangroves that capture carbon dioxide. The removal of carbon from the atmosphere is verified by an international accreditation body, thereby generating carbon offset credits that could be sold to those wishing to reduce their 'net'[4] emissions through an unregulated carbon

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[3] While trees, mangroves, peat, and soil will remove and store carbon, there is a growing realization that such storage may only be temporary, for instance if the trees are destroyed by fire or the soil eroded (ironically due to climate change). Companies using natural sources to offset their emissions typically sign 20, 30 or 40-year contracts. Yet a permanent solution is needed to remove six billion tons of carbon dioxide from the atmosphere each year by 2050 to keep global warming below 1.5 degrees Celsius. See the reports of the Intergovernmental Panel on Climate Change (ipcc.ch/reports). Means of permanently removing carbon from the atmosphere include burying it in wells and natural reservoirs and ocean biomass sinking.
[4] 'Net' emissions can be defined as the total emissions from an entity's activities minus the value of carbon offset credits purchased from the carbon trading market.

trading market. These carbon offset credits could over time become very valuable. The host state in turn may seek to capture some of that value for itself through increased taxes or financial impositions, or forcibly redirect the privately held carbon credits towards its domestic market to help achieve its own climate goals while setting a domestic carbon price lower than that which could be obtained in the international market. In short, the state could seek to rebalance the ecological or financial benefits of an investment once it is de-risked, potentially causing significant losses for the foreign investor.

While those harmed by such actions could seek redress from the host state's courts, often that is not an attractive option if the local judiciary is not sufficiently independent of the very government whose actions the investor seeks to challenge. Investment treaties are powerful instruments as they allow qualifying investors to seek relief from a neutral tribunal applying international law, seated in a neutral country, and whose decisions are more easily enforced globally than local court judgments.

In this article, we provide a brief description of carbon sequestration and trading, illustrate the types of sovereign risk to which foreign investments can be exposed, and explain how investments in carbon sequestration projects can be protected through investment treaties.

II. The Carbon Trading Market

A. The Origins of the Carbon Trading Market

A system for the international trade of carbon credits was first established under the 1997 Kyoto Protocol[5] in which 37 industrialised states and developing economies committed to reducing carbon emissions to 'a level that would prevent dangerous anthropogenic interference with the climate system.'[6] The carbon reduction targets for each participating state were measured using 'assigned amount units'(***AAUs***) of greenhouse gas emissions that a state was allowed to discharge over a particular period. While participating states committed to meeting their targets primarily through national measures, the Kyoto Protocol also allowed these targets to be met through a market-based cap-and-trade scheme (i.e., the 'Clean Development Mechanism'). States which hit their carbon reduction targets with AAUs to spare could sell their excess units to other countries that had not yet met their targets.

The Kyoto Protocol kickstarted the creation of regulated and unregulated carbon trading markets across the world, with the largest markets now based in Europe, the United States, Canada, China, and Australia.[7] The Kyoto Protocol has since been supplanted by the 2015 Paris

[5] The Kyoto Protocol to the United Nations Framework Convention on Climate Change (Kyoto Protocol) was an international treaty committing states to reducing greenhouse gas emissions to mitigate the effects of global warming. The Kyoto Protocol created the first *international* market for the trade of carbon offset credits. The first carbon trading markets, however, were established by the US Environmental Protection Agency (EPA) in the early 1970s when it created quotas on polluting emissions but allowed local firms to transfer their emissions quotas internally between its facilities. This practice then extended to allowing transfers between firms and eventually created an 'offset mechanism' that received official sanction through the 1977 amendments to the Clean Air Act. See Raphael Calel, *Climate Change and Carbon Markets: A panoramic history,* Centre for Climate Change Economics and Policy Working Paper No. 62 (July 2011), London School of Economics, page 12.

[6] Kyoto Protocol, Article 2. See also <unfccc.int/kyoto_protocol>

[7] "What are carbon credits? How fighting climate change became a billion-dollar industry", October 30, 2021 <www.nbcnews.com/business/business-news/are-carbon-credits-fighting-climate-change-became-billion-dollar-indus-rcna3228>

Agreement,[8] which aims to limit global warming to within 2°C (and preferably within 1.5°C) compared to pre-industrial levels. Article 6 of the Paris Agreement sets out an overarching framework to achieve this goal, including by establishing a centrally governed international carbon market.[9] Although the broad mechanisms for such a market were finally agreed at the recent UN Climate Change Conference in Glasgow (COP26), it may take some time to implement as there are still questions of methodology and administration to be resolved.[10]

B. Regulated and Unregulated Carbon Markets

There are two types of carbon trading markets: regulated and unregulated. Regulated markets, which are also known as compliance carbon markets (***CCMs***), are created by statute or other formal legal mechanisms. They are usually enacted by states seeking to comply with carbon reduction commitments under international or national carbon reduction schemes, such as the Kyoto Protocol's Clean Development Mechanism.

Typically, CCMs are based on a cap-and-trade system. By way of illustration, Company A and Company B could be allotted 100 units of carbon emission credits per year. Each credit unit is certified by a national government agency and allows a company to emit 100 tonnes of carbon dioxide into the atmosphere. If Company A emits 120 units of carbon one year and Company B only emits 80 units of carbon, then Company A may purchase Company B's excess of 20 units through a CCM to avoid a penalty (i.e., fines or additional taxes).

The regulated entities in a CCM will usually be those industries and corporations which emit the highest amounts of carbon into the atmosphere. For instance, the EU's emissions trading system (***EU ETS***) is targeted at energy intensive industry sectors and commercial aviation within the European Economic Area.[11] Similarly, China's recently launched CCM is focused on electricity companies but will eventually extend to other sectors such as steel, cement, chemicals, and aviation.[12]

In contrast, unregulated or voluntary carbon markets (***VCMs***) are set up by private project developers that establish and implement international market-based programs generating tradable voluntary carbon credits.[13] Instead of a cap-and-trade system, a VCM is usually project-based in the sense that a developer will create a means for reducing carbon emissions in the atmosphere that would not otherwise happen and then sell the resulting voluntary carbon credits to individuals, companies, and other organisations seeking to meet voluntary 'net zero'[14] commitments. By creating a market for the sale of voluntary carbon credits, VCMs can be an important source of private funding for climate action projects that would otherwise

[8] The Paris Agreement (also known as the Paris Climate Accords) is a legally binding international treaty on climate change. It was adopted by 196 states in Paris on 12 December 2015 and entered into force on 5 November 2016.
[9] Paris Agreement, Article 6.4.
[10] Carbon Market Watch FAQ: Deciphering Article 6 of the Paris Agreement, <carbonmarketwatch.org/2021/12/10/faq-deciphering-article-6-of-the-paris-agreement/>
[11] EU Emissions Trading System (EU ETS), <ec.europa.eu/clima/eu-action/eu-emissions-trading-system-eu-ets_en>
[12] "China's New National Carbon Trading Market: Between Promise and Pessimism", July 23, 2021 <www.csis.org/analysis/chinas-new-national-carbon-trading-market-between-promise-and-pessimism>
[13] Such as Verra (verra.org/project/vcs-program) which has set up its own VCM program.
[14] 'Net zero' refers to a state in which carbon emissions going into the atmosphere are balanced by their removal out of the atmosphere. A company might achieve 'net zero' by ensuring that any carbon emitted by its activities is offset by the purchase of carbon credits equivalent to the amount of carbon emitted.

struggle to get off the ground. As part of an unregulated market, voluntary credits are usually certified by the project developers themselves or through a third party.[15] The standards for certification are not always consistent from one certifier to another,[16] which can create uncertainty as to how much carbon is being sequestered.

While both regulated and unregulated carbon trading markets can be exposed to sovereign risk, unregulated markets are particularly vulnerable to unreasonable interference from the governments of the states in which the markets operate.

III. Investment Treaties

A. Introduction to Investment Treaties

An investment treaty is an agreement between two or more states in which each promises to protect investments made in their territory by qualifying investors from the other state or states which are party to the treaty. There are three types – bilateral investment treaties (***BITs***), multilateral investment treaties (***MITs***), and free trade agreements which incorporate an investment chapter (***FTAs***). The first BIT was agreed in 1959 between the Germany and Pakistan.[17] Today, there are around 2,500 investment treaties in force, including with many of the countries now hosting carbon sequestration projects.[18]

States enter into these treaties to encourage foreign investment, which may be necessary for a state to achieve its economic and social goals. Investment treaties provide foreign investors with a range of substantive protections to encourage their investment, which is usually backed up with a right to seek compensation from the host state through international arbitration should the substantive guarantees be violated.

Each treaty must be interpreted according to its precise terms.[19] Indeed, modern investment treaties are often heavily negotiated, can include detailed provisions and annexures prescribing the scope and application of the treaty's benefits, and may reflect the contracting states' views on issues that have been previously referred to arbitration.[20] Nonetheless, there are certain trends and unifying features that can be observed in investment treaty practice, which are discussed below.

[15] For instance, Climate Action Reserve (climateactionreserve.org) and Gold Standard (goldstandard.org).

[16] "A blueprint for scaling voluntary carbon markets to meet the climate challenge", January 29, 2021 <www.mckinsey.com/business-functions/sustainability/our-insights/a-blueprint-for-scaling-voluntary-carbon-markets-to-meet-the-climate-challenge>

[17] Pakistan and Federal Republic of Germany Treaty for the Promotion and Protection of Investments (with Protocol and exchange of notes). Signed at Bonn, on 25 November 1959, <treaties.un.org/doc/Publication/UNTS/Volume%20457/volume-457-I-6575-English.pdf>

[18] The Future of Investment Treaties, <www.oecd.org/investment/investment-policy/investment-treaties.htm>

[19] The Vienna Convention on the Law of Treaties (1969) is an international agreement governing treaties between states, including rules and guidelines on how treaties should be interpreted. Article 31(1) provides that 'A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.'

[20] See generally Kristi How and Emily Choo, 'Chapter 1: Negotiation, Compliance and Termination of Investment Treaties: The State's Perspective, in Mark Mangan and Noah Rubins QC (eds), *GAR Guide to Investment Treaty Protection and Enforcemen*t (Law Business Research 2021).

B. Qualifying criteria

Investment treaties typically protect qualifying 'investors' from a state which is a party to the treaty (i.e., the ***investor's state***) in relation to their 'investments' in the territory of another state that is a party to the treaty (i.e., the ***host state***).

1. Qualifying Investors

Qualifying investors are usually defined to include natural persons, companies, and other legal entities. For instance, Indonesia and Singapore, which recently agreed to collaborate on carbon markets, green finance, and carbon credit investments,[21] are signatories to a 2018 BIT which defines an 'investor' as follows:

investor means:

(a) an enterprise of a Party [which is defined as 'an enterprise constituted or organised under the law of a Party, and carrying out business activities there']; or

(b) a natural person who, under the law of a Party, is a national of that Party or has the right of permanent residence in that Party;

that has made an investment.

Some treaties go further and limit their protections to incorporated entities that have a 'real economic connection'[22] or have their seat in the investor's state.[23]

As noted, investment treaties are intended to promote foreign investment. Accordingly, they usually do not protect local investments made by nationals and legal entities of the host state. Thus, Article 25(2)(a) of the ICSID Convention[24] stipulates that a qualifying investor must have 'the nationality of a Contracting State other than the State party to the dispute…'. Article 25(2)(b) of the ICSID Convention, however, provides an exception for a legal entity incorporated in the host state if it is (a) controlled by foreigners and (b) the parties agree to treat it as a foreign company in recognition of such foreign control. This exception was included to

[21] The parties signed a memorandum of understanding to this effect on 22 March 2022 <carboncredits.com/singapore-and-indonesia-carbon-trading/>

[22] Borzu Sabahi, Noah Rubins et al., Investor-State Arbitration (Second Edition), 2nd edition (Oxford University Press 2019), 'XI. Investors', page 379. For instance, Article 1(a) of the Russian-Thai BIT (2002) provides that an 'investor' includes companies 'which are constituted or otherwise duly organised under the law of the Contracting Party and have their seat, together with *real economic activities*', in the territory of that same Contracting Party.'

[23] For instance, Article 1(4) of the German Model BIT (1991) provides that the term 'companies' means 'any juridical person as well as any commercial or other company or association with or without legal personality having its seat [i.e., the *place of its effective management*] in the territory of the Federal Republic of Germany, irrespective of whether or not its activities are directed at profit…'

[24] Many investment treaty provisions allow for investor-state dispute settlement under the auspices of the International Centre for Settlement of Investment Disputes (***ICSID***), which is a specialized institution that deals exclusively with investor-state disputes and administers investment arbitrations under the ICSID Arbitration Rules. ICSID was established under the 1965 Convention on the Settlement of Investment Disputes between States and Nationals of Other States (i.e., the ICSID Convention, which is also known as the Washington Convention).

reflect the fact that many states require foreign investments to be implemented through locally incorporated companies.[25]

Several tribunals have grappled with the question of whether an investment owned by a company incorporated in the investor's state but owned or controlled by investors from the host state can qualify for protection under an investment treaty. A majority of arbitrators in one case held that the ultimate ownership of a qualifying investor was irrelevant under the terms of the relevant treaty in issue,[26] whereas another tribunal took the view that it might sometimes be appropriate to 'pierce the corporate veil' to determine whether an investor is effectively a legal entity of the host state, which would deprive it of protection under the treaty.[27]

2. Qualifying Investments

Investment treaties typically protect qualifying 'investments', which is usually defined broadly to include 'every kind of asset' along with a list of non-exhaustive examples. Article 1 of the Indonesia-Singapore BIT (2018), for instance, provides the following definition of 'investment':

> For the purposes of this Agreement, 'investment' means any kind of asset owned or controlled, directly or indirectly, by an investor that has the characteristics of an investment. Forms that an investment may take include, but are not limited to:
>
> (a) shares, stocks and other forms of equity participation in an enterprise, including rights derived therefrom;
>
> (b) bonds, debentures, loans and other debt instruments, including rights derived therefrom;
>
> (c) turnkey, construction, management, production, concession, revenue-sharing, and other similar contracts;
>
> (d) claims to money or to any contractual performance related to a business and under contract having an economic value;
>
> (e) intellectual property rights which are conferred pursuant to the laws and regulations of a Party where the investment is located and goodwill;
>
> (f) licences, authorisations, permits, and similar rights conferred pursuant to applicable domestic law, including any concession to search for, cultivate, extract or exploit natural resources; and
>
> (g) other tangible or intangible, movable or immovable property and related property rights such as mortgages, liens or pledges.

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[25] Christoph Schreuer, et al., *The ICSID Convention: A Commentary* (Cambridge University Press 2008), pages 316-317.
[26] See, for instance, *Tokios Tokeles v Ukraine*, ICSID Case No ARB/02/18, Decision on Jurisdiction and Dissenting Opinion (29 April 2004).
[27] See, for instance, *National Gas SAE v Egypt*, ICSID Case No. ARB/11/7, Award (3 April 2014).

There may be additional requirements that must be met to establish a qualifying 'investment' under the ICSID Convention even though the term is not defined under the Convention.[28] For instance, some ICSID tribunals have applied the test for an 'investment' adopted by the arbitral tribunal in *Salini v Morocco*.[29] The tribunal in that case considered that the core characteristics of an investment were (a) a contribution of money or assets;[30] (b) a certain duration of contractual performance;[31] (c) an element of risk; and (d) a contribution to the economic development of the host state.[32] Other tribunals, however, have concluded that the *Salini* test has no solid basis under the ICSID Convention and prefer to limit themselves to the qualifying criteria prescribed in the relevant investment treaty.[33] This in turn illustrates the importance of arbitrator selection in investment treaty cases.[34]

Investments in foreign carbon sequestration projects could qualify for protection under an investment treaty. For instance, the purchasing or leasing of land for the purposes of planting trees that sequester carbon dioxide is likely to qualify for protection.[35] Concessions conferred on a business by a state or permits to use land or sea for certain purposes, such as generating renewable energy (solar, wind, etc) or capturing and storing carbon, could qualify for protection. Similarly, rights conferred by contract, including through agreements with state owned entities, could fall within the concept of a qualifying 'investment'.

A carbon offset credit could potentially qualify as a protected investment subject to the precise definition of 'investment' in the relevant treaty.

a. Intangible property. Most investment treaties expressly protect intangible property. There have been several judicial pronouncements in recent years that a compliance carbon credit is a type of intangible property right. For instance, in *Armstrong DLW GmbH v Winnington Networks Ltd*,[36] the English High Court held that emissions allowances under the EU ETS satisfied the basic characteristics of property, namely, that they are 'definable, identifiable by third parties, capable in its nature of

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[28] The omission was deliberate. A draft of Article 30(i) of the ICSID Convention defined an investment as 'any contribution of money or other assets of economic value for an indefinite period or, if the period be defined, for not less than five years.' However, no agreement could be reached on a suitable definition.

[29] *Salini v Morocco*, ICSID Case No. ARB/00/4, Decision on Jurisdiction (16 Jul. 2001), 42 ILM 609, 622 (2003).

[30] The notion of contribution is flexible and can include a commitment of economic resources of value extending beyond a flow of capital to providing technology, technical know-how, personnel, etc.

[31] This requirement excludes one-off transactions and includes an expectation of a long-term relationship. See Daniel Martinez, *The Definition of "Investment" in the Interplay between IIAs and the ICSID Convention: Revisiting the Double-Barrelled Approach* (2019), page 27.

[32] Some tribunals have accepted accept, however, that only the first three criteria need to be met, particularly since the fourth criteria assumes that only successful projects would count as investments, which is clearly not the case. See, for instance, *Quiborax S.A., Non Metallic Minerals S.A. and Allan Fosk Kaplún v Bolivia*, ICSID Case No. ARB/06/2, Decision on Jurisdiction (27 September 2012); *KT Asia Investment Group v Kazakhstan*, ICSID Case No. ARB/09/9, Award (17 October 2013).

[33] For instance, the tribunal in *Biwater Gauff (Tanzania) Ltd v Tanzania* ICSID Case No. ARB/05/22, Award (24 Jul. 2008) held that an overly strict application of the *Salini* test risked excluding certain investments from the scope of the ICSID Convention based on criteria that were absent from the text of the ICSID Convention.

[34] Mark Mangan and Ananya Mitra, 'Chapter 12: Substantive Protections: MFN' in Mark Mangan and Noah Rubins QC (eds), *GAR Guide to Investment Treaty Protection and Enforcemen*t (Law Business Research 2021), pages 228-238.

[35] Such investments are likely to satisfy the treaty definition of 'investment' and the *Salini* test of being (a) a contribution of money or assets (b) over a certain duration with (c) an element of risk that (d) contributes to the host state's development by generating tradeable carbon credits that help boost the state's carbon trading regime.

[36] [2012] EWHC 10 (Ch).

assumption by third parties, and has some degree of permanence or stability.'[37] The European Court of Justice also accepted in *ArcelorMittal v Luxembourg*[38] that emissions allowances under the EU ETS could constitute 'possessions' for the purposes of Article 17 of the EU Charter of Fundamental Rights, but only if they were 'properly' allocated in line with existing regulations. While these decisions are not binding on an arbitral tribunal constituted under an investment treaty, they may be found to be persuasive.

b. License or permit. Investment treaties will typically define a qualifying investment as including rights attaching to licenses and permits. For instance, Article I(g) of the US Model BIT lists 'licenses, authorisations, permits, and similar rights' in its definition of 'investments'. Compliance carbon credits could be classified as licenses or permits on the basis that they are allowances granted to the owner under a state-sanctioned regulatory framework to emit a specified amount of carbon into the atmosphere.[39] Such a classification is less likely to apply to voluntary carbon credits, however, since they are (by definition) not regulated by the state but issued by private parties.

Carbon credits may also qualify for protection for claims brought under the ICSID Convention based on the aforementioned *Salini* test (to the extent it is held to apply) if the credits were purchased pursuant to contractual arrangements of a certain duration (i.e., usually at least several years[40]). A one-off sales transaction, however, is unlikely to qualify for protection under either the terms of an investment treaty or the *Salini* test.[41]

C. Substantive Protections

Investment treaties typically provide a range of substantive protections., Those most relevant for investments in carbon sequestration projects are discussed below.

1. Protection from Expropriation without Compensation

States are allowed under international law to expropriate a foreign investor's investment rights or property. Investment treaties, however, typically insist that any expropriation be exercised

[37] It is possible that voluntary carbon credits would satisfy these criteria as well, although its unregulated nature may make it less 'permanent' and 'stable' compared to compliance carbon credits.

[38] C-321/15 - ArcelorMittal Rodange and Schifflange, Judgment of The Court (Fifth Chamber) 8 March 2017, EU:C:2017:179.

[39] Lisa Bennett, *Are Tradeable Carbon Emissions Credits Investments? Characterization and Ramifications under international Investment Law*, NYU Law Review, Volume 85(5), November 2010, pages 1596-1599.

[40] See, for instance, *GEA v Ukraine*, ICSID Case No. ARB/08/16, Award (31 March 2011), paragraph 152 (three years); *Jan de Nul v Egypt*, ICSID Case No. ARB/04/13, Decision on Jurisdiction (16 June 2006), paragraph 93 (two years).

[41] See Daniel Martinez, *The Definition of "Investment" in the Interplay between IIAs and the ICSID Convention: Revisiting the Double-Barrelled Approach* (2019), page 27. The other *Salini* requirements of a contribution of money and an element of risk should be easily satisfied in relation to both compliance and voluntary carbon credits. To the extent that it is necessary to satisfy the 'contribution to the economic development of the host state' criterion, it could be argued that participating in the carbon market helps to create volume and liquidity, which boosts the state's carbon trading regime.

for a public purpose, be non-discriminatory, respect due process, and be accompanied by prompt and adequate compensation.[42]

The expropriation of property can occur directly or indirectly. Direct expropriation (or nationalisation) occurs when a state seizes property and extinguishes the investor's title.[43] Indirect expropriation occurs when an investor retains title to the property, but its value has been effectively wiped out.[44] Indirect expropriation also includes 'creeping expropriation' that happens gradually and insidiously.[45] For instance, a host state could seize or nationalise property being used to generate carbon credits for its own gain without providing sufficient compensation. Alternatively, a state might compel a foreign investor to redirect its carbon credits to the host state's own domestic market, where they may be less valuable.

These hypotheticals have recently become reality. In December 2021, Koch Industries and Koch Supply & Trading (***Koch***) filed an ICSID claim against Canada in response to the state's reversal of an emissions trading program. Koch had bought emission allowances valued at USD 30 million under a system that Ontario established in 2016, only for a new government to abruptly cancel the program in 2018 – thereby wiping out its carbon trading business in Canada. In submissions filed in February 2022, Koch contended that the state's actions amounted to an unlawful expropriation and a breach of NAFTA's minimum standard of treatment (which is similar to the fair and equitable treatment standard discussed below).

Although Canada's defence is not publicly available as of the date of this article, the Ontario provincial government has asserted that the cancellation of the emissions trading program was done in the public interest, namely, to fulfil a campaign commitment 'to reducing gas prices by 10 cents per litre' and that 'the elimination of the cap-and-trade carbon tax will remove a cost burden from Ontario businesses, allowing them to grow, create jobs and compete around the world.'[46] In this regard, some tribunals have found that measures taken by states in the pursuit of legitimate public policy objectives will not necessarily constitute expropriatory action and therefore might not require compensation.[47] Other tribunals, however, have expressed the view that a state's alleged public interest justification for its expropriatory acts 'does not alter the legal character of the taking for which adequate compensation must be paid.'[48]

2. Fair and Equitable Treatment

A foreign investor in carbon credits might also be subject to unfair and unequitable treatment from a host state which could constitute a violation of the relevant treaty. For instance, the state

[42] 'Chapter 5: Expropriation', in Josefa Sicard-Mirabal and Yves Derains, Introduction to Investor- State Arbitration (Kluwer Law International 2018), page 115; Derk Soller et al, 'Chapter 14: Substantive Protections: Expropriation', in Mark Mangan and Noah Rubins QC (eds), *GAR Guide to Investment Treaty Protection and Enforcemen*t (Law Business Research 2021), page 260.
[43] *Metalclad Corporation v Mexico*, ICSID Case No. ARB(AF)/97/1, Award (30 August 2000).
[44] 'XVIII. Expropriation', in Borzu Sabahi, Noah Rubins et al., Investor-State Arbitration (Second Edition), 2nd edition (Oxford University Press 2019), page 603.
[45] *Generation Ukraine v Ukraine*, ICSID Case No. ARB/00/9, Award (16 September 2003), paragraph 20.22.
[46] "Ontario Introduces Legislation to End Cap and Trade Carbon Tax Era in Ontario", July 25, 2018 <news.ontario.ca/en/release/49786/ontario-introduces-legislation-to-end-cap-and-trade-carbon-tax-era-in-ontario>
[47] *Methanex Corporation v United States*, UNCITRAL, Final Award on Jurisdiction and Merits (3 August 2005).
[48] Compañia del Desarrollo de Santa Elena S.A. v Republic of Costa Rica, ICSID Case No. ARB/96/1, Award (17 February 2000)

could revoke the investor's license to use a parcel of land for reforestation without good reason or due process. Alternatively, it might introduce new laws or taxes that it seeks to apply retroactively.[49]

Investment treaties typically guarantee that qualifying investors will be subject to fair and equitable treatment (***FET***), which is the single most relied upon protection within the investor-state legal framework.[50] While there has been considerable uncertainty (and mixed jurisprudence) as to what is meant by FET, modern treaties tend to stipulate that it refers to the 'minimum standard' of protection required under customary international law.[51] With that said, some treaties stipulate the opposite – namely, that it is an autonomous clause subject to a commercial understanding of fairness unconstrained by notions of customary international law.[52] The distinction may be academic as various arbitral tribunals have expressed the view that there is no practical difference between the customary international law standard of minimum treatment and an autonomous FET treaty standard.[53]

In any event, numerous tribunals have held that one of the core components of FET is the protection of legitimate expectations.[54] Thus, if an investor makes a long-term investment to generate carbon credits on the basis of a host state's specific representations that it will maintain a supportive framework for carbon sequestration or trading, the host state would potentially be in breach of its FET obligations if it were to abandon its support or introduce new regulations that contradicts its earlier representations.[55]

Again, these hypotheticals have in recent times become reality. In September 2020, a group of renewable energy investors argued before an ICSID tribunal that Romania breached the Energy Charter Treaty, which includes many of the protections described in this article, including the FET standard,[56] when it modified its incentives regime built around so-called 'green certificates'. The green certificates were issued to producers of renewable energy based on the amount of renewable energy that they produced, which could then be sold as tradeable credits to energy consumers who were required to purchase a certain number of green certificates

[49] The case of *Cairn Energy PLC and Cairn UK Holdings Limited v India* (PCA Case No. 2016-7) was filed following India's decision in 2012 to retroactively amend its income tax laws, resulting in the claimant being imposed with a USD 1.6 billion tax liability in 2015 for failing to deduct withholding tax on alleged capital gains from 2006. On 21 December 2020, India was found to have breached its FET obligations under the India-United Kingdom BIT (1994) and ordered India to pay Cairn USD 1.2 billion in damages. India was then forced to change its tax laws to prevent similar actions from other investors, thus demonstrating the potential power of investment treaties.

[50] 'Chapter 6: Standards of Protection', in Josefa Sicard-Mirabal and Yves Derains, Introduction to Investor-State Arbitration (Kluwer Law International 2018), page 135; Elodie Dulac and Jia Lin Hoe, 'Chapter 13: Substantive Protections: Fairness' in Mark Mangan and Noah Rubins QC (eds), *GAR Guide to Investment Treaty Protection and Enforcemen*t (Law Business Research 2021), page 240.

[51] See, for instance, Article II(3)(a) of the US-Ukraine BIT and Article II(2)(a) of the Argentina-US BIT.

[52] Article 2(2) of the Germany-Iran BIT.

[53] *Saluka v Czech Republic*, UNCITRAL, Partial Award (17 March 2006), paragraph 291. See also, Elodie Dulac and Jia Lin Hoe, 'Chapter 13: Substantive Protections: Fairness' in Mark Mangan and Noah Rubins QC (eds), *GAR Guide to Investment Treaty Protection and Enforcemen*t (Law Business Research 2021), page 244.

[54] *Saluka v Czech Republic*, UNCITRAL, Partial Award (17 March 2006), paragraphs 301-302.

[55] *Glencore International AG v Colombia*, ICSID Case No. ARB16/6, Award (27August 2019), paragraph 1367; *Agility Public Warehousing Company v Iraq*, ICSID Case No. ARB/17/7/, Award (22 February 2021), paragraph 162.

[56] The Energy Charter Treaty, Article 10: '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.'

under Romanian law. Romania initially imposed fixed quotas of green certificates for energy consumers, but then lowered these quotas to reduce consumer prices, which inevitably decreased the demand for the green certificates. The claimants allege that the changes caused them losses of more than £250 million.[57]

It is well-established that arbitrary conduct by a state against an investor 'founded on prejudice or preference rather than on reason or fact'[58] constitutes a breach of the FET standard.[59] The threshold for establishing arbitrary state action is relatively high, however, as the state's actions must extend beyond 'inconsistent or questionable application of administrative or legal policy or procedure to the point where the action constitutes an unexpected and shocking repudiation of a policy's very purpose and goals, or otherwise grossly subverts a domestic law or policy for an ulterior motive.'[60]

The FET standard also provides protection against denials of justice.[61] In practice, this has been held to include an unreasonable delay in proceedings; a lack of judicial independence; a failure to enforce final judgments or awards; judicial corruption; and a breach of fundamental due process guarantees such as the right to be heard.[62]

3. Other Substantive Protections

Investment treaties often provide a range of other substantive protections that could be important to those investing in carbon trading markets, such as the following.

(a) Full protection and security (***FPS***). The FPS standard requires states to take 'active and reasonable measures' to protect a qualifying investor and its investment from harm.[63] This might include ensuring that an investor's staff and property be kept safe or taking steps to stop civil unrest or other types of public disorder that might endanger a foreign investment.[64]

(b) Free transfer of funds. Investment treaties often guarantee that qualifying investors can transfer their funds out of the host state without restrictions. Some treaties also set out examples of the types of payments covered and include various exceptions to the transfer right such as allowing the host state to protect its financial system if a balance of payments crisis occurs or to ensure compliance with tax obligations.[65]

(c) Most-favoured nation (***MFN***) and national treatment clauses. MFN clauses require a host state to accord qualifying investors with treatment that is no less favourable to that which is afforded to investors from a third state. An investor may deploy an

[57] "44 renewables investors initiate ECT arbitration against Romania", September 18, 2020, <www.iareporter.com/articles/44-renewables-investors-initiate-ect-arbitration-against-romania/>
[58] *Lauder v Czech Republic*, UNCITRAL, Award (3 September 2001), paragraph 221.
[59] *CMS Gas Transmission Company v Argentina*, ICSID Case No. ARB/01/8, Award (12 May 2005), paragraph 290.
[60] *Cargill v Mexico*, ICSID Case No. ARB(AF)/05/2, Award (18 September 2009), paragraph 293.
[61] 'XIX. Fair and Equitable Treatment, 'Full Protection and Security, and War Clauses', in Borzu Sabahi, Noah Rubins et al, *Investor-State Arbitration* (Oxford University Press 2019) page 670, paragraph 19.82.
[62] 'XIX. Fair and Equitable Treatment, 'Full Protection and Security, and War Clauses', in Borzu Sabahi, Noah Rubins et al., Investor-State Arbitration (Oxford University Press 2019) page 632.
[63] 'Chapter 6: Standards of Protection', in Josefa Sicard-Mirabal and Yves Derains, Introduction to Investor-State Arbitration (Kluwer Law International 2018) page 146.
[64] Ibid.
[65] See, for instance, Articles 1 to 4 of the ASEAN Comprehensive Investment Agreement (2009).

MFN clause either as the basis of a claim in itself or to import substantive or procedural protections from another investment treaty.[66] Many investment treaties also include so-called national treatment clauses which guarantee that qualifying investors are treated the same as domestic investors in 'like' or 'similar' circumstances, although some treaties may include specific exceptions in relation to particular economic sectors or taxation.[67]

D. Procedural Protections

Traditionally, if a host state expropriated a foreign investor's property without compensation or committed some other breach of customary international law the investor would either have to pursue a claim before the offending state's own courts, which often will not be an attractive option, or lobby its own state to pursue the claim on its behalf in a process referred to as 'diplomatic protection'.[68] As already noted, one of the great innovations with investment treaties is that they typically empower qualifying investors to pursue claims against the host state directly for breaches of the treaty.

Investment treaties will often give investors a choice between institutional arbitration and ad hoc (or non-administered) arbitration.

(a) ICSID is the most common form of institutional treaty arbitration.[69] An investment treaty may also allow an investor to pursue a claim which is administered by a commercial arbitral institution such as the International Chamber of Commerce's International Court of Arbitration (ICC) or the Singapore International Arbitration Centre (SIAC).

(b) In theory, parties to an ad hoc arbitration have the freedom to craft a procedure to suit their precise needs, although in practice many choose to adopt the Arbitration Rules of the United Nations Commission on International Trade Law (UNCITRAL).

Should a claim be unsuccessfully established, tribunals have a broad discretion to determine an appropriate amount of compensation or provide other relief.[70] States can often be expected to comply voluntarily with an adverse decision so as not to defeat the very reason the state entered into the treaty in the first place – namely, to attract foreign investment. Nonetheless,

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[66] Mark Mangan and Ananya Mitra, 'Chapter 12: Substantive Protections: MFN' in Mark Mangan and Noah Rubins QC (eds), *GAR Guide to Investment Treaty Protection and Enforcemen*t (Law Business Research 2021), page 198.

[67] See, for instance, Article 4 of the French Model BIT: '[National] treatment shall not include the privileges granted by one Contracting Party to nationals or companies of a third party State by virtue of its participation or association in a free trade zone, customs union, common market or any other form of regional economic organization. The provisions of this article do not apply to tax matters.'

[68] 'II. History and Limitations of the Traditional System for Resolving Investment Disputes', in Borzu Sabahi, Noah Rubins et al., Investor-State Arbitration (Oxford University Press 2019) pages 13-46.

[69] ICSID administers approximately 65% if all publicly known investment treaty disputes. <investmentpolicyhub.unctad.org/ISDS>.

[70] In three awards dated 18 July 2014, an UNCITRAL arbitral tribunal under the auspices of the Permanent Court of Arbitration ordered Russia to pay over USD 50 billion in compensation for the indirect expropriation of OAO Yukos Oil Company. This is the largest damages award to-date in an investment treaty arbitration.

should enforcement action be required, states can be forced to comply under the terms of the ICSID Convention and the New York Convention[71] for non-ICSID cases.[72]

IV. The Importance of 'Treaty Planning'

The central thesis of this article is that investment treaties can provide important protections for those engaged in foreign carbon trading markets as well as other industries. Foreign investors can structure their investments so as to access an optimal level of treaty protection. Indeed, just as investors routinely undertake tax planning to optimise the value of an investment, foreign investors can undertake an analysis (with the assistance of legal counsel) to determine which treaty or treaties could potentially protect a foreign investment.

For those investors which come from countries that do not have an investment treaty with the state hosting an investment, the investment could be structured through a third state which does have an adequate treaty in place. For instance, if a German company wishes to invest in a forest conservation project in Laos, there is no investment treaty between those states which the company could rely upon. The German investor, however, could obtain treaty protection indirectly by incorporating a subsidiary in Singapore, whose investments in Loas would be covered by the Laos-Singapore BIT (1997), the ASEAN Comprehensive Investment Agreement (2012), and several other FTAs among ASEAN states.[73]

An existing investment which is presently not protected can also be restructured so as to bring it within the terms of an investment treaty. However, any such restructuring would need to happen before a dispute arises (or is foreseeable), as otherwise it could be considered an abuse of process. As the tribunal noted in *Phoenix v Czech Republic*, 'an international investor cannot modify downstream the protection granted to its investment by the host state, once the acts which the investor considers are causing damages to its investment have already been committed.'[74]

V. Conclusion

Foreign investments in regulated and unregulated carbon markets, renewable energy and other sectors can be fraught with sovereign risks such as expropriation without compensation, unfair and inequitable treatment, and denials of justice in local courts. Foreign investments can be protected from such unlawful state interference through investment treaties. Several claims have already been pursued by investors against states in relation to their climate policies and more can be expected in the future as a number of states grapple with the tension between achieving their ambitious climate goals and their continuing reliance on carbon-intensive industries while also juggling the competing demands of other segments in society.

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[71] The Convention on the Recognition and Enforcement of Foreign Arbitral Awards (***New York Convention)*** requires courts of its 169 contracting states to give effect to arbitration agreements as well as recognize and enforce arbitration awards made in other contracting states.

[72] The grounds for refusing to enforce or to set aside an award under the ICSID and New York Conventions are, broadly speaking, limited to matters of jurisdiction and procedure (i.e., due process issues).

[73] Ministry of Trade and Industry, Singapore, International Investment Agreements (IIAs) <www.mti.gov.sg/Improving-Trade/International-Investment-Agreements>

[74] *Phoenix Action, Ltd. v. The Czech Republic*, ICSID Case No. ARB/06/5, Award (15 April 2009), paragraph 95.