Submission in respect of the *Trade and Foreign Investment (Protecting the Public Interest) Bill 2014*

A. Introduction

The *Trade and Foreign Investment (Protecting the Public Interest) Bill 2014* (the ***Bill***) should not be passed. Its attempt to prohibit the Government from entering into trade and investment treaties that contain Investor-State Dispute Settlement (***ISDS***) provisions is misconceived. The Bill will, if enacted, harm Australia's interests both as a capital importer and a capital exporter.

There are both benefits and detriments that flow from ISDS clauses. The main detriment is that Australia may be subject to ISDS claims by treaty-covered foreign investors. But even if such claims are made, that does not mean they will succeed, and in any event the cost they represent can only amount to a fraction of the benefit Australia enjoys by including ISDS provisions in its trade and investment treaties. The main benefits Australia receives are, first, that Australian investors are protected by ISDS clauses when they do business abroad, and, second, the legal framework for foreign investment in Australia remains aligned with international best practice, which in turn promotes and attracts foreign investment.

The Government's current policy of considering the inclusion of ISDS provisions on a case-by-case basis should be maintained without legislative impediment. The Government has a range of negotiating strategies available to address Senator Whish-Wilson's apparent concerns. In particular, the Government can negotiate for the inclusion of interpretive provisions that clarify the substantive protections and standards of treatment granted under the treaty or condition access to ISDS procedures.

Imposing a blanket ban on ISDS clauses is neither sensible nor necessary, and would put Australia in the unlikely company of a small group of countries that have rejected ISDS (examples being Venezuela, Ecuador and Bolivia). It would also depart from the current treaty practice of Australia's major regional trading partners, including the Association of South East Asian Nations (***ASEAN***) and the People's Republic of China, which is to include ISDS clauses in investment treaties.

Finally, consideration must be given to the unique contribution that the ISDS system has made - and continues to make - to the promotion of the international rule of law. As the former President of the International Court of Justice, Judge Stephen Schwebel, said in his 7 April 2014 keynote address to the International Council of Commercial Arbitration, to cast aside the ISDS system now would be "*one of the profoundest misjudgements ever to afflict the procedures of peaceful settlement of international disputes*".

B. General Comments on the Bill

1. Rationale of ISDS clauses

ISDS clauses give trade and investment treaties teeth. The investor's right to arbitrate against the state in which its investment is made (***host state***) makes the substantive rights and protections of an investment treaty enforceable. Take ISDS provisions away, and the investor has two options for the enforcement of its treaty rights: first, the investor can commence proceedings against its host state in the host state's own courts; second, the investor can ask the state from which it originates (***home state***) to take steps on its own behalf (either in the form of diplomatic protection or formal state-versus-state dispute resolution proceedings).

Option one – action in the local courts – is no good because the sovereign risk of the decision maker is the same as the sovereign risk of the defendant (the host state). Regardless of whether or not the foreign investor actually suffers from "home town justice" (or bias in favour of the home state), the *perception* of this adjudicatory risk is real. It is this perception that is reflected in sovereign risk. Put another way, even if (as in Australia) the courts of the host state dispense a high quality of justice, they are still perceived by many foreign investors (and their financiers) to be riskier than a neutral, international tribunal. So, when the investor has only local courts to turn to, the sovereign risk of its investment is relatively higher, and this makes the financing of its investment more costly. Without ISDS, foreign investment is more expensive. As an investment destination, Australia is expensive enough.

Option two – home state assistance through diplomatic channels – is defective for other practical reasons. First and foremost, the availability of diplomatic assistance depends upon the willingness of the home state to engage. Few businesses are big and important enough to expect their home state to weigh in on their behalf, especially where significant bilateral relationships are involved. Further, the people of the home state rarely have an interest in their government fighting on behalf of specific private entities doing business abroad. It would be wrong, therefore, to think that investors take comfort in the possible availability of diplomatic protection. Moreover, even if a diplomatic settlement is reached, the investor still has no direct entitlement to any compensation paid under that settlement. The payment of the settlement amount is at the home state's complete discretion. In reality, the remote possibility of home state protection is no substitute for the certainty of direct recourse that ISDS provisions give investors.

Attached is a chapter from a book co-written by one of the authors of this submission. This chapter explains the general legal framework of investor-state arbitration, which is the mechanism to which most ISDS provisions refer.

2. Australia must be able to accept ISDS even though it has low sovereign risk

ISDS provisions are typically intended to protect investors doing business in countries with high sovereign risk. Where a treaty is signed between two countries that both have similar and low sovereign risk, the negotiators may not consider it necessary to include an ISDS clause. This is why, for example, the United States-Australia Free Trade Agreement does not include an ISDS clause. But this parity of sovereign risk is relatively rare. The far more common scenario is one in which there is a significant *disparity* in the sovereign risk of the states that are negotiating the treaty. In this situation, the low sovereign risk state will have a strong interest in obtaining ISDS protection for its nationals when they invest in the high sovereign risk state. To secure that essential protection for its investors, it will almost always be necessary for the low sovereign risk state to agree to a reciprocal ISDS clause, i.e. an ISDS clause that allows *both* contracting states to be sued, not just the high sovereign risk state. So Australia must remain open to the inclusion of ISDS clauses even though it has low sovereign risk and reliable courts.

3. Reality of Australia's investment arbitration experience

ISDS provisions, like nearly all of the provisions of an investment treaty, cut both ways. Australia is more often the beneficiary of ISDS provisions than the respondent to claims under them. Based on publically available information, the ISDS provisions of Australian investment treaties have been formally invoked in five cases (*Tethyan Copper v Pakistan, Planet Mining v Indonesia, White Industries v India, African Petroleum Gambia Ltd (Block A4) v Gambia* and *Philip Morris Asia Limited v Australia*).

The current record is, therefore, four claims *by* Australian investors to one claim *against* Australia. In policy terms, it would be a mistake to make too much of that one case against Australia, especially given that it is yet to be decided. It is also significant to note that, of the four claims brought by Australian investors against foreign host states, all related to activities in the energy and resources sector – an area in which a growing number of Australian companies operate internationally.

4. Importance of the ISDS system to the international rule of law

No system of justice is perfect, nor will it ever be. The investor-state arbitration system (to which ISDS clauses usually refer) has its issues, but it is still young. On any view, it is a lot better than what we had before. The very fact that there is a growing dialogue about ISDS and state rights shows how effective the system has been at promoting respect for the international rule of law – if this was not the case, states would simply ignore awards against them. We all have an interest in promoting the rule of law and leaving behind the days of "gunboat diplomacy". It is critical that countries like Australia remain active participants in the investment treaty system (and, in the rare event they are sued, the ISDS process), both for this reason and reasons of their own national interest.

5. The Bill poses a threat to Australian trade

Without the ability to accept ISDS provisions in future agreements (including the Trans-Pacific Partnership Agreement), Australia's trade and investment treaty program will stall. While the Australian treaty program currently covers a reasonable range of countries, it provides only limited protection for other regions that will be important to Australian trade in the future. For example, treaty coverage is currently lacking for certain emerging markets in

Africa, where sovereign risk is high. ISDS-backed treaties are needed to promote Australian investment in these developing countries.

C. Specific Comments on the Second Reading Speech

1. Allocation of sovereign risk

In the Second Reading of the Bill on 5 March 2014, Senator Whish-Wilson said that:

> "[…] *risk is part of doing business. The purpose of ISDS clauses is to push more of that* [sovereign] *risk onto governments and away from corporations*".

Risk certainly is part of doing business. If the risks of doing business in Australia are too high, investors will go elsewhere (capital being increasingly mobile). Investment treaties generally (and ISDS clauses specifically, as key features of them) allow investors to price and carry sovereign risk in an affordable way. In other words, where an investor is covered by an enforceable investment treaty, it is able to effectively self-insure against sovereign risk. The risk associated with any given state measure is only allocated to the host state if the investor opens an ISDS procedure and prevails.

2. Availability and implications of WTO dispute resolution

In arguing that ISDS provisions are not necessary, the Senator has referred to the plain packaging case (*Philip Morris Asia Limited v Australia*) and the fact that the same measure has been challenged in the World Trade Organisation (***WTO***) by Ukraine, Honduras and the Dominican Republic. The Senator has said:

> "[…] *the World Trade Organisation's mechanisms are being used to dispute* [plain packaging]; *there are clearly mechanisms in place to appeal decisions. The case for why an additional avenue of litigation needs to be established in this area has not been made.*"

This statement fails to recognise that the WTO and investment treaty systems are quite different. First, the WTO system is for states. Unlike arbitrations commenced under ISDS provisions, private parties have no standing to make WTO claims or complaints. Second, the WTO deals with cross-border trade in goods and services, not cross-border investments. There is some overlap between the WTO and the investment treaty systems (intellectual property protection being an example), but not so much that the WTO could be said to offer an "additional avenue of litigation" for private investors.

Further, it is hard to see how the Australian public could have any interest in encouraging private parties to seek the indirect prosecution of their claims in the WTO system, in which Australia's multilateral trade relations are implicated. Rather, the interests of the Australian public would be better served by *limiting* the impact of investment disputes.

3. Costs of ISDS procedures

The Senator has also said that:

> *"Even if it were true, that in the majority of cases signatory governments do win ISDS cases brought against them, there is still the cost that governments must bear to defend their cases."*

Where a state has to defend itself in an ISDS procedure, the costs of defence comprise mostly legal fees. The host state is likely to incur significant legal expenses even without ISDS, because it will either have to defend itself in its own courts or respond to measures taken by the investor's home state, or both. So, for the host state, investment disputes carry cost consequences in any event, and these costs are higher when the dispute plays out in multiple forums. ISDS is, in contrast, a single procedure.

However, the main cost benefit of ISDS is macroeconomic. As a procedure, ISDS allows the dispute to be resolved in a way that does not require its escalation to the inter-state plane. This is important because, when a dispute does play out on the inter-state plane, the bilateral relations of the host state and the home state may be damaged. ISDS allows states to avoid this risk and the shorter-term costs of intervening on behalf of their investors. This cost saving is, by its nature, hard to measure, but it should be taken into account.

Finally, it must also be remembered that, when an investor brings an ISDS claim and fails, the tribunal has the power to order that the investor pay some or all of the host state's costs of defence. Such costs orders are common.

4. Content of ISDS clauses and "indirect expropriation"

The Senator has also said:

> *"ISDS clauses are designed to allow foreign corporations to sue governments if their business activities and interests are impinged on by the policy and legislative decisions of the government. The key concept which is enshrined in these clauses is the idea of 'indirect expropriation', under which any law or policy of government that reduces the value of the investment is considered harmful."*

The reference here to "ISDS clauses" is misunderstood. ISDS provisions are procedural and not substantive in nature. They are designed to provide a means by which the covered investor may enforce the substantive protections and standards of treatment accorded to it under the treaty. ISDS clauses are, therefore, provisions of general application. The rules concerning expropriation (direct and indirect) are the subject of specific substantive provisions of the treaty. If the Senator's concern is with the principle of 'indirect expropriation', then the Bill should speak to the expropriation standard, not ISDS.

Even if indirect expropriation is the concern, legislative action is not needed because, in future treaty negotiations, it is open to Australia to push for special rules for the qualification of a measure as an act of indirect expropriation. Australia has good experience in this regard.

An example is the ASEAN-Australia-New Zealand Free Trade Agreement (***AANZFTA***). The investment chapter of AANZFTA contains an Annex on Expropriation and Compensation. Paragraph 2(b) of this Annex clarifies that the expropriation provision includes situations "*where an action or series of related actions by a Party has an effect equivalent to direct expropriation without formal transfer of title or outright seizure*", i.e. indirect expropriation. However, paragraph 4 of the Annex provides as follows:

> *"Non-discriminatory regulatory actions by a Party that are designed and applied to achieve legitimate public welfare objectives, such as the protection of public health, safety, and the environment do not constitute expropriation of the type referred to in Paragraph 2(b)."*

Many countries are now taking similar approaches to the drafting of expropriation clauses, particularly in multilateral treaty negotiations. The same can be done with ISDS clauses. Conditions can be (and often are) attached to the investor's right to resort to ISDS procedures under the treaty. Such conditions include "cooling off" periods for negotiations, the requirement that the investor first exhaust local remedies for a period of time and the exclusion of certain subject matters from determination by arbitration.

5. Regulatory chill

The Senator has also said:

> *"The influence of ISDS goes beyond the direct impact of cases. In their 2010 report the Productivity Commission identified the phenomenon of 'regulatory chilling.' In other words ISDS provisions mean governments second guess themselves on whether a public policy initiative will cause an arbitration claim to be made against them by a foreign corporation."*

Regulatory chill is a complex thesis and is, as many of its proponents would concede, still being developed. Studies in the field have moved on considerably from when the Productivity Commission released its report in 2010. Empirical evidence for the phenomenon is, however, still lacking. But that does not mean it should be dismissed, only that more work needs to be done before regulatory chill can be considered a reliable policy premise.

At the moment, the best evidence for regulatory chill is anecdotal. There have been cases where, faced with claims under ISDS clauses, states have backed down, and arguably legitimate measures have – rightly or wrongly - been reversed (Australia is not an example). But settlements are a feature of every dispute resolution system, and the terms of settlements naturally vary from case to case. It would be wrong to suggest that settlements necessarily represent victories for the investor.

Further, as the 42% rate of state victory cited by the Senator shows, states have good chances of successfully defending legitimate public interest measures in an ISDS process. In defending measures they have taken in the public interest, states have a range of international law principles and doctrines at their disposal, including rules against abuse of process, limitations on the types of investments given protection, the defence of necessity, statefriendly readings of the fair and equitable treatment standard and rules for the review and annulment of ISDS tribunal decisions. Again, it is open to Australia to continue to negotiate for the inclusion of provisions that clarify, codify or expand these rules and principles in future trade and investment treaties, as it did in the AANZFTA.

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Dr Sam Luttrell

Dr Romesh Weeramantry

CLIFFORD CHANCE