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An Appraisal of Indirect Expropriation

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Preface and Acknowledgements

In 2000 the residents of Cochabamba in Bolivia led an unprecedented protest that came to be known as the 'Cochabamba water war'. The trigger was the privatisation of the public water services provider – SEMAPA – and the sudden and extreme rise of water tariffs that came after a private foreign service provider took over. As a result, the government cancelled the concession contract it had made with Aguas del Tunari S.A., a foreign investor who would then initiate an investment treaty arbitration, alleging that Bolivia had failed to protect its investment in accordance with international treaty obligations.

The case was finally settled between Bolivia and the foreign investor and the rest is history. However, the repercussions of this event are significant, both to the legitimacy of the investment arbitration regime, as well as for advocates and water academics. As a former resident of Cochabamba I am no stranger to water shortages; yet, as a legal officer at the regulatory system for public utilities during the conflict, I have understood, with time, that the problem neither started with the privatisation process, nor would it end with the termination of a concession contract. During the course of writing this book, Cochabamba continues to suffer from water scarcity and still lacks the proper infrastructure to supply water services to its citizens.[1]

As it was eloquently put by the United Nations in 2006 'there is enough water for everyone. The problem [...] is largely one of governance'.[2] In essence this is a book about governance and how international tribunals ought to allocate risk when governance fails, especially in the context of water resources-related disputes. While international investment law seeks stability, water law strives for adaptability. In the context of investment treaty arbitration, this tension plays out as a balance between the need for predictability on the one hand and the need for change on the other. However, the theoretical underpinnings and intrinsic interrelation between these two areas of law strike me as an unlikely friendship. It is difficult to get the balance right. For many years I have been interested in observing how these two regimes interact and whether they could achieve mutual supportiveness, from a developmental as well as legal

1 El sueño de Misicuni aún requiere más inversiones' available at: http://www.lostiempos.com/actualidad/local/20160410/sueno-misicuni-aun-requiere-mas-inversiones, visited on 10 July, 2016.

2 World Water Assessment Programme, 'The United Nations World Water Development Report 2: Water a Shared Responsibility,' (United Nations, 2009) 3.

perspectives. Yet, the absence of communication and exchange between epistemic communities weakens decision-making and prevents holistic solutions. Domestic public law experts (such as water lawyers) are not always aware that their decisions might have repercussion under international law and could become under the scrutiny of international arbitrators and judges. In turn, international investment tribunals often feel little connection to the domestic realities and pressures under which local decisions are adopted, nor do they have the mandate under international law to incorporate such considerations.

The focus of my work has been to determine the extent to which these two distinct communities might better understand one another. I have focused on the issue of indirect expropriation, as it allows for a comprehensive reflection of States' regulatory practice. While it is argued that expropriation has been largely studied, in the last ten years I have observed further developments which are worth close examination.

In this process I have been privileged with the opportunity to interact with both the investment law and water law communities, as a government official and later as an academic. The University of Dundee where I started this project, and the University of Edinburgh where I am concluding it, have been a source of enriching debate. Of course several other academic communities have had an impact on my ideas, stimulated my thinking and ultimately contributed to this work. I am indebted to colleagues, research assistants, family and friends around the world, especially to Dr Daniel Behn from the University of Oslo.

Abbreviations

CAA	Aguas de Aconquija from Argentina
BIT	Bilateral Investment Treaty
CAFTA	Central American Free Trade Agreement
COMESA	Common Market for an Eastern and Southern African Investment Agreement, Common Investment Area
DR-CAFTA	Dominican Republic-Central American Free Trade Agreement
ECT	Energy Charter Treaty
ECHR	European Court of Human Rights
EU	European Union
CETA	EU-Canada Comprehensive Economic and Trade Agreement
FET	Fair and Equitable Treatment
FAO	Food and Agriculture Organisation
FIPA	Foreign Investment Promotion and Protection Agreement
FTA	Free Trade Agreement
GATT	General Agreement on Tariffs and Trade
GATS	General Agreement on Trade in Services
GWP	Global Water Partnership
TEC	Global Water Partnership Technical Committee
GDP	Gross Domestic Product
HDI	Human Development Index
IWRM	Integrated Water Resources Management
ILC	International Law Commission
ICSID	International Centre for Settlement of Investment Disputes
ICC	International Chamber of Commerce
ICA	International Court of Arbitration
IISD	International Institute for Sustainable Development
IIA	International Investment Agreement
ITA	International Taxation Agreement
ITLOS	International Tribunal for the Law of the Sea
IWRA	International Water Resources Association
IUSCT	Iran–US Claims Tribunal
LCIA	London Court of International Arbitration
MTBE	Methyl tertiary-butyl ether
MDGs	Millennium Development Goals
MPI	Multidimensional Poverty Index

MAI	Multilateral Agreement on Investment
NIEO	New International Economic Order
NGO	Non-Governmental Organisation
NAFTA	North American Free Trade Agreement
OECD	Organisation for Economic Cooperation and Development
PCA	Permanent Court of Arbitration
PCIJ	Permanent Court of International Justice
PSNR	Permanent Sovereignty over Natural Resources
PDVSA	Petróleos de Venezuela S.A.
PSA	Product Sharing Agreement
PPP	Public Private Partnership
Helsinki Rules	Rules on the Uses of the Waters of International Rivers
S.A.	Sociedad Anónima
SCC	Stockholm Chamber of Commerce
TPP	Trans-Pacific Partnership
TTIP	Transatlantic Trade and Investment Partnership
UN	United Nations
UNCED	United Nations Conference on Environment and Development
UN Watercourses Convention	United Nations Convention on the Law of the Non-Navigational Uses of International Water Courses
UNICEF	United Nations Children's Emergency Fund
UNCTAD	United Nations Conference on Trade and Development
UNEP	United Nations Environment Programme
WWDR	United Nations World Water Development Report
UK	United Kingdom
US	United States
VCLT	Vienna Convention on the Law of Treaties
WHO	World Health Organisation
WTO	World Trade Organization
WWDR	World Water Development Report

Contents

CHAPTER 1

Introduction

1.1 Introduction

As the law evolves, expands and specialises, the overall normative coherence of particular legal orders can become more elusive. This increases the likelihood for potential conflict arising between different regimes or areas of law, such as water law and international investment law. On the one hand, water laws and policies are increasingly moving towards a holistic and adaptive approach to the management of water resources. International investment law, on the other hand, covers the obligation to protect foreign investment through stable and predictable legal environments, by means of international investment agreements.

To date, any conflict between the epistemic communities of water and investment law has been engaged, by necessity, in the context of disputes arising out of international investment obligations. International investment law, and not water law *per se*, constitutes the applicable law to decide potential conflicts between the regulation of water resources and the obligation to protect foreign investment. The proliferation of investment treaties has given rise to specific dispute settlement mechanisms granting jurisdiction to handle investment disputes. In contrast, the fields of international environmental and water law have somewhat less cohesive dispute settlement mechanisms embedded in their respective treaties.

At the end of the 1980s and during the early 1990s, the field of international investment law witnessed an explosion of Bilateral Investment Treaties (BITs) and other International Investment Agreements (IIAs).[1] By the early 2000s, there was an upsurge in the initiation of disputes granted jurisdiction under these BITs and Free Trade Agreements (FTAs) with investment chapters. International investment disputes allow a private foreign investor to initiate binding arbitration against the State hosting their investment. To date, these cases have been brought primarily under the International Centre for Settlement of Investment Disputes (ICSID) Convention or ad hoc arbitrations under the United Nations Commission on International Trade Law (UNCITRAL) arbitration rules. Increasingly, investment disputes are also brought under the rules of

1 UNCTAD reports that by July 2016, there is a total of 3316 IIAs, between BITs and other investment agreements. See UNCTAD, International Investment Agreements Navigator. Available at: http://investmentpolicyhub.unctad.org/IIA, last visited 5 July, 2016.

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international arbitration centres such as the Permanent Court of Arbitration (PCA), the International Chamber of Commerce (ICC), the London Court of International Arbitration (LCIA), and the Stockholm Chamber of Commerce (SCC).[2]

During the period between the 1990s and the early part of the 2000s, international investment practitioners and commentators were well aware of the potential disputes arising from the exercise of regulatory prerogatives of host States in relation to the promises given to foreign investors. A vast number of academics and practitioners wrote extensively about political and regulatory risk.[3] Perhaps, having observed the Libyan nationalisation cases and the decisions coming out of the Iran – US Claims Tribunal (IUSCT), very few investment specialists believed that IIAs constituted a real threat to the regulation of the environment, health and safety. As Wälde *et al.* noted, as far back as the mid-1990s, Non-Governmental Organizations (NGOs) and other civil society actors might have adopted exaggerated views towards the scope of BITs and their effects over the police power of States.[4]

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2 Up to July 2016 the number of investment treaty disputes reached 696. UNCTAD, Investment Dispute Settlement Navigator. Available at: http://investmentpolicyhub.unctad.org/ISDS, last visited July 1, 2016.

3 Thomas Wälde and Stephen Dow, 'Treaties and Regulatory Risk in Infrastructure Investment. The Effectiveness of International Law Disciplines versus Sanctions by Global Markets in Reducing the Political and Regulatory Risk for Private Infrastructure Investment,' *Journal of World Trade* 34, no. 2 (2000); Thomas Wälde and Todd Weiler, 'Investment arbitration under the Energy Charter Treaty in the light of new NAFTA precedents: Towards a global code of conduct for economic regulation,' *Transnational Dispute Management* 1(2004); Thomas Wälde and Abba Kolo, 'Environmental Regulation, Investment Protection and "Regulatory Taking" in International Law,' *International and Comparative Law Quarterly* 50, no. 4 (2001); Andrew Newcombe, 'The Boundaries of Regulatory Expropriation in International Law,' *ICSID Review* 20, no. 1 (2005); Vaughan Lowe, 'Regulation or expropriation?' *Current legal problems* 55 (2002); L. Yves Fortier and Stephen L. Drymer, 'Indirect Expropriation in the Law of International Investment: I know it when I see it, or Caveat Investor,' *ICSID review: Foreign investment law journal* 19, no. 2 (2004); Howard Mann, 'The Right of States to Regulate and International Investment Law,' in *Expert Meeting on the Development Dimension of FDI: Policies to Enhance the Role of FDI in Support of the Competitiveness of the Enterprise Sector and the Economic Performance of Host Economies, Taking into Account the Trade/Investment Interface, in the National and International Context* (Geneva 2002); Howard Mann and Konrad von Moltke, 'NAFTA's Chapter 11 and the Environment: Addressing the Impacts of the Investor-State Process on the Environment,' *International Institute for Sustainable Development, Publication Centre* (1999); M. Sornarajah, 'State responsibility and Bilateral Investment Treaties,' *Journal of World Trade Law* 20, no. 1 (1986).

4 Thomas Wälde and Abba Kolo, 'Environmental Regulation, Investment Protection and "Regulatory Taking" in International Law,' 814.

Several commentators agreed with the view that regulatory measures aimed at protecting the environment, if adopted in good faith and following due process of law, would hardly be challengeable as violations of relevant provisions in IIAs.[5]

The opposite views challenge the legitimacy of the dispute settlement mechanism in investor-State arbitration, which permits a private foreign investor – a natural person or corporation – to sue a sovereign State before an international arbitral tribunal. Furthermore, the broad provisions on investment protection contained in IIAs have also been criticised. Given their broad scope they are perceived as biased in favour of investors.[6]

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5 *Ibid.* See also Christoph Schreuer, 'The Concept of Expropriation under the ECT and other Investment Protection Treaties,' (2005); Gary H. Sampliner, 'Arbitration of Expropriation Cases under U.S. Investment Treaties: A Threat to Democracy or the Dog didn't Bark?' *ICSID Review: Foreign investment law journal* 18, no. 1 (2003).

6 Celine Levesque, 'Investment and Water Resources: Limits to NAFTA,' in *Sustainable Development in World Investment Law*, ed. Marie-Claire Cordonier Segger, Markus W. Gehring, and Andrew Newcombe, *Global Trade Law Series* (Alphen aan den Rijn: Kluwer Law International 2011); Howard Mann, 'Who Owns "Your" Water? Reclaiming Water as a Public Good under International Trade and Investment Law,' *International Institute for Sustainable Development* (2003); Howard Mann, 'International Economic Law: Water for Money's Sake,' *International Institute for Sustainable Development* (2004); Howard Mann, 'Implications of International Trade and Investment Agreements for Water and Water Services: Some Responses from Other Sources of International Law,' TDM (2006); Hugo A. Muñoz, 'La administración del agua y la inversión extranjera directa ¿Cómo se relacionan?' in *Estudios en homenaje al Dr Rafael González Ballar*, ed. Universidad de Costa Rica (UCR) (San Jose: Isolma S.A., 2009); Miguel Solanes, 'Water Services and International Investment Agreements,' in *Global Change: Impacts on Water and food Security*, ed. Claudia Ringler, Asit K. Biswas, and Sarah Cline, *Water Resources Development and Management* (Berlin/Heidelberg: Springer 2010); Miguel Solanes and Andrei Jouravlev, 'Revisiting Privatization, Foreign Investment, International Arbitration and Water,' *Serie Recursos Naturales e Infrastructura* 129 (2007); Attila Tanzi, 'On Balancing Foreign Investment Interests With Public Interests in Recent Arbitration Case Law in the Public Utilities Sector,' *The law and practice of international courts and tribunals: A Practioners' Journal* 11, no. 1 (2012); Paul Stanton Kibel, 'Grasp on Water: A Natural Resource that Eludes NAFTA's Notion of Investment,' *Ecology Law Quarterly* 34, no. 2 (2007); Joseph Cumming and Robert Froehlich, 'NAFTA Chapter XI and Canada's Environmental Sovereignty: Investment Flows, Article 1110 and Alberta's Water Act,' *University of Toronto Faculty of Law Review* 65(2007); Vivien Foster and Tito Yepes, 'Is Cost Recovery a Feasible Objective for Water and Electricity? The Latin American Experience,' *World Bank Policy Research* Working Paper 3943 (2006); John D. Leshy, 'A Conversation About Takings and Water Rights,' *Texas Law Review* 83, no. 7 (2005); Fabrizio Marrella, 'On the changing structure of international investment law: The human right to water and ICSID arbitration,' *International Community Law Review* 12, no. 3 (2010); Stuart Orr, Anton Cartwright and Dave Tickner, 'Understanding water

One could argue that these two epistemic communities of investment lawyers and environmental/water lawyers do not look at the relationship between water and investment from the same angle. Perhaps they do not share the same values, and the interests to be protected are diverse. It was not too long ago that the investment arbitration regime saw as its mandate the application and enforcement solely of investment obligations, as purported in the relevant agreement, as a clear and strict one. In this light, Hirsh noted:

> thus far no arbitral tribunal has absolved a party to an investment dispute from its investment obligations (or significantly reduced its responsibility to compensate the injured investor).[7]

With reference to the standard of expropriation and compensation, the difficult task was, and still is, to ascertain when the legitimate exercise of the police power of the State, which does not entail compensation, has gone 'too far' and

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risks A primer on the consequences of water scarcity for government and business,' (World Wildlife Fund, 2009); Carin Smaller and Howard Mann, 'A Thirst for Distant Lands: Foreign investment in agricultural land and water,' *International Institute for Sustainable Development. Foreign Investment for Sustainable Development Program* (2009); Paul Stanton and Jon Schutz, 'Two Rivers Meet: At the Confluence of Cross-Border Water and Foreign Investment Law,' in *Sustainable Development in World Investment Law*, ed. Marie-Claire Cordonier Segger, Markus W. Gehring, and Andrew Newcombe, *Global Trade Law Series* (Alphen aan den Rijn: Kluwer Law International, 2011); AquaFed, 'Bilateral Investment Treaties and the Right to Water: The case of the provision of public water supply and sanitation services. (Submission by AquaFed),' in *Office of the UN High Commissioner for Human Rights: Consultation on business and human rights: Operationalizing the 'Protect, Respect, and Remedy' framework on business and human rights* (Geneva 2009); Epaminontas E. Triantafilou, 'No Remedy for an Investor's Own Mismanagement: The Award in the ICSID Case Biwater Gauff v. Tanzania,' *International Disputes Quarterly. Focus: An Arbitrator's Perspective* Winter (2009); Jorge E. Vinuales, 'Access to Water in Foreign Investment Disputes,' *The Georgetown International Environmental Law Review* 21(2009); Jorge E. Vinuales, 'Iced Freshwater Resources: A Legal Exploration,' *Yearbook of International Environmental Law* 20, no. 1 (2011). See also Marie-Claire Cordonier Segger, Markus W. Gehring, and Andrew Newcombe, eds., *Sustainable Development in World Investment Law*, Global Trade Law Series (Alphen aan den Rijn Kluwer Law International, 2011); Edith Brown Weiss, Laurence Boisson de Chazournes, and Nathalie Bernasconi-Osterwalder, eds., *Fresh Water and International Economic Law* (Oxford; New York: Oxford University Press, 2005).

7 Moshe Hirsh, 'Sources of International Investment Law,' in *International Investment Law and Soft Law*, ed. Andrea K. Bjorklund and August Reinisch (Cheltenham, UK; Northampton, MA: Edward Elgar Pub., 2012), 13.

therefore constitutes an act of expropriation. Academics and practitioners in the area of environmental law saw the implementation and continuity of environmental regulation as dependent on the decision of investment tribunals. For this reason, it is arguable that the environmental community might often see international economic law forums (such as investment treaty arbitration and the World Trade Organization (WTO) dispute settlement mechanisms) as a means of converting trade and investment tribunals into environmental tribunals. While this has certainly been the case in the context of investment arbitration, the WTO has faced similar challenges, stimulating to some extent cross-fertilization between the two regimes. In the context of the WTO, some academics have adopted an institutional perspective to illustrate the normative boundaries of the WTO in relation to the applicability or non-applicability of the other fields of law, in their intricate relationships:

> one of the phenomena we observe in relation to WTO law is jealousy on the part of environmentalists, labor rights advocates, human rights proponents and others due to the stronger enforceability and sanctions available with respect to violations of WTO law.[8]

It is incontestable that a balance between the protection of foreign investment and the protection of other societal values is needed to advance economic as well as human development. However, it is a reality that welfare objectives such as environmental, health and safety regulations often constitute the subject matter of investment and trade disputes; and that arbitral tribunals are called upon to scrutinise them. It follows that host States may have to repeal the measure as a way of restitution, or when this is not possible, pay compensation.[9] It should be noted, however, that in most cases, foreign investors seek compensation instead of restitution, because the relationship between investor and State is no longer one of trust and cooperation.

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8 Joel P. Trachtman, 'Transcending "Trade and..." An Institutional Perspective,' *SSNR.* (2001). Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=271171, last visited March 21, 2016. In this article Professor Trachtman coins the term 'penance envy' to argue that not all international law has been created equal, and therefore some fields still lack institutions and enforcement mechanism.

9 This is the principle of reparation adopted in the case of *Chorzów Factory (Germany v. Poland) 1928 PCIJ (ser. A) No. 17.* For an account of remedies in International Law, see for instance Dinah Shelton, 'Righting Wrongs: Reparations in the Articles on State Responsibility,' *Symposium: The ILC's State Responsibility Articles. The American Journal of International Law* 96, no. 4 (2002).

1.2 Initial Thoughts: Water and Investment

The core issues examined in this book pertain to the potential tensions that the protection of foreign investment has created in relation to water resources and its management. A regulatory measure seeking to protect, allocate or prioritise water resources may deprive the investor of his water entitlement, affecting the investment as a whole.[10] This action in turn could be considered as a *de facto* or indirect expropriation.[11] As discussed later in this book, these measures contrast with acts of direct expropriation of the investment, where a shift in ownership takes place, depriving the investor of the title and control over the property rights.

The application of standards of investment protection to secure long-term economic returns on investments, include water licences and permits (water rights) as production inputs from naturally variable water flows. The application of water management principles in turn requires a flexible legal framework to ensure sustainable availability and environmental protection. This approach involves an exploration of two potentially contradictory sets of concepts: *security* and *predictability*, which are at the core of international investment law; and *variability* and *adaptability*, which are inherent to the nature and management of water resources.

The argument develops on the basis of the police power doctrine, or the prerogative of States to regulate, because this doctrine has been consistently recognised by investment tribunals as a legitimate exercise of State's sovereignty. However, the notion of the police power needs to be revisited in the context of its foundations and underlying values. In order for the police power to be reasonably invoked and legitimately applied, there must be a dividing line between an act of indirect expropriation and the adoption of a legitimate regulation, which imposes reasonable burdens on investors.

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10 A comparison could be drawn between 'investment,' as a complex project formed by contracts, licences, concessions, etc., and the 'bundle of rights' formed by sticks representing the enjoyment of each attribute of the property rights. The comparison of the 'investment' with a bundle of rights was proposed for instance in *ATA Construction, Industrial and Trading Company v. Hashemite Kingdom of Jordan,* ICSID Case No. ARB/08/2, Award of 18 May, 2012, para. 96.

11 This work will use the terms indirect expropriation, *de facto* expropriation, and takings indistinctively. However, one can refer to their different conceptions in Veijo Heiskanen (for instance), 'The Contribution of the Iran-United States Claims Tribunal to the Development of the Doctrine of Indirect Expropriation,' *International law FORUM du droit international: The Journal of the International Law Association International Law Forum du droit international* 5, no. 3 (2003).