Clash of the Titans

A study of the interaction between environmental regulations and foreign investment protection in the context of indirect expropriation

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### List of Abbreviations

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<th>Abbreviation</th>
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<tr>
<td>ASEAN</td>
<td>Association of Southeast Asian Nations</td>
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<td>BIT</td>
<td>Bilateral Investment Treaty</td>
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<td>ECT</td>
<td>Energy Charter Treaty</td>
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<td>FTA</td>
<td>Free Trade Agreement</td>
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<td>ICJ</td>
<td>International Court of Justice</td>
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<td>IIA</td>
<td>International Investment Agreement</td>
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<td>ISDS</td>
<td>Investor-state dispute settlement</td>
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<td>ITA</td>
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<td>MIT</td>
<td>Multilateral Investment Treaty</td>
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1. Introduction

Foreign investment has experienced a big growth over the latest decades, resulting in an increasing number of international investment agreements between states. There are approximately 3000 bilateral investment agreements and a number of multilateral investment agreements such as the ECT and NAFTA. Most of the agreements contain clauses providing an investor state dispute settlement mechanism referring to investor-state arbitration. The ISDS mechanism is an investment procedural mechanism that provides an opportunity for the investor to commence arbitration against the host state, even though the investor is not a party to the Treaty. There are some common features in most ISDS provisions such as the choice of an arbitration regime i.e. a choice of arbitration rules and in some even a choice of forum for the dispute. The common ground is however the protection against expropriation which can be considered as the most severe form of governmental interference with the rights of the investor to its property.¹

In recent years the environment and environmental protection, has become one of the biggest topics on the international political agenda. Concerns on climate change due to pollution, waste disposal and the increase of carbon dioxide emissions, have led to global agreements such as the Paris Agreement², regulating the States’ environmental commitment, requiring the national states’ to take legal measures in order to protect the environment. This evolution and environmental understanding causes arbitration courts the difficulties resolving disputes having an environmental component. Which could be one of the reasons why environmental norms are yet to be fully recognized as having a material role to play in the field of foreign investment law. Environmental protection and foreign investment protection have competing objectives and are not balanced. On the one hand, there are norms of international law which seek to encourage foreign direct investment by providing full and effective protection to the investor, and on the other hand, norms of

¹ Kaj Hobér, Selected writings on Investment Treaty Arbitration (1. ed. Lund: Studentlitteratur, 2013) 11-12
² The Paris Agreement central aim is to strengthen the global response to the threat of climate change by keeping a global temperature rise this century well below 2 degrees Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5 degrees Celsius. Additionally, the agreement aims to strengthen the ability of countries to deal with the impacts of climate change. See United Nations Climate Change https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement
international and national law which seek to protect the environment. These interest collide where, for instance, a State pursues environmental objectives through the adoption of regulations and other measures and thereby interferes with a foreign investment to the extent that it becomes less profitable, or even worthless. The clash between competing obligations of the State to, on one hand promote foreign investment, and on the other hand to protect the environment has created tensions and challenges for many States.

1.1 Problem Statement

The earliest investment disputes can be traced back to the 1970s, but it was not until the last two decades that environment-related disputes have emerged. In these cases, disputes often arise when governmental policies have affected the investors investment in a negative way due to regulations aimed at protecting the environment. Most of the cases are related to the denying of permits to operate landfills, refusing to grant licenses and the change in governmental policies on renewable energy due to climate change mitigation. To this date more than 60 investment disputes filed since 2012 have had some environmental component. Amongst them, there have been several cases in which States have sought to enforce environmental law against investors in investment arbitration. The potential clash between protection of investors under investment treaties and protection of the environment has emerged in a number of recent arbitrations and has become of big issue of concern regarding the interaction between investment treaty arbitration and environmental law, especially when the measures lead or can be seen to be tantamount to an indirect expropriation. As a result, arbitral tribunals also struggle to differentiate between non-compensable regulation and compensable indirect expropriation.

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3 Philippe Sands, 'Litigating environmental disputes: Courts, tribunals and the progressive development of international environmental law', (Session 2.2.: The policy framework for investment: the social and environmental dimensions, Global Forum on International Investment, 27-28 March 2008) 7
5 Ibid, 384-386
1.2 Aim and Research questions

The aim of this thesis is to investigate the interaction between environmental protection and international investment law, more specific the State´s power to regulate for environmental purposes in light of the standards of foreign investment protection from indirect expropriation. The criticism against the ITA system presented in this thesis is by no mean meant to be of general criticism to the system, but rather to give a clear understanding of the challenges the system face when environmental issues are raised under investment treaty disputes.

Following two research questions constitute the basis of this thesis:
- Under what conditions may a State regulation for environmental purposes be deemed tantamount to indirect expropriation?
- Should environmental regulations tantamount to indirect expropriation be compensable?

1.3 Scope and Limitations

The scope of this thesis covers the different arbitral standards and the legal reasoning made by arbitral tribunals when identifying if an environmental regulation is tantamount to indirect expropriation. The definition of indirect expropriation is made according to international investment law in which treaties do not provide an explicit definition of the concept. That is why arbitral tribunals are required to judge on their own criteria and take into consideration the competing rights of the host state and the foreign investor. Even though a case-by-case method is the more practical and governing method for determining when indirect expropriation has occurred, it is argued that a more clear and consistence method must be encourage by tribunals. This is why reference to arbitral standards is the most appropriate method. However, arbitral standards are by no mean meant to be an alternative to treaty interpretation according to the VCLT, but are rather used in this thesis as a mean to resolve competing rights and interests when the VCLT does not give guidance on the issue. The scope and content of environmental provisions

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7 Omar Chehade, "The evolution of the law of indirect expropriation and its application to oil and gas investments (Journal of World Energy Law and Business, 2016, 9, 64–73) 64
also vary from treaty to treaty, and it’s therefore impossible and impractical in this thesis to give a complete analysis of all the environmental provisions or all treaties.

The language in the treaties varies and the treaties have therefore to be interpreted according to the principles of the VCLT in order to determine the proper legal significance. This thesis will not refer to, analyse or compare different treaties, since the purpose is to give a general understanding of the interaction of environmental regulations and foreign investment protection in light of indirect expropriation. Further, in analysing the issue of compensation, the scope of this thesis is limited to the second research question; if environmental regulations tantamount to indirect expropriation should be compensable, and not to determine the valuation model or quantum of the compensation. This is also the reason why lawful v. unlawful expropriation is not discussed deeper in this thesis. Finally, it’s important to understand that the scope of the thesis amounts only to cases in which the claimant challenge the environmental regulations taken by the host state and not to cases in which the claimant challenges the host states failure to protect the environment.

1.4 Methodology and Disposition
The methodology used for this thesis is the legal dogmatic method i.e. that the relevant law and other sources of law describing the interaction between environmental regulations and foreign investment protection will be presented, discussed and analysed according to how the law is, de lege lata and how the law should be, de lege ferenda. Investment tribunals, when deciding investment arbitration cases, have considered environmental issues as part of the facts, rather than a question of law. That’s why case law and the arbitral standards with the different lines of reasoning argued by the arbitral tribunals for identifying indirect expropriation are the most important legal source for this thesis.

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9 Ibid, 396
The chapters in this thesis are aimed at describing, analysing and discussing the interaction between environmental regulations and international investment law i.e. that only relevant information for achieving the aim of the thesis is going to be presented. Chapter 2 starts with a general overview of international investment law and its relevant sources of law. The chapter also describes existing provisions in international law and discuss the clash of ideas and interest that exist in ITA. Chapter 3 summarizes the State’s power to regulate and its sovereign right to expropriate. The chapter also describes environmental protection and the concept of regulating for environmental purposes. Chapter 4 deals with indirect expropriation and the scope of the doctrine. It gives a general and hopefully clear understanding of what constitutes a lawful expropriation. In Chapter 5, three arbitral standards to identify indirect expropriation, are going to be presented. These arbitral standards constitute the basis of further discussion and analyse in chapter 6 and 7. In Chapter 6, three similar cases dealing with environmental issues and indirect expropriation are going to be presented. The purpose is to illustrate the different approach arbitral tribunals take when deciding the scope of indirect expropriation and compensation. Chapter 7 continues with a deeper analyse and discussion of the arbitral standards in light of the arbitral decisions in chapter 6. This chapter will further try to answer the two research questions of this thesis and to give a summarised conclusion.

2. International investment law

The roots of modern investment law go back to customary law and the protection of aliens after the end of the First World War, this in direct relation to the revolution of capital importing countries such as Mexico and the Soviet Union. The law has mainly evolved to protect the investor and the investment against the background of conflicts of interest with the host state. Capital exporting countries argued for an independent system of protection under international law that could provide for prompt, adequate and effective compensation for expropriation. The capital-importing countries in their turn, supported protection under national law and argued against an independent standard under international law. This clash of
interests between capital-exporting and capital importing countries have characterized the evolution of international investment law.¹⁰

2.1 International Investment Agreements

Protection of foreign investment is based on the idea of protection of property and recognized as a human rights.¹¹ Investment protection treaties can be traced back to the end of the 18th century to the conclusion of the US and Frances first commercial treaty. Treaties between the US their European allies and Latin American states were signed during the following years, addressing issues on trade but also containing provisions requiring compensation in case of expropriation. Investment rules were not prominent in the earliest treaties but became more detailed and distinctive first under the 20th century, were matters of investment and the protection of foreign investment, were regulated in separate treaties and bilateral agreements entered into force.¹³ International investment agreements defines commitments on investment protection, but also help to interpret how these commitments should be integrated with public policy objectives. Investment protection in the context of environmental regulation has caused a great deal of controversy as environmental concerns have moved up societies’ priority lists and due to the fact that environmental regulation in investment treaty arbitration interacts with treaty concepts such as indirect expropriation.¹⁴

2.1.1 Environmental provisions in investment agreements

The scope of environmental regulation in the IIAs differs. While some agreements reserve policy space to regulate environmental matters, others remain silent on environmental issues. There is here a big difference between BITs and FTAs. Most of FTAs and also MITs refer to environmental concerns in the agreement.¹⁵ A clear

¹⁴ Ibid, 7
example is NAFTA Article 1114 (1). Critics of the investment treaty system argue that investment treaties are asymmetric because they in fact they only limit the sovereignty of developing countries and the policy space for the protection of public interests such as the protection of the environment. Capital importing countries depend on foreign investment from developed countries, a situation that create potential liabilities of development for developing countries.

International investment law and models for IIAs have treated international development in passing. Investment layers have tended to ignore development discourses. However, this is changing and new framework The United Nations Conference on Trade and Development (UNCTAD) on the interaction between investment law and sustainable development has been launched, which aim is to make investment law development friendly. Based on the rapidly evolving engagement in environmental issues, relating to Global change, some states that do not include reference to environmental concerns in their investment agreements, have begun to view the provisions in the agreements as leaving enough policy discretion for the State to address ant present and future environmental concern, i.e. that the international thinking about the environment has changed their perspective on the right for the state to address environmental concerns, despite of the provisions set out in the treaties.

2.2 Investment Treaty Arbitration

Over the latest 30 years there has been a dramatic increase in the production of case law in the field of international investment law. This is due to ISDS being more available as forum for investment disputes in agreements and the growing number BITs. Despite of the success of investment law and the investment arbitration system, there is also a great deal of criticism stating that the system restricts the

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16 NAFTA Article 1114 (1): Nothing in this Chapter shall be construed to prevent a Party from adopting, maintaining or enforcing any measure otherwise consistent with this Chapter that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns.
18 Ibid, 6
freedom of states to take regulatory action\textsuperscript{21}, as in the case of measures taken for environmental reasons. The subject arises because of the convergence of two recent developments: the rapid growth in direct foreign investment, and the increase in environmental consciousness, resulting in new norms of environmental law adopted at the national and international levels.\textsuperscript{22} The growth of IIAs has also lead to the growth of the investment treaty arbitration field, with more than 300 treaty-based known disputes\textsuperscript{23}.

Part of the reason is the political tension between capital exporting countries and capital importing countries and their competing rights and interests. The investment treaty system is not balanced in this aspect, only imposing substantive obligations on the host state for the protection of the foreign investor, and in most cases restricting the host states right to take measures for the public interest. Critics argue that the ITA system does not take consideration of other international legal regimes e.g. laws and regulations for the protection of human right and the environment. This leads, according to the critics, to a limited development of international investment law.\textsuperscript{24} This raises questions on how the tribunals should balance between environmental protection and foreign investor protection. Research in the field shows that there is a mixed picture of the role of ITA the context of environmental measures leading to expropriation. There is both an asymmetry in the amount of compensation in the outcomes of the cases and in the view of the environmental measures taken. In cases where the claimant wins, the tribunals frequently views the environmental measures with suspicion, indicating that ITA has still not fully understood the importance of environmental arguments for the judgement of disputes arising from environmental regulations.\textsuperscript{25}

\begin{thebibliography}{99}
\bibitem{22}Philippe Sands, `Litigating environmental disputes: Courts, tribunals and the progressive development of international environmental law´, (Session 2.2.: The policy framework for investment: the social and environmental dimensions, Global Forum on International Investment, 27-28 March 2008) 7
\bibitem{23}Benedict kingsbury, `Public Law Concepts to Balance Investors´ Rights with State Regulatory Actions in the Public Interest – the Concept of Proportionality´ (in Stephan W. Schill (ed), International Investment Law and Comparative Public Law, Oxford Scholarship Online 2010) 75
\bibitem{24}Benedict kingsbury, `Public Law Concepts to Balance Investors´ Rights with State Regulatory Actions in the Public Interest – the Concept of Proportionality´ (in Stephan W. Schill (ed), International Investment Law and Comparative Public Law, Oxford Scholarship Online 2010) 77
\bibitem{25}Daniel Behn, 'Trumping the Environment? An Empirical Perspective on the Legitimacy of Investment Treaty Arbitration', The journal of world investment & trade (01/01/2017)
\end{thebibliography}
2.3 Other sources of law

Public international law and Customary international law play an important role in the understanding of the interaction between environmental regulations and foreign investment protection. These sources of law are especially important for the understanding of the obligations of the parties to the disputes raised under ITA.

2.3.1 Public international law

The rules and principles of public international law play an important role when states and state entities are involved in arbitration and expropriatory measures are the focus of the dispute. The rules and principles of public international law play an important role relating to the standards of foreign investment protection and to the interpretation of treaties in investment treaty arbitration, were the primary source of interpretation is the Vienna convention On the Law of treaties. Equally important questions in public international law are issues relating to State responsibility according to customary international law. State responsibility means that a state e.g. party to a treaty is under international obligation to follow the requirements of the treaty. The breach of an international obligation will be characterized as an international wrongful act, irrespective of how the act is characterized by the states domestic law.26

2.3.2 Customary international law

Customary international law gives the states the right to expropriate foreign investments if the expropriation: (i) is for a public purpose; (ii) is non-discriminatory; (iii) complies with due process principles; and (iv) provides the investor with prompt, adequate, and effective compensation. While treaties can provide for a different scope of this exception to expropriate, both NAFTA, the ECT and the ASEAN, outline these common principles for expropriation.27

3. The State’s power to regulate for environmental purposes

Under customary international law, states have the right to regulate commercial and business activities within their territory. However, there are great concerns in the international community regarding the standards of foreign investment protection and the doctrine of indirect expropriation, interfering with the state’s right to regulate. Conflicts of interests between competing rights have led to disputes concerning the scope of indirect expropriation and the power of the state to regulate in the public interest. In order to analyse the interaction between the State’s right to regulate for environmental purposes and the investors right to its investment, it’s crucial to understand the basic principle of sovereignty. Sovereignty in the actual context means that a state is independent and has the right to legislate and regulate as it will, including issues of public interest and for environmental purposes. The effect of globalization has change the way sovereign states regulate their societies in light of international agreements and international law. The power of arbitrators to review national state’s legislation and public measures has caused concerns regarding the state’s regulatory power and a state’s sovereign decision-making authority.

However, and as mentioned above, investment agreements transfer the States national decision making to the international level and in doing so also transferring the state’s public power to an international institution as the case of and arbitration court. Even though state parties to investment agreements can no longer rely on its sovereign power to regulate in response to public concerns, the state’s right to regulate in the public interest has gradually emerged in investment arbitration practice. In *Marvin Feldman v. Mexico*, the tribunal stated that the government must be free to act in the broader public interest through the protection of, inter alia, the environment. The tribunal also stated that reasonable governmental regulations cannot be achieved if any business affected by the measures taken in the public

30 Ibid
interest seek compensation. This can be seen in light of international law and the doctrine of indirect expropriation, where measures tantamount to indirect expropriation must be accompanied by compensation.

3.1 Environmental regulations for the public interest

The concept of public interest is the interest of the state and its constituents. The state has a broad mandate to define what public purpose is as long as it’s reasonable. The public purpose can also be seen in a more global context, taking into consideration the interest of mankind, such as environmental concerns, and deal with issues concerning the common interest. Public interest relating to the environmental are as mentioned earlier, common in arbitrations where issues on expropriation are raised. Tribunals have taken in consideration environmental standards when interpreting the substantive provisions. The treaties are not static and is should be open to adapt to emerging norms of international law. Even if environmental provisions are present in most treaties, some scholars argue that the treaties are not appropriate for the protection of the environment through provisions since their objective is the protection of the investment.

3.2 Environmental protection

The 1992 Rio Declaration on Environment and Development emphasizes the link between environmental protection and economic development. There is a widespread view in the international law context that investment lead to development. However, there is also a big gap between investment law and the concept of sustainable development, not only in literature but also in practice. Environmental protection can touch upon a wide range of issues relating to the environment such as the air, water and climate. The principle relating to this is

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sustainable development\textsuperscript{35} and the protection of the environment for future generations.\textsuperscript{36} The concerns relating to the negative impact that trade has on the environment has grown over time and lead to an international debate on trade agreements and environmental protection. Arguments against free trade often points out the disproportionately impact environmental deterioration has on the local community of developing countries, giving as example the harmful mining industry. Investment of this type are often rejected by local communities due to environmental concerns.\textsuperscript{37}

One example is the case of \textit{Pacific Rim v El Salvador}, where more than 300 civil society groups demonstrated outside the World Bank’s headquarters in Washington DC against the investment arbitration initiated by the mining company against El Salvador, accusing the company of using arbitration to subvert the debate over mining and environmental health.\textsuperscript{38} However, and as contradictory as it may seem, there are thousands of agreements establishing some form of environmental protection and defining environmental protection.\textsuperscript{39} The challenge is the interpretation of the agreements and the commitment from the States since international agreements is a compromise by states that often result in vague language. Since environmental protection in investment treaties are relative absent, and environmental claims are rarely raised in isolation, arbitral tribunals have very little guidance on how to balance the environmental objectives of governmental measures.\textsuperscript{40} Therefore the problem are not the arbitral tribunals, but the lack of guidance in the subject matter.

\textsuperscript{35} Definition of sustainable development in accordance with the UN’s Brundtland Report is a ‘development that meets the needs of the present without compromising the ability of future generations to meet their own needs’ See: Stephan W. Schill, Christian J. Tams & Rainer Hofmann, \textit{International Investment Law and Development: Bridging the Gap} (Edward Elgar Publishing, Incorporated 2015-12-18) 94


\textsuperscript{39} Tamara L. Slater, ‘Investor-State Arbitration and Domestic Environmental Protection’ (14 Wash. U. Global Stud. L. Rev. 131 2015) 141

3.3 The Policy Space of Host States to expropriate

Even though the standards of foreign investment protection from indirect expropriation guarantees the right of the investor, the State can still take measures in the public interest that harms the foreign investment. The State’s responsibility under international law and the measures taken may be challenge by the investor, even if the measures are taken are for environmental protection. However, that does not take away the fact that a State, under its sovereign rights, has the right to expropriate. The only restriction according to international law, is that the expropriatory measure is in non-discriminatory, taken in the public interest and follow by compensation. This restriction can however lead to various difficulties for the host state, since it both needs to protect the public interest and meet its international obligations. The State may be unable to compensate and be therefore unable to amend its legislation even if needed to protect the environment. A State that is bound to international obligations to protect the environment, will be forced to amend its legislation even if that leads to indirect expropriation and an obligation to compensate. It’s therefore important to find a way for the State to balance between public and private interest and to find the scope of indirect expropriation.41

4. Indirect expropriation

Claims of indirect expropriation are increasingly being seen as threat to State’s power to regulate within their territory, leading to uncertainty regarding the manner in which this claims are being dealt with under international law.51 The concept of expropriation originates from international law and has always been controversial due to the fact that it both represent infringement of property rights and the sovereign right of the State.52 From the investors point of view, expropriation is the most severe form of threat from the host state. That is why, the protection against expropriation is the most important provision of the IIAs. Even though is a common acceptance under international law that states have the right to expropriate foreign

41 Suzy H. Nikkiema, ‘Best Practices Indirect Expropriation, International Institute for Sustainable Development’ (March 2012) 3-4
52 Suzy H. Nikkiema, ‘Best Practices Indirect Expropriation, International Institute for Sustainable Development’ (March 2012) 1
property, it is also argued that they can do so only under certain circumstances and conditions.\textsuperscript{53}

The expropriatory provisions in many IIAs make reference to measures being tantamount and equivalent to expropriation which the arbitral decision in \textit{S.D. Meyers}\textsuperscript{54} shows. The tribunal in the actual case stated that the meaning of the word `tantamount´ is `equivalent´ according to the Oxford Dictionary and that when something is equivalent to something else it cannot encompass more, i.e. that measures tantamount to expropriation is very narrowly defined to include expropriations that occur in substance but not in form.\textsuperscript{55} Expropriation is defined as a modification or taking made by the government to an individual´s property rights. This means that an expropriation does not have to be physical i.e. involve a taking of property to constitute an expropriation. A modification of the property rights e.g. through measures that deprive the investor of the enjoyment of its property, also constitute an act of expropriation.\textsuperscript{56} This is what is referred to as indirect expropriation.

The measure amounting to indirect expropriation does not have to occur due to a single action from the state, instead indirect expropriation can be the result of many regulatory measures taken and progressing over time.\textsuperscript{57} Measures that may constitute an indirect expropriation vary an include restriction of physical access to production facilities, denial of entrance of essential spare part and also measures that constitute changes of the legal framework of the host state. To analyse whether such measures are tantamount to expropriation or not, arbitral tribunal have to analyse whether the measures were made within the legitimate sovereign power of the state and if the investor was deprived from its property rights.\textsuperscript{59} The crucial

\textsuperscript{54} In S.D. Meyers the claimant operated a PCB hazardous waste treatment in Canada. After Canada passed a law banning the exportation of PCB waste, the claimant alleged that this constituted a measure tantamount to expropriation. See Peter D Isakoff, `Defining the Scope of Indirect Expropriation for International Investments´ (The Global Business Law Review Law Journals 2013) 194
\textsuperscript{55} Peter D Isakoff, `Defining the Scope of Indirect Expropriation for International Investments´ (The Global Business Law Review Law Journals 2013) 194
\textsuperscript{57} Peter D Isakoff, `Defining the Scope of Indirect Expropriation for International Investments´ (The Global Business Law Review Law Journals 2013) 196
issues is therefore to determine the conditions under which the measures taken by the State is considered to be an indirect expropriation and if so, if the State is required to compensate the investor. As will be discussed in this paper, not all regulations that impact the investment in a negative way are tantamount to indirect expropriation, and need hence to be compensated.

4.1 The minimum international standard

In general, investment provisions don’t explicitly state the requirements for determining whether a measure taken by the host state constitute an indirect expropriation. However, implicitly they indicate which requirements do not establish that an indirect expropriation has occurred. The position of capital exporting states is that three requirements must be fulfilled in order for the expropriation to be lawful and comply with a minimum international standard. Firstly, the expropriation must be made for a public purpose, secondly, the expropriation must not discriminate against foreigners and thirdly, the expropriations must be accompanied with compensation.

The minimum international standard is sometimes referred to as the police power exception i.e. that a state is allowed to expropriate or take measures tantamount to expropriation if it complies with the requirements. This so called police power exception is incorporated in most investment treaties allowing states to expropriate in certain cases. A clear example is Article 13 of the ECT.

4.1.1 Public purpose

The requirement of a public purpose or public interest for an expropriation to be lawful, is found in most IIAs. The public purpose criterion is well recognized in customary international law, where a public purpose is needed in order to legitimate

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60 Suzy H. Nikiema, ‘Best Practices Indirect Expropriation, International Institute for Sustainable Development’ (March 2012) 1
61 Ibid, 7
63 ECT Article 13: Investments of Investors of a Contracting Party in the Area of any other Contracting Party shall not be nationalized, expropriated or subjected to a measure or measures having effect equivalent to nationalization or expropriation (hereinafter referred to as ‘Expropriation’) except where such expropriation is: (a) for a purpose which is in the public interest; (b) not discriminatory; (c) carried out under due process of law; and (d) accompanied by the payment of prompt, adequate and effective compensation.
The public purpose criterion is a common requirement applied by international tribunals when defining the scope of indirect expropriation. However, the use and interpretation of the criterion differs. While some tribunals support and recognize that states have an extensive discretion in determining its scope, others argue that an expropriation doesn’t serve a public purpose, even if this has been of secondary importance. The concept of public purpose is broad and tribunals have been reluctant to second-guess the host state's determination of public purpose. Case law is consistent in recognizing the public purpose requirement. This does however not mean that the scope of the public purpose in light of a lawful expropriation is defined. On the contrary, a precise definition of the concept has never been agreed upon in international law.

4.1.2 National treatment

National treatment is a non-discriminatory principle where a host state extends to foreign investors treatment that is at least as favourable as the treatment that it grants to national investors. This is important in order to guarantee foreign investors the possibility to have competitive equality with national investors. Discrimination is prohibited by customary law in the context of expropriation, and the non-discrimination can in some cases be seen as an aspect of the public purpose requirement. Even though arbitral tribunals give the principle a broad definition and some confusions exist on the requirement for breaching the principle, the measure taken by the host state should be directed directly towards the foreign investor in order for the measure to be discriminatory. There are also different views among tribunals concerning the intention versus effect of the measures taken in order to constitute a breach of the principle. Intent, is however difficult to prove and not necessary when the measure result in discriminatory treatment.

64 Reinisch A, 'Legality of Expropriations' (in August Reinisch (ed), Standards of Investment Protection Oxford Scholarship Online 2008) 178
4.1.3 Compensation

Compensation is the most relevant form of reparation for expropriation. Under customary international law, it does not matter if the expropriation is direct or indirect, both are compensable. The duty of a state to compensate for its wrongful acts against a foreign investor is a part of the state responsibility. The standard of compensation according to capital exporting states is the Hull formula, which establish that an expropriation is lawful only if accompanied by “adequate, effective, and prompt” compensation. Capital importing countries have however, no always accepted this standard but considered that compensation has to be appropriate i.e. that account has to be taken to the circumstances the State considers relevant\textsuperscript{70} e.g. environmental regulations taken by the host state in the public interest. Even though uncompensated expropriations are not recognized in international law, there are prevailing opinions that the Hull formula is no longer accepted as a general standard of compensation under customary international law. Instead, the determination on compensation has to be considered based on the specific case and the legitimate expectations invoked by both parties.\textsuperscript{71}

5. Arbitral standards to identify indirect expropriation

In every legal order there are conflicts of interests and determining the law applicable to an ISDS arbitration is not always an easy task. One of the biggest difficulties is how to identify the existence of an indirect expropriation. While claims concerning nationalization can be seen as a clear case of direct expropriation, claims of indirect expropriation are more difficult to assess.\textsuperscript{72} Arbitral tribunals have applied a variety of standards to identify indirect expropriation, which makes the standards complex and ambiguous\textsuperscript{73}. The balancing of the public interest of the host state and the private interest of the foreign investor is a normative substance in the factual situation of an arbitral dispute relating to indirect expropriation. It is up

\textsuperscript{70} Kaj Hobér, \textit{Selected writings on Investment Treaty Arbitration} (1. ed. Lund: Studentlitteratur, 2013) 142
\textsuperscript{71} August Reinisch, ‘Legality of Expropriations’ (in August Reinisch (ed), \textit{Standards of Investment Protection} Oxford Scholarship Online 2008)194-197
\textsuperscript{72} Gebhard Bücheler, ‘Proportionality in Investor-State Arbitration’ (Published to Oxford Scholarship 2015) 29
\textsuperscript{73} Peter D Isakoff, ‘Defining the Scope of Indirect Expropriation for International Investments’ (The Global Business Law Review Law Journals 2013) 189, 191
to the arbitral tribunals to decide on the extent to which public interest should be considered. In the past, arbitration practice focus either on the effect of the measures taken by the state for public purposes, referred to as the Sole effect doctrine, or on their purpose, the so called Police power doctrine. However, nowadays the starting point of most tribunals is the balancing test, also called the proportionality doctrine. In the following, the three different arbitral standards for identifying an indirect expropriation are going to be presented and discussed against the background of environmental regulations for public purposes.

5.1 The Sole effect doctrine
Under the sole effect doctrine the central factor for determining whether an indirect expropriation has occurred, is solely the effect of the governmental regulatory measure on the investor i.e. the degree of deprivation and impact the measure has on the investor’s rights. The sole effect doctrine is seen as investor-friendly due to the fact that it does not consider the intention behind the regulatory measure taken by the state, but instead solely considers the effect of the measure on the property allegedly expropriated. However, there are scholars arguing that the sole effect doctrine, in contrary of what others suggest, does not threaten the States’ right to regulate, in the contrary it is provides for consistency in claims of indirect expropriation whilst balancing the interests of the State and the investor.

The effect of the regulatory measures taken by the state is examined in most arbitral tribunals. It does not always have to be the only standard a tribunal analyses, but it’s a general approach to examine if the state is responsible for an expropriation when it unreasonably interfered with the enjoyment of a foreign investors right to its property. Despite of this general approach to the sole effect doctrine, different tribunals have come to different conclusions to when expropriation occurred. In the Tippetts case, the tribunal stated that expropriation occurred when the investor was deprived of his fundamental rights of ownership and that the deprivation was not

75 Omar Chehade, ‘The evolution of the law of indirect expropriation and its application to oil and gas investments (Journal of World Energy Law and Business, 2016, 9, 64–73) 65
ephemeral, whilst in the case of Housing Corp, the tribunal stated that the interference amount to expropriation when the investors right are rendered to be so useless that they must be deemed to have been expropriated.\textsuperscript{77}

The sole effect doctrine is recognized in customary law and used as a method for determining indirect expropriation in several cases\textsuperscript{78}, specially under the ECHR which has held that the effect of the measure should weigh more than the intent of the state i.e. that it does no matter why the measure was taken. Many other ISDS tribunals has taken the same approach, agreeing that the effect is more important than the intent. The question that has arisen among tribunals is however, which measure that is tantamount to expropriation i.e. that the tribunals have to determine the scope of the deprivation, if its substantial or total, temporary or permanent. The non-occurrence of Substantial deprivation is the most common argument for dismissing a claim of indirect expropriation, which mean that it’s not a deprivation of ownership, of the economical use of the investment or that the investment is lost or has become worthless.\textsuperscript{79}

5.2 The Police power doctrine

The Police power doctrine emerged from the state´s power to regulate the economy and has develop to regulations in the public interest e.g. concerning public health, safety and the environment. These areas have become a major factor and concern in determining the scope of indirect expropriation due to the fact that the police power doctrine recognize the states´ right to regulate for public purposes.\textsuperscript{80} In contrary to the sole effect doctrine, the tribunals that follows the Police power doctrine focus exclusively on the purpose of the measure taken by the State i.e. that general public measures in the public interest cannot in itself give raise to the question of expropriation. The sovereign power of a State to make the law necessary to preserve and serve the public interests is essential and cannot be taken away from

\textsuperscript{77} Peter D Isakoff, `Defining the Scope of Indirect Expropriation for International Investments´ (The Global Business Law Review Law Journals 2013) 197-198

\textsuperscript{78} See e.g. Sporrong & Lonnroth v Sweden, Papamichalopoulos v Greece. Omar, Chehade `The evolution of the law of indirect expropriation and its application to oil and gas investments´ (Journal of World Energy Law and Business, 2016, 9, 64–73) 65

\textsuperscript{79} Omar Chehade, `The evolution of the law of indirect expropriation and its application to oil and gas investments (Journal of World Energy Law and Business 2016, 9, 64–73) 66-67

\textsuperscript{80} Ibid, 69
the government. This type of strict definition and application of the doctrine is however severe critiqued. The requirement in most BITs stating that an expropriation in order to be lawful, has to be for a public purpose, would be redundant if a State measure for a public purpose would not qualify as an expropriation.\footnote{81} There are several references to cases in which the police power doctrine has been applied. One of them is the Sedco case where the tribunal stated that a State is not liable for the economic consequences of a bona fide regulation accepted within the police power of a state.\footnote{82}

The essence of the police power doctrine is that a State will not be liable for claims of indirect expropriation as result of a regulatory measure taken by the State. Either because of the measure, according the police power doctrine, not being tantamount to indirect expropriation or as an exception to the rule of compensation in international law i.e. that expropriation is follow by compensation.\footnote{85} When regulations are accepted to be within the police power of States, the general view of States is that they do not compensate for expropriation made in good faith, as long as the regulation is not discriminatory. This line of thoughts was elaborated under the Saluka case\footnote{86}, where the tribunal found that the Czech Republic acted within state police powers and therefore, did not have to compensate. The decision of Saluka tribunal has caused confusion regarding the distinction between compensable expropriation and non-compensable regulatory measures that could amount to indirect expropriation. The arbitral tribunals have adopted an \textit{ad hoc} approach for identifying indirect expropriation in order to distinguish between the two.\footnote{87}

\footnote{81} Gebhard Bücheler, ‘Proportionality in Investor-State Arbitration’ (Published to Oxford Scholarship 2015) 127-129
\footnote{86} In Saluka, the claimant acquired 36% of one of the for major state-owned banks in the Czech Republic during the bank privatization process. The claimant’s bank did not receive state subsidies given to the other three major banks and the bank was consequently forced into receivership. See Peter D Isakoff, ‘Defining the Scope of Indirect Expropriation for International Investments’ (The Global Business Law Review Law Journals 2013) 193
\footnote{87} Peter D Isakoff, ‘Defining the Scope of Indirect Expropriation for International Investments’ (The Global Business Law Review Law Journals 2013) 193
The question to consider is therefore which governmental measures that fall into the police power doctrine. The broad definition of the doctrine considers that all governmental acts taken in good faith for the public interest and being non-discriminatory, whilst the most common view is that only certain purposes may be pursued. The narrow view is that measures for the public welfare are not sufficient to qualify within the scope of the police power doctrine and that it is only measures for tax, crime and the maintenance of public order that falls within the States’ police powers.  

5.3 The doctrine of proportionality

The doctrine or principle of proportionality originates from German law and is used a method of legal interpretation and decision-making when disputes arise due to differences in competing rights and interests. In the international context the principle has been used for balancing the international legal order with domestic public policy e.g. the right of an investor to its property according to the investment agreement, against the host state right to regulate for public purposes. The principle is not categorical in the sense that it is all or nothing but allows for a more balanced approach to the validity and competing principles are evaluated based on their legal weight.

Proportionality was increasingly invoked by arbitration courts when assessing the legality of state conduct e.g. for a balancing test between the states right to take environmental measures and the investors rights to its investment. It may consider the legitimacy of the aim pursued, whether the measure is the appropriate way to reach the objective, the necessity of the measure, i.e. if there no other less restrictive alternative exist, and if the measure is excessive in relation to the interests involved. The principle of proportionality has been adopted in some investment treaties as part of the standards in relationship to expropriation and there are clear

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89 Benedict kingsbury, 'Public Law Concepts to Balance Investors’ Rights with State Regulatory Actions in the Public Interest – the Concept of Proportionality’ (in Stephan W. Schill (ed), International Investment Law and Comparative Public Law, Oxford Scholarship Online 2010) 79
suggestions from scholars that arbitral tribunals should take a proportionality analysis when determining whether a State is liable under an IIA, even though the wording of standard expropriatory provisions does not call for such an analysis.\textsuperscript{91} This is particularly interesting when discussing the fine line between non-compensable regulations and compensable indirect expropriations.

There are as quickly mentioned above, three sub-elements to consider in proportionality analysis, developed from jurisprudence. The first step is to analyse whether the measures taken by the state serve a legitimate purpose in the public interest and whether the measures are the most suitable to achieve this purpose. The second step is to analyse the necessity of the measure and whether other equally effective means to achieve the objective were available. The third step is to balance between the effects of the state measures with the importance of the government purpose. In few words, proportionality analysis looks at the relationship between the objectives of a specific state action and the means used to achieve this objective.\textsuperscript{92} These three sub-elements are going to be further discussed and analysed in chapter 7.

6. International investment arbitration cases

In order to provide for a brief and summarized overview of the arbitral standard used in disputes dealing with environmental issues, three of the most relevant cases for this thesis are going to be analysed and discussed below. The choice of cases has been made by taking into account the two research questions of this paper in the context of the different standards of arbitration. The purpose is to illustrate the different approach arbitral tribunals take when deciding the scope of indirect expropriation and compensation. Following three cases, dating from year 2000 – 2005, discussed under NAFTA (even though Tecmed is raised pursuant to the Spanish and Mexico BIT) and dealing with, inter alia, claims on indirect expropriation in light of the states right to regulate for environmental purposes. The

\textsuperscript{91} Gebhard Bücheler, ‘Proportionality in Investor-State Arbitration’ (Published to Oxford Scholarship 2015) 123, 132

\textsuperscript{92} Benedict kingsbury, ‘Public Law Concepts to Balance Investors’ Rights with State Regulatory Actions in the Public Interest – the Concept of Proportionality’ (in Stephan W. Schill (ed), International Investment Law and Comparative Public Law, Oxford Scholarship Online 2010) 85-88
cases are presented in a short summary, followed by the relevant parts of the award and a brief commentary connected to the arbitral standards mentioned in chapter 5. The cases are going to be deeper analysed and discussed under chapter 7.

Metalclad v. Mexico
ICSID Case No. Arb/AF/97/1 (NAFTA) Award, 30 August 2000

Summary: The dispute arose after the Mexican Municipality of Guadalcazar interfered in the activities of the Claimant (Metalclad). Metalclad had received a governmental permit to construct a hazardous waste landfill in Guadalcazar, yet was notified by the Municipality, five months after construction began that it was unlawfully operating without a municipal construction permit. Metalclad applied for the permit and completed the construction. The Municipality turned down Metalclad’s application barring the operation of the completed facility. Later the Governor issued an Ecological Decree declaring a Natural Area for the protection of rare cactus. The Natural Area encompassed the area of the landfill. Metalclad relied in part on this Ecological Decree as an additional element in its claim of expropriation, maintaining that the Decree effectively and permanently precluded the operation of the landfill.

The award: The Tribunal determined that the municipal government had no authority to deny the construction permit on environmental grounds and also because of the absence of clear rules and procedures governing the municipal construction permit which amounted to a failure on the part of Mexico to ensure transparency required by NAFTA. The Tribunal also found that the same actions of the local government amounted to an indirect expropriation. Further, the Tribunal held that the Ecological Decree alone also constituted an act of expropriation according to NAFTA article 1110 (expropriation). The Tribunal determined that Metalclad’s investment was completely lost as a result of Mexico’s actions. The amount of compensation was determined on the basis of the actual investment made by Metalclad.

Commentaries: The case generated a great deal of criticism regarding the implications free trade and globalization has on local governance and
environmental regulation. The ruling was said to be an attack on the right of municipal governments to make decisions on development proposals and the right of governments to regulate in the public interest. Critics also argue that the Tribunal adopted a definition of compensable takings that is much broader than what prevails under customary international law. The Tribunal did not decide or consider the motivation or intent of the adoption of the Ecological Decree. However, the Tribunal considered that the implementation of the Ecological Decree would, in and of itself, constitute an act tantamount to expropriation. The Decree had the effect of barring forever the operation of the Landfill and The Tribunal was not persuaded by Mexico’s presentation to the contrary. The sole effect doctrine was applied by the tribunal i.e. that the measures taken by Mexico were tantamount to expropriation and that the tribunal needed not to decide or consider the motivation or intent of the adoption of the Ecological Decree.

**Tecmed v. Mexico**

**ICSID Case No. ARB (AF)/00/2 (Mexico/Spain BIT) Award, 29 May 2003**

**Summary:** The Claimant (Tecmed), a Spanish company with two Mexican subsidiaries, brought a claim against Mexico relating to an investment in a waste landfill acquired in a public auction. Tecmed acquired the landfill by public auction and applied for the renewable authorization for the operating licence from the National Ecology Institute of Mexico (INE). The authorization was given to Tecmed and could be extended every year at Tecmed’s request. However, after only two years, the authorization was rejected. Tecmed argued that as a result of this arbitrary and non-substantiated decision of Mexico, the investment was completely lost. This, in Tecmed’s view, constituted expropriation. The Respondent (Mexico) claims that denial of the permit is a control measure in a highly regulated sector and which is very closely linked to public interests. Mexico stresses the negative attitude of the community towards the landfill due to its location and to the negative and highly critical view taken by the community with regard to the way the Claimants company performed its task of transporting and confining the hazardous toxic waste originating in the former lead recycling and recovery plant.

95 Chris Tollefson, "Metalclad v. United Mexican States (Revisited: Judicial Oversight of NAFTA’s Chapter Eleven Investor-State Claim Process," Citation: 11 Minn. J. Global Trade 183 2002, Heinonline) 184-185
The award: The Tribunal found that Mexico’s actions indeed constituted expropriation and that Tecmed should be compensated. The Tribunal concluded that INE’s decision not to renew the license was in fact indirect expropriation, i.e., the investment was permanently deprived of economic value and could not be exploited. By expropriating Tecmed’s investment and not paying an adequate compensation, Mexico violated Article 5 of the actual BIT. The Tribunal found that the Mexican authorities did not keep a reasonable proportionality between the interest protected and the protection of the investor’s rights to its investment. In this regard, the Tribunal considered that although Tecmed had committed breaches of certain environmental regulations, they were not the true reason for the non-renewal of the license. Tecmed had also agreed to relocate the landfill and was waiting for new land that the Mexican authorities would provide.

Commentaries: In order to determine if the denial of the authorization were tantamount to expropriation, the tribunal examined the legitimacy of the aims pursued by the resolution denying the renewal of the licence of the investor. This is traditionally considered to be the first step in proportionality analysis. The tribunal noted that the government resolution did not suggest that the investor’s violations compromised public health, impaired ecological balance or protection of the environment. The tribunal concluded that the resolution was mainly a response to social-political factors arising from community pressure. From a critical point of view is difficult to understand if environmental measures have been considered at all. Tribunals tend to avoid taking bold decisions on such issues. In the actual case tribunal considered that the measures had been adopted for political reasons, as a form of protectionism intent from Mexico, leaving aside a deeper discussion on environmental considerations.

97 Pierre-Marie Dupuy & Jorge E. Vihuales, Harnessing Foreign Investment to Promote Environmental Protection: Incentives and Safeguards (Cambridge University Press 2013) 279
Methanex v. United States
UNCITRAL (NAFTA) Final Award, 3 August 2005

Summary: Methanex, a Canadian Investor raised a claim against the United States of America (the “USA”) for losses cases by the State of California’s ban on the sale and use of the gasoline additive “MTBE”. Methanex was the world’s largest producer of methanol, a feedstock for MTBE. According to Methanex, MTBE is a safe, effective and economic component of gasoline. Methanex also claimed that MTBE was said to, inter alia, produce significant environmental benefit. Methanex claimed that the California ban and regulation of MTBE breached the USA’s obligations under NAFTA 1110 (expropriation) and that Methanex and its investments have incurred loss or damage by reason of, or arising out of, that breach. Methanex’s alleged damages are to a substantial portion of their customer base, goodwill, and market for methanol in California and that the US measures have and will continue to cause substantial downward pressure on the global methanol price. Methanex submits that this was tantamount to expropriation. It also submitted that the various exceptions listed in Article 1110 had been met, i.e. the host states measures were not intended to serve a public purpose, were not in accordance with due process of law, and that no compensation had been paid.

The award: The arbitral tribunal stated that no direct nor indirect expropriation had taken place. Methanex had not established that the ban was tantamount to expropriation, even though the tribunal agreed with Methanex that an intentionally discriminatory regulation against a foreign investor is a key requirement for establishing expropriation. However, the tribunal stated that as a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and, which affects a foreign investor is not consider to be expropriatory and compensable unless specific commitments had been given by the host state to the foreign investor contemplating investment that the government would refrain from such regulation. The tribunal stated that no such commitments were given to Methanex and that it was widely known that governmental environmental and health protection institutions continuously monitored the use and impact of chemical compounds and commonly prohibited or restricted the use of some of those compounds for environmental and/or health reasons. Indeed, the very market for MTBE in the United States was the result of
precisely this regulatory process. Hence, Methanex’s central claim of expropriation under one of the three forms of requirements in that provision fails. From the standpoint of international law, the California ban was a lawful regulation and not an expropriation.

Commentaries: Even though not expressly stated in the award, the approach taken by the tribunal is that if the measure taken by the host state qualifies as a “non-discriminatory regulation for public purpose” under due process, it is not tantamount to an indirect expropriation i.e. that the effect the measures has on the investor and its investment is irrelevant. This means that not every measure that impacts the investment in a negative way is an expropriation. The degree of interference to the investment is key for the tribunal to determine if the measure is viewed as tantamount to expropriation. In the actual case, the tribunal asserted that the USA had not made a specific commitment to the investor, and that the investor could therefore not have expected the host state to refrain from such regulation. Have it been the contrary i.e. that the host state has made a specific commitment, the regulation could have be found to be tantamount to an indirect expropriation.98

7. Environmental regulations and investment protection

First of all, the agreements between the parties are in most cases very vague or non-existing. This makes it difficult for the arbitration courts to apply the law to the particular facts of the case. Second, in most cases environmental issues raises competing scientific claims, that can be difficult for international arbitrators, not specialized in the field, to decide upon. Third, environmental claims are rarely raises in isolation of other legal instruments, which lead to difficulties in the evaluation of environment issues and to difficulties for not specialized arbitrators to agree upon the substantive areas of law. Fourth, there is no common understanding of the general legal and political hierarchy of environmental objectives i.e. that not all countries, and even regions have the same priorities.

98 Fiona Marshall with contributions from Aaron Cosbey and Deborah Murphy, ‘Climate change in investment agreements: Obstacles and opportunities’, International Institute for Sustainable Development (IISD), Published by the International Institute for Sustainable Development (March 2010) 47-48, 50
concerning the environment. Lastly as a fifth factor, some States are hesitant to refer environmental dispute to international arbitration. This due to avoid international conflicts. They rather want international adjudicatory mechanism that regulate these issues and national systems of administrative character.99

7.1 Under what conditions may a State regulation for environmental purposes be deemed tantamount to indirect expropriation?

NAFTA tribunal as well as other tribunals, apply certain criteria’s in order to strike a balance between the investors right to protection and the host states right to regulate in the public interest. Although every case is different and has to be judge under its own merits, the tribunals take into consideration, inter alia, the duration of the investment and the effect of the expropriatory measure.102 There are here three lines of reasoning on regulatory expropriations that define the state’s power to regulate in the public interest. The first line is that regulations made in good faith do not exempt the government from its obligations under the investment treaty and its expropriation provisions. Tribunals have in most cases been reluctant to examine the motivations behind the environmental measures, as in the case of Metalclad, where the tribunal stated that the environmental decree constituted an expropriation and that it did not need to consider the intent of the adoption104 i.e. that it didn’t matter if the measure was made in good faith. The sole effect doctrine was applied in the actual case, where the tribunal stated that the measures taken by Mexico were tantamount to expropriation and the tribunal needed not to decide or consider the motivation or intent of the adoption of the Ecological Decree105. Since it’s reasonable to think that almost all regulatory measures leading to indirect expropriation are made for a public purpose, investor-friendly proponents to the sole effect doctrine and this line of thinking argue that the purpose, whether it’s for

102 Mary E. Footer, 'Bits and Pieces: Social and Environmental Protection in the Regulation of Foreign Investment ' (Michigan State Journal of International Law Vol. 18:12009) 41-42
105 ICSID Case No. Arb/AF/97/1 (NAFTA) Award, 30 August 2000
environmental objectives or other public interests, should not be taken into account.\textsuperscript{106} The police powers exception is totally ignored here, it does not either matter if the expropriation is lawful or unlawful, it should always be followed by “adequate, effective, and prompt” compensation according to international law. The lawfulness of the expropriation is very important for the nature of the remedy and the valuation of compensation and damages. This is however a questions outside the scope of this thesis and therefore not to be discussed here.

In contrary to the first approach, the second line of reasoning acknowledge the state’s sovereignty and its power to regulate, in so far that environmental measures do not constitute an expropriation and are therefore not either compensable.\textsuperscript{107} Nevertheless, in real practice and as already discussed in this thesis, some of the clauses regularly used in investment treaties restrict the government’s ability to make political choices, at least as far as environmental measures are concerned.\textsuperscript{108} Defining the police power exception’s scope is therefore essential to determining whether states can legislate in the public interest, even if when doing so conflicts with investor rights.\textsuperscript{109} This is why a proportionality analysis should be applied in order to show that the measures are in fact expropriatory. This was the case of \textit{Tecmed} where the tribunal examined if the measures taken by Mexico for the public interest were proportional to the protection granted to the investments. The tribunal also stated that it may be reasonable for nationals to bear a greater burden since foreign investors cannot participate in the host-states democratic processes that give rise to the measures taken. The police power exception can therefore under this second line of reasoning only be invoked when a proportionality analysis have been made.\textsuperscript{110} States could under this line of reasoning defend themselves against the investors claim and not be found liable for a measure with expropriatory effect, by

\textsuperscript{106} Peter D Isakoff, ‘Defining the Scope of Indirect Expropriation for International Investments’ (The Global Business Law Review Law Journals 2013) 199
\textsuperscript{110} Ibid, 794-795
explaining that the measure taken in the public interest was legitimate and that the act was neither discriminatory not arbitrary.\footnote{111}{Christina L. Beharry & Melinda E. Kuritzky, `Going Green: Managing the Environment Through International Investment Arbitration’ (American University International Law Review Volume 30 | Issue 3 Article 2, 2015) 397-398}

The third line of reasoning suggest that arbitration disputes of this kind, always should be decided in favour of the environment. In \textit{Methanex} the Tribunal concluded that measures taken for public purposes, under due process and not discriminatory, did not constitute an expropriation. This is a much broader interpretation of the police power exception mentioned above where public purpose is allowed to affect investments only if compensation if paid.\footnote{112}{Barnali Choudhury, `Recapturing Public Power: Is Investment Arbitration’s Engagement of the Public Interest Contributing to the Democratic Deficit?’ (Vanderbilt Journal of Transnational Law, Vol. 41:775, 2008) 796} The purpose of the state is therefore of relevance in this third line of thinking. If the public purpose if for legitimate reasons, as e.g. the environment, the tribunals in ISDS disputes will have to determine if the measure taken is suitable to achieve the purpose of the measure. In practice the majority, not to say all, of environmental measures taken by the state will be for legitimate purposes in the public interests.\footnote{113}{Benedict kingsbury, `Public Law Concepts to Balance Investors’ Rights with State Regulatory Actions in the Public Interest – the Concept of Proportionality’ (in Stephan W. Schill (ed), International Investment Law and Comparative Public Law, Oxford Scholarship Online 2010) 86} Applying this line of reasoning to this kind of environmental disputes will therefore never, if no other measures are suitable, lead to compensation, even though the measures can be seen as tantamount to indirect expropriation.

It’s crucial for future development of the ISDS system, when dealing with issues relating to environmental concerns, to find a clear standard for identifying indirect expropriation.\footnote{122}{Peter D Isakoff, `Defining the Scope of Indirect Expropriation for International Investments’ (The Global Business Law Review Law Journals 2013) 203} Otherwise, Tribunals may continue to hold that the purpose of the regulation tantamount to indirect expropriation is irrelevant, or that it should be in proportion to the effect of the measure, or that it does not amount to a compensable interference.\footnote{123}{Barnali Choudhury, `Recapturing Public Power: Is Investment Arbitration’s Engagement of the Public Interest Contributing to the Democratic Deficit?’ (Vanderbilt Journal of Transnational Law, Vol. 41:775, 2008) 807} Among the suggestions for a clear standard an line of reasoning, are that the tribunal only recognize indirect expropriation when the regulatory measures
by the states substantially deprived the investor from its investment. With substantially deprivation meaning that the investor cannot make economic use and enjoy its investment.\textsuperscript{124} In the case of \textit{Tecmed} the Tribunal examined in its expropriation analysis whether Tecmed was radically deprived of the economical use and enjoyment of its investments. As if the rights related, such as the income or benefits related to the Landfill, had ceased to exist.\textsuperscript{125} If the claim amounts to a substantial deprivation, the second step should be to and consider if the measure taken by the state was reasonably predictable to the investor.\textsuperscript{126} It can however be difficult for a foreign investor to predict if the government is going to shift its own environment regulations and it can therefore be argued that the investor doesn’t have to expect changes if the investor has been persuaded by a government to make an investment.\textsuperscript{127}

The second step in this so called two-steps suggestion falls into the scope of legitimate expectations and the FET standard. In the case of \textit{Metalclad} the tribunal focused, inter alia, on the investors reasonable reliance on the permits from the municipality and obtained regulatory assurances from different governmental representatives, which would lead to a presumption against indirect expropriation. This, since investment protection is not an insurance policy and investor must bear the risk associated with a business. Compensation would be awarded if the measure taken by the state was not reasonably predictable after due diligence.\textsuperscript{128}

7.1.1 Conclusion
To identify the scope of indirect expropriation in cases involving environmental protection is not an easy task. As we have seen, not all measures that deprive the investor of the enjoyment of its property are deemed to be tantamount to indirect expropriation, even if they affect the investment in a negative way. In \textit{Methanex}

\textsuperscript{124} Peter D Isakoff, ‘Defining the Scope of Indirect Expropriation for International Investments’ (The Global Business Law Review Law Journals 2013) 203
\textsuperscript{125} Técnicas Medioambientales Tecmed S.A, v. United Mexican States, (ICSID Case No. ARB (AF)/00/2) (Mexico/Spain BIT) Award, 29 May 2003
\textsuperscript{126} Peter D Isakoff, ‘Defining the Scope of Indirect Expropriation for International Investments’ (The Global Business Law Review Law Journals 2013) 203
\textsuperscript{128} Peter D Isakoff, ‘Defining the Scope of Indirect Expropriation for International Investments’ (The Global Business Law Review Law Journals 2013) 202-205
e.g. the Tribunal concluded that measures taken for legitimate environmental purposes, did not constitute an indirect expropriation. In other words, if the measures are not legitimate they will be deemed tantamount to indirect expropriation. It is however important that the states’ right to regulate don’t become a disguise for protectionism, which can be an argument against this line of reasoning, since all environmental regulatory measures tantamount to indirect expropriation are made for a legitimate public purpose. This is why investment-friendly proponents only consider the effect of the expropriatory measure under the sole effect doctrine.

Even if the arbitral tribunal would acknowledge the States’ rights to regulate for environmental purposes, the regulatory measures could be deemed tantamount to indirect expropriation only after a proportionality analysis. Some suggestions have been mentioned in order to balance the environmental regulations in the public interest with investment treaty arbitration and to find the scope of indirect expropriation. The two-step suggestion is the most interesting approach in order to balance between the parties competing rights. Under this approach a state regulation for environmental purposes is deemed tantamount to indirect expropriation only if the investor was substantially deprived of its investment and the measure taken by the state was not reasonably predictable to the investor.

7.2 Should environmental regulations tantamount to indirect expropriation be compensable?

The discussion that arises in the issue of compensation is if measures intended to protect environmental requirements are lawful measures, even if they interfere with the private property of an investor. Conflicts between the protection of individual property rights and environmental requirements haven been raised in case law under the European Convention for the protection of Human Rights, where the first protocol provided for the rights of every natural or legal person to the enjoyment of its possessions. However, when dealing with foreign investments, the ECHR leaves the issue to be determined by the rules of international law. The ECHR has stated that protection of the environment is an increasingly important consideration and that the right to compensation implied in article 1 of the first protocol, does not
guarantee full compensation. Instead, legitimate objectives that justify environmental measures have to be taken into consideration in order to achieve a fair balance between the environmental requirements and the private property rights.

Investors and lenders argue that any expropriation by the state should result in sufficient compensation from the state to ensure that the investor is in no worse a position than if the expropriation by the state had not taken place. However, from case law the general trend is for the expropriating state either to seek to justify its expropriation of the asset and thereby not pay any compensation, or claim that no expropriation has taken place and therefore no compensation is due, such as in *Metalclad v Mexico*. As seen, State regulatory measures can sometimes transcend police power and rise to the level of indirect expropriation. However, the difficulty lies in distinguishing between non-compensable regulation and compensable expropriation. In *Methanex* the tribunal concluded that regulations for public purposes are not compensable, even if they affect foreign investment. As a result, the compensability criteria established by the police-power exception in international law could be changing in practice i.e. that regulatory measures in the public interest, even if they lead to indirect expropriation are non-compensable. This form of regulatory taking, or indirect expropriation, allows the state to give effect to environmental measures, without having to compensate, even if it deprives the investor of its investment. Following Methanex, the Tribunal in *Saluka* had a similar reasoning, stating it was now established in international law that a State is not liable to pay compensation for expropriation when it exercises its regulatory powers.

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129 “Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by general principles of international law” See Philippe Sands, ‘Litigating environmental disputes: Courts, tribunals and the progressive development of international environmental law’, (Session 2.2.: The policy framework for investment: the social and environmental dimensions, Global Forum on International Investment, 27-28 March 2008) 8

130 Philippe Sands, ‘Litigating environmental disputes: Courts, tribunals and the progressive development of international environmental law’, (Session 2.2.: The policy framework for investment: the social and environmental dimensions, Global Forum on International Investment, 27-28 March 2008) 7-8


132 Mary E. Footer, ‘Bits and Pieces: Social and Environmental Protection in the Regulation of Foreign Investment’ (Michigan State Journal of International Law Vol. 18:12009) 40
powers in a non-discriminatory manner and take regulations in good faith for public purposes.\textsuperscript{136}

There are scholars proposing that only direct expropriation, involving a physical taking e.g. governmental controlling or nationalization should be compensable as expropriation. This drastic proposal is said to have the advantage of making no difference between foreign and domestic investors, since the indirect expropriation provisions in international law only makes it possible for foreign investors to seek compensation. By limiting compensation to direct expropriation, states would be allowed to take regulatory measures in the public interest for environmental objectives without fear of claims from the investor for indirect expropriation.\textsuperscript{137} The relevant question to ask is why the investor would agree with such terms or what the incentives for investing are? There are of course other situations beside good faith regulations in the public interest that can lead to an indirect expropriation. However, following the Methanex tribunal, one condition could be a reverse approach to the police power exception i.e. that measures that are unlawful, discriminatory and arbitrary and that deprive the investor from its investment are tantamount to direct expropriation and compensation.

7.2.1 Conclusion

When a state regulatory measure rise to the level of indirect expropriation it is important to determine if the investor should be compensated. In Methanex e.g. the tribunal concluded that regulations for public purposes are not compensable, even if they affect foreign investment in a negative way. To follow the two-step suggestion also regarding compensation, can be of help when determining if environmental regulations tantamount to indirect expropriation should be compensable. Compensation should be awarded if the investor was substantially deprived of its investment and the measure taken by the state was not reasonably predictable after due diligence i.e. that the state has the obligation to compensate for measures tantamount to indirect expropriation even if they are for legitimate environmental purposes in the public interest.

\textsuperscript{136} Gebhard Bücheler, ’Proportionality in Investor-State Arbitration’ (Published to Oxford Scholarship 2015) 128

\textsuperscript{137} Peter D Isakoff, ’Defining the Scope of Indirect Expropriation for International Investments’ (The Global Business Law Review Law Journals 2013) 200-201
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