

Investor-State Dispute Settlement: Myths and Reality

ISDS is a key mechanism to protect foreign investors against arbitrary government action without due compensation.

ISDS facilitates international trade by lowering the risk premium for investors, ensuring that the cost of regulation to government reflects all the costs imposed on society, but without undermining its ability to legislate.

Between 1990 and 2013, ISDS cases grew 6-fold, as did worldwide FDI stock. There has been no ‘explosion’ in frivolous cases, as is sometimes alleged.

ISDS provides an avenue for peaceful dispute settlement, preventing economic disputes from spilling over into full-fledged political and diplomatic conflicts between governments.

42 per cent of ISDS cases involve intra-EU disputes, with EU states as respondents and EU-based investors as claimants. Worldwide, 43 per cent of cases of rulings favour the state, with 31 per cent in favour of investors.

Recommendation: With cross-border trade volumes reaching new heights every year, and with governments still prone to arbitrary action, there is a need for effective, transparent, independent and swift ISDS. CETA, TTIP and future trade deals should contain an ISDS chapter.

Investor-state dispute settlement (ISDS) refers to a provision commonly found in bilateral investment treaties (BITs) and regional trade agreements that allows foreign investors to bring a case directly against a government before an arbitration tribunal, when that government is judged to have breached the conditions set forth in the agreement.ⁱ

ISDS has been a regular feature of BITs since the 1950s and has been increasingly common in FTAs (notably NAFTA) in recent years.ⁱⁱ ISDS has recently come under fire from activists and politicians who claim that it undermines the domestic policy-making autonomy of governments, compromising initiatives that legitimately seek to protect the public interest when private interests are affected.ⁱⁱⁱ They argue that this is apparent in the alleged ‘explosion’ of ISDS cases in recent years,^{iv} which reflects investors’ abuse of clauses calling for “fair and equitable” treatment by governments.

The following addresses some of the most salient claims made against ISDS.

ISDS is about compensation, not blocking government regulation

Critics claim that ISDS jeopardises the ability of governments to regulate, even when intervention is justified by the public interest in domains like the environment and public health.

However, there is nothing in ISDS that prevents governments from regulating,^v even when such actions severely damage the interests of foreign investors, as in expropriations or the banning of certain commercial activities. For instance, the ongoing arbitration case between Vattenfall and the German government (a commonly cited example) has not deterred Germany from proceeding with its phasing-out of nuclear power by 2022, let alone reduced its ability to regulate, expropriate and ban.^{vi}

Governments are still free to regulate under ISDS.

ISDS arbitration is strictly about securing adequate compensation for government action, yet the ability and the final decision to act rests squarely with governments.

ISDS reflects the true cost of regulation to the economy, helping government decision-making

While governments retain the ability to regulate and expropriate with and without ISDS, they may face added costs when foreign investors have the ability to bring a complaint before international tribunals when they feel inadequately compensated for adverse legislation.

In this way, ISDS helps to create incentives for better government decision-making by more accurately reflecting the true cost of government regulation. In proposing new legislation and regulations, governments are often quick to point out the alleged benefits of the proposed actions, be it a cleaner environment, a healthier population or a more sustainable economy. At the same time, there is a tendency to neglect the real costs of regulation, e.g. reduced competition, job losses, impaired innovation and the elimination of future profit streams for existing and potential players, particularly when these costs will fall on foreign parties with no representation in the country in question.

ISDS lowers the risk premium on foreign investment and helps to inform the public.

In the *Vattenfall v. Germany* case, the Swedish power company's claim for \$3.7 billion as compensation for the German government's decision to phase out nuclear power has elicited some public outcry. Yet considering that Vattenfall operates two nuclear plants on German soil, and that it estimated its losses over the financial year 2011-2012 at €1.18 billion,^{vii} the sought amount is not quite as egregious as it might seem at first glance. Furthermore, considering that in 2010 the German government had voted to extend the life of nuclear plants by eight to 14 years, it is fair to say that the phase-out disrupted the business plans of Germany's nuclear operators. Thus the company's claim represents a genuine economic cost of the government's regulation. If compensation were not given, that cost would be hidden even more opaquely in higher costs passed on to consumers resulting from the increased risks and costs of business operations. ISDS makes the costs of regulatory action explicit and can therefore improve decision making.

The increase in arbitration cases in recent years reflects greater FDI and transparency

Critics of ISDS often cite the growth of investor-state arbitration cases as an example of corporate lawyers' taking advantage of investment clauses and pursuing frivolous cases against wholly justified government action.^{viii}

Yet the increase in investor-state disputes (from fewer than 10 in 1993 to at least 57 in 2013^{ix}) is broadly correlated with the enormous growth in foreign direct investment (FDI) over the past two decades,^x following the opening up of former communist countries and a general encouragement of FDI by developing-country governments. Thus, when considered in relative terms, the increase in ISDS cases has been much smaller than commonly assumed, if it indeed has occurred at all.

Growth in ISDS cases is broadly correlated with FDI growth.

It should be noted that statistics on investor-state disputes only include known cases, as there is no public registry for such arbitration cases.^{xi} And given the increase in transparency that has taken place in recent years, the alleged increase in ISDS cases may be partly due to a greater proportion of disputes coming to the surface.

Finally, the last two decades have witnessed an unprecedented activism on the part of Western governments in the fields of public health and energy/ environmental policy, which may have played a role in the growing recourse to ISDS arbitration on the part of affected companies. At any rate, it is worth pointing out that, of the 274 cases that had been concluded internationally as of the end of 2013, 43 per cent were ruled in favour of the state, with 31 per cent in favour of the investor and 26 per cent settled.^{xii}

ISDS is an important tool in relations between developed countries, as well as developing ones

ISDS and its inclusion in BITs took off in the 1950s, as newly independent former colonies sought to reassure foreign investors that they would be protected and adequately compensated in the event of expropriation.^{xiii}

This has led critics to argue that, while it may make sense in the context of investment and trade agreements with countries with a poor record of respecting the rule of law, it is not appropriate for pacts between Western nations where violating fundamental principles of international law is out of the question. This is particularly relevant in the context of the Transatlantic Trade and Investment Partnership between the United States and the European Union.^{xiv}

ISDS makes state predation and bad economic policy less likely.

However, with 42 per cent of ISDS cases in 2013 concerning intra-EU disputes (i.e. cases brought by EU-based investors against EU Member States) and with EU countries topping the list of both respondent and investor home states,^{xv} there does seem to be demand for an ISDS mechanism even when only developed countries are concerned.

Moreover, the German nuclear phase-out and Argentina's expropriation of YPF in 2012 show that unexpected bans and expropriations are still commonplace. Indeed it is largely thanks to the BIT between Spain and Argentina that the YPF dispute did not escalate from an economic dispute between a private company and a government into a tit-for-tat political confrontation.^{xvi}

ISDS is not a deciding factor for FDI – but neither does it lead to sub-optimal investment

Some ISDS critics have contended that it leads to sub-optimal business decisions by multinationals, guided not by market forces but by political judgements based on where they would have recourse to ISDS.^{xvii}

The more vulnerable to political meddling a sector is, the more influence ISDS on FDI flows into that sector.

However, evidence that ISDS has a significant impact on FDI is mixed.^{xviii} Some studies have found that liberal admission rules were the main factor in promoting FDI, with ISDS playing only a minor role.^{xix} Moreover, the impact of ISDS on FDI has been found to vary significantly across sectors, with those subject to greater regulation and political intervention (e.g. utilities, natural resources, real estate) more likely to be affected by BITs, and those where market forces play a larger role remaining largely unaffected.^{xx}

ISDS is a much-needed provision which should be preserved in CETA, TTIP and other future EU trade deals.

ⁱ http://trade.ec.europa.eu/doclib/docs/2013/october/tradoc_151791.pdf

ⁱⁱ Simon Lester, "Liberalization or litigation? Time to rethink the international investment regime," Policy Analysis No. 730 (Washington, DC: Cato Institute, 2013), 2-5.

ⁱⁱⁱ Cf. <http://corporateeurope.org/international-trade/2014/07/ttip-debunking-business-propaganda-over-investor-rights> for a list of the arguments commonly cited against ISDS.

^{iv} United Nations Conference on Trade and Development (UNCTAD), "Recent developments in investor-state dispute settlement (ISDS)," IIA Issues Note No. 1 (New York: UNCTAD, 2014), 2.

^v Daniel Ikenson, "A compromise to advance the trade agenda: purge negotiations of investor-state dispute settlement," Free Trade Bulletin No. 57 (Washington, DC: Cato Institute, 2014), 2.

^{vi} Nathalie Bernasconi-Osterwalder and Rhea Tamara Hoffmann, "The German nuclear phase-out put to the test in international investment arbitration? Background to the new dispute *Vattenfall v. Germany (II)*" (Berlin/ Amsterdam: PowerShift, 2013).

^{vii} *Ibid.*, 2.

^{viii} Lester, "Liberalization or litigation?," 9.

^{ix} UNCTAD, "Recent developments in ISDS," 2.

^x Roderick Abbott, Fredrik Erixon and Martina Francesca Ferracane, "Demystifying investor-state dispute settlement (ISDS)," ECIPE Occasional Paper No. 5 (Brussels: ECIPE, 2014).

^{xi} Cf. footnote 10, *ibid.*, 8.

^{xii} UNCTAD, "Recent developments in ISDS," 10.

^{xiii} Abbott et al., "Demystifying ISDS," 4-5.

^{xiv} Lester, "Liberalization or litigation?," 6-7.

^{xv} UNCTAD, "Recent developments in ISDS," 2-4.

^{xvi} Fredrik Erixon, "The 'Repsol case' against Argentina: lessons for investment protection policy," ECIPE Bulletin No. 4 (Brussels: ECIPE, 2014).

^{xvii} Lester, "Liberalization or litigation?," 9.

^{xviii} Cf. Abbott, Erixon and Ferracane, "Demystifying ISDS," 15-19, for a succinct review of the literature on the relationship between BITs and FDI.

^{xix} Axel Berger, Matthias Busse, Peter Nunnenkamp and Martin Roy, "Do trade and investment agreements lead to more FDI? Accounting for key provisions inside the black box," Staff Working Paper ERSD-2010-13 (Washington, DC: World Trade Organization, 2010), 18.

^{xx} Abbott, Erixon and Ferracane, "Demystifying ISDS," 18-19.

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