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## **Submission to Senate Foreign Affairs, Defence and Trade References Committee Inquiry on the Korea-Australia Free Trade Agreement**

This submission concerns Investor-State Dispute Settlements (ISDS) mechanisms in the proposed Korea-Australia free trade agreement (KAFTA). It addresses the effectiveness of public welfare safeguards as a protection against regulatory risks for Australian governments resulting from the ISDS provisions in KAFTA.

The submission proceeds in four sections. First, it outlines the policy context for ISDS in free trade agreements. Second, it reviews the ISDS provisions and associated public welfare safeguards in the proposed KAFTA legal text. Third, it evaluates the effectiveness of these safeguards in preventing regulatory risk for current and future Australian governments. It concludes with three recommendations for how these safeguards may be more effectively implemented in KAFTA.

### **1. The policy context: ISDS provisions, free trade agreements and public welfare safeguards**

Investor-state dispute settlement has become one of the most controversial aspects of free trade agreements, both in Australia and globally. ISDS provisions are a legal mechanism included in trade and investment treaties, which grants foreign investors the right to access an international arbitral tribunal<sup>1</sup> if they believe policies undertaken by a host government breach investment rules. Their core purpose is to provide an instrument of public international law through which private investors can seek redress when governments fail to meet their treaty commitments to protect foreign investors.

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<sup>1</sup> Most agreements containing ISDS provisions specify one of two international tribunals: the *United Nations Commission on International Trade Law* (UNCITRAL) or the World Bank Group's *International Centre for Settlement of Investment Disputes* (ICSID).

Modern ISDS provisions have a relatively long history in international trade law, first appearing in bilateral investment treaties (BITs) which became popular during the 1960s<sup>2</sup>. However, ISDS was to go mainstream as a result of the North American Free Trade Agreement (NAFTA) of 1994, which was the world's first major *trade* (rather than investment) agreement to include ISDS provisions. Since the NAFTA agreement, there has been an increasing trend for governments to include ISDS in free trade agreements (FTAs), in recognition of the fact that investment protection is now considered an important 'trade-related' policy issue.

At present, Australia currently has ISDS provisions in its 21 bilateral investment treaties, as well as four of its seven in-force FTAs (Chile, Singapore, Thailand and Australia-NZ-ASEAN). They are also included in the signed Korea-Australia FTA, but not in the Japan-Australia Economic Partnership agreement.

ISDS provisions have proven extremely controversial, and their recent inclusion in FTAs has generated an intense debate amongst businesses, civil society groups and trade policy experts. Broadly speaking, the terms of this debate are as follows:

- Advocates of ISDS provisions argue they augment the strength of investment policy commitments made in FTAs. By providing investors an independent legal route to seek redress against expropriation by host governments, they increase certainty that investment protections will be adhered to. This is argued to increase investor confidence, and ultimately flows of foreign direct investment, resulting from FTAs containing ISDS.
- Critics of ISDS provisions contend they impose unnecessary and asymmetric restrictions on the regulatory capacity of governments. Some argue that ISDS protections, which are only extended to investors from a partner country, asymmetrically create legal rights for foreign (but not local) companies. Others go further to suggest that as ISDS tribunals are not subject to the laws created by a democratically-elected legislature they are inherently illegitimate. Others have also contended that ISDS restricts the ability to enact various public welfare provisions – including environmental, cultural, and public health policies – and will produce a 'chilling-effect' on governments' willingness to regulate in these areas in future.

In Australia, the public policy debate regarding ISDS has seen renewed attention as a result of an investor-state dispute brought by Philip Morris Asia Limited (PMA) against the *Tobacco Plain Packaging Act 2011 (Cth)*. In June 2011, PMA served Australia with a written notification of claim pursuant to articles of the Hong Kong BIT (1993). PMA claims that Australia's plain packaging tobacco policy constitutes an 'indirect expropriation' of its Australian investments as per Article 6 of the Hong Kong BIT, and is also an 'unreasonable and discriminatory' measure as per Article 2(2) of the same agreement. The arbitration tribunal was constituted in May 2012, and at time of writing legal procedures are continuing under the *UNCITRAL Arbitration Rules 2010*<sup>3</sup>.

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<sup>2</sup> While BIT activity peaked during the mid-1990s, governments have continued to sign these agreements in the two decades since. There are presently 2857 BITs in-force globally. UNCTAD (2013), *World Investment Report 2013*, New York and Geneva: United Nations, p. 102.

<sup>3</sup> It should be noted that in April 2012, the High Court of Australia heard two domestic legal challenges to the plain packaging tobacco laws: *British American Tobacco Australasia Limited and Ors*

The PMA arbitration is the first and only ISDS case to be brought against the Commonwealth of Australia under any of its existing BITs or FTAs.

Australian critics have argued the PMA case demonstrates the inherent risks to public welfare regulation associated with including ISDS in FTAs. Not only does the Australian government have to bear the legal costs of arbitration, an adverse ruling may result in the award of compensation to PMA, and also set a precedent for compensation to other affected tobacco companies. Moreover, even if Australia obtains a favourable ruling in PMA, there is a broader concern that future Australian governments may be reticent to engage in public health regulation for fear of further legal challenges. It has been suggested that this 'chilling effect' from the PMA case – irrespective of its final outcome – may also spill over into other public welfare domains, such as environmental and cultural policy.

As a result of these concerns, many have begun exploring options for incorporating 'public welfare safeguards' into Australia's FTAs containing ISDS. These safeguards aim to carve out a specified range of regulatory activities that are defined as being beyond the scope of ISDS arbitration, thus avoiding the problem of regulatory chill for present and future governments. For supporters of ISDS, these safeguards are seen as a balanced compromise that improves the perceived legitimacy of these provisions; while for critics they are considered a second best option that nonetheless prevents some of the more adverse consequences of ISDS.

However, significant questions remain over the design of ISDS safeguards. What specific regulatory activities should be included in the list of public welfare carve-outs? How can legal texts be designed in a way that minimises regulatory risk for present and future Australian governments? And what lessons do prior experiences with ISDS safeguards have to offer when negotiating agreements such as KAFTA?

## **2. Public welfare safeguards in the proposed KAFTA agreement**

The core legal issue of relevance to ISDS safeguards is the matter of expropriation – when a government takes ownership of private property through regulatory measures. Two forms of expropriation are identified in KAFTA: *direct expropriation*, where a government takes legal control of private property (i.e. nationalisation); and *indirect expropriation* – where “an action or a series of actions by a Party has an effect equivalent to direct expropriation without formal transfer of title or outright seizure” (KAFTA 11-B.3).

The risk of investor claims regarding indirect expropriation is the core matter at the heart of the debate over ISDS safeguards. On one hand, indirect expropriation is a real and genuine concern for investors, and has a legitimate place in ISDS clauses. However, because an extremely broad set of regulatory behaviour might potentially qualify as indirect expropriation, concerns exist that it widens the scope of expropriation to be dangerously broad. Thus, there is a need to strike a balance between enshrining robust investment protections on the one hand, and the need

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*v. Commonwealth of Australia and J T International SA v. Commonwealth of Australia.* In both cases the Court ruled that *Tobacco Plain Packaging Act 2011 (Cth)* did not result in an acquisition of property that would require provision of 'just terms' under s.51(xxxi) of the Constitution.

to limit the scope of their effects of governments' broader regulatory autonomy on the other.

The proposed text of the KAFTA agreement is by no means blind to these concerns. Importantly, the investment protections in KAFTA Chapter 11 do not prevent public welfare regulations that lead to indirect expropriation per se, but simply insist that property owners are compensated promptly and at fair market values (KAFTA 11.7.2). Nonetheless, the concern remains that the cost of such compensation – or uncertainty over whether an international tribunal would determine a policy to constitute indirect expropriation or not – may still deter governments from undertaking such regulations in the first place.

To address these risks around regulatory uncertainty, KAFTA also includes a safeguards which identify a range of policy areas that will not be considered to constitute indirect expropriation for the purposes of ISDS arbitration. The relevant KAFTA safeguards are:

*Safeguards relating to the investment chapter (Chapter 11):*

- 22.1.3 indicates the following regulatory behaviours are not prohibited so long as they are implemented in a non-discriminatory manner that does not restrain trade: health, environmental protection, domestic laws not inconsistent with KAFTA, national treasures, and exhaustible natural resources.
- 22.1.1 reaffirms GATT exceptions for: environmental measures for human, animal or plant life or health (GATT XX(b)); and exhaustible natural resources (GATT XX(g))
- Annexes I, II and III (Non-conforming measures) outlines specific exceptions for a wide range pre-existing policies.
- 11.12.1c protects the government's right to amend any non-conforming measure so long as it does not "decrease" the measure's conformity with Chapter 11.

*Safeguards in the definition of expropriation*

- 11.B.5 indicates that regulatory measures for "*legitimate public welfare objectives*" do not constitute expropriation, except in "*rare circumstances*". An indicative though not exhaustive list of examples includes public health, safety and the environment.
- 11.I.a indicates the imposition of tax measures (including new taxes) generally does not constitute expropriation.
- 11.B.4 indicates that determining indirect expropriation requires a case-by-case analysis of factors specific to the investment by the ISDS tribunal. These factors include the following:
  - o the economic impact of the government action (though noting that an adverse economic impact is not sufficient to establish expropriation)
  - o the extent to which government action interferes with distinct, reasonable investment-backed expectations
  - o the character of government action, including objectives and context

*Safeguards for the Foreign Acquisitions and Takeovers Act (as amended) (Cth)*

- 11.G indicates that decisions to refuse or impose conditions on an investment subject to Australia's foreign investment policy shall not be subject to ISDS

In summary, the KAFTA ISDS safeguards: (a) define a set of public welfare measures explicitly protected from expropriation claims by investors; and (b) set guidelines for how all other indirect expropriation claims shall be assessed by the tribunal. These provisions broadly conform to – and in some cases directly reproduce text<sup>4</sup> from – the ISDS safeguards included in the United States' *Model Bilateral Investment Treaty* (2012).

### **3. Evaluating the effectiveness of ISDS safeguards in KAFTA**

Assessing whether these ISDS safeguards will mitigate regulatory risks for present and future Australian governments is an exceedingly difficult task.

As an emerging area of international trade policy, there is presently a lack of robust academic research that examines the legal implications of differing ISDS safeguard designs. Similarly, while a body of previous rulings involving ISDS safeguards has now accumulated from the UNCITRAL and ICSID tribunals (identified by several other submissions to this inquiry), these arguably offer few insights into how KAFTA will be interpreted. As every BIT and FTA features different types of ISDS safeguards, and there are variations in language even where the broad intention is similar, prior tribunal decisions cannot be considered 'precedents' that will apply to KAFTA either now or into the future. As a result, it is arguably impossible to evaluate the effectiveness of the KAFTA safeguards with reference either to precedents in public international law, or other countries' ISDS experiences.

Nonetheless, a detailed analysis of the KAFTA ISDS safeguards allows us to identify three specific areas in which the proposed text may fail to protect Australian governments against regulatory risk as effectively as possible.

#### *Risk 1: Retreat from stronger ISDS safeguard standards in AANZFTA (2009)*

KAFTA is not Australia's first trade agreement to include ISDS safeguard measures. Some form of limitation on expropriation claims is included in all Australia's FTAs which include ISDS provisions.

However, the safeguards in the proposed KAFTA text are weaker than those in Australia's most significant ISDS-containing agreement to date: the Australia-NZ-ASEAN FTA of 2009. KAFTA marks a retreat from the higher standards of AANZFTA in two ways:

1. 'Rare circumstances': While both protect government action designed for "*legitimate public welfare objectives*", the KAFTA agreement adds the caveat "*except in rare circumstances*" (KAFTA 11.B.5). This caveat is not included in AANZFTA, which unequivocally protects public welfare regulations (AANZFTA 11-Annex 4).

By adding this caveat, KAFTA allows investors to claim a 'rare circumstances' exception when bringing expropriation claims. 'Rare circumstances' are

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<sup>4</sup> For example, the KAFTA definitions of expropriation (Annex 11-B) are a verbatim reproduction of those in the US Model BIT 2012 (available at <http://www.state.gov/e/eb/ifa/bit/index.htm>).

undefined in the text, thus requiring the tribunal to make case-by-case assessments of the applicability of this exception. This exposes Australian governments to additional costs of litigation (required for tribunals to make 'rare circumstances' decisions), as well as the regulatory risk that tribunals may define rare circumstances in hard-to-foresee ways.

2. Determining indirect expropriation: The criteria for determining expropriation in KAFTA indicates that the tribunal should consider the "*extent to which the government action interferes with distinct, reasonable investment-backed expectations*" (KAFTA 11.B.4). AANZFTA provides a stronger criterion, which instead states "*whether the government action breaches the government's prior binding written commitment to the investor whether by contract, licence or other legal document*" (AANZFTA 11-Annex 3.B)

By weakening the criterion from a 'prior binding written commitment' to 'distinct, reasonable investment-backed expectations', KAFTA broadens the definition of indirect expropriation. As a result, a much wider range of regulatory behaviours constitute indirect expropriation under KAFTA than under AANZFTA.

For these reasons, the proposed KAFTA text exposes Australian governments to a higher level of regulatory risk from ISDS claims than previous FTAs. Its safeguards would be considerably strengthened if they conformed to the prior standard established in AANZFTA.

#### Risk 2: Cost and regulatory uncertainty associated with frivolous and unfounded claims

One of the major concerns raised around ISDS is the risk posed by frivolous and unfounded investor claims. ISDS arbitration is a technically-demanding, expensive and costly process, which: (a) imposes significant financial burdens on governments; and (b) creates regulatory uncertainty during the period in which proceedings take place. Even in cases where investor claims are weak and without basis, the costs and uncertainty associated with ISDS procedures can significantly impinge on the regulatory behaviour of governments.

To address these risks, KAFTA includes a number of mechanisms to reduce the burden faced by governments when contesting ISDS claims of dubious legal merit:

- Provisions for expedited decisions on whether a matter is 'within the tribunal's competence' (i.e. a matter for which an award may be made) (11.20.6 and 11.20.7)
- Mechanisms to consolidate related claims into a single dispute (11.25)
- Provisions to award costs to the prevailing party when claims or objections are deemed frivolous (11.20.8)

However, the provision for expedited decisions only allows the tribunal to rule on whether "*a claim submitted is not a claim for which an award in favour of the claimant may be made under Article 11.26 (Awards)*". If an investor brings a claim that could potentially lead to an award the tribunal cannot make an expedited decision, even if the claim is manifestly unfounded or without legal merit.

It should be noted that KAFTA embodies a weaker standard for dealing with unfounded claims than AANZFTA. This agreement allows for the expedited decisions on the grounds that a claim is “*manifestly without merit*” (AANZFTA 11.25.2), whereas KAFTA only allows it in cases where the claim cannot lead to an award of damages (KAFTA 11.20.6).

The protection against frivolous and unfounded claims would be significantly strengthened if KAFTA adhere to the higher standard of protection in AANZFTA, by allowing expedited decisions in situations where claims are manifestly without legal merit.

### *Risk 3: The definition of legitimate public welfare objectives*

The most significant ISDS safeguard in KAFTA is the provision that regulatory actions “*designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment*” do not constitute expropriation (11.B.5).

Advocates have argued that this ‘public welfare safeguard’ will protect Australian governments from ISDS claims such as PMA in the future. It has also been suggested that this provision will protect Australian governments from claims targeting environmental regulations or the Pharmaceutical Benefits Scheme<sup>5</sup>.

The primary difficulty with the KAFTA public welfare safeguard is that it leaves the concept of ‘legitimate public welfare objectives’ entirely undefined. While an indicative list of areas – public health, safety and the environment – is included in the text, this does little to resolve ambiguity over the full range of regulatory behaviours that have public welfare objectives, and what is required to ensure their legitimacy.

As a consequence, the matter of defining the scope of this safeguard then falls to the ISDS tribunal, which must decide on the definition of a legitimate public welfare objective before the safeguard can be interpreted. Any investor challenging a regulatory measure can invoke a competing definition of public welfare in an attempt to circumvent KAFTA 11.B.5. This exposes Australian governments to two forms of regulatory risk:

1. Many disputes will need to go to arbitration simply to obtain a ruling on the definition of public welfare itself. Even in cases where the tribunal rules in Australia’s favour, this exposes the Commonwealth to unnecessary litigation costs and policy uncertainty during the arbitration period.
2. The possibility exists that different tribunals, or even the same tribunal in different cases, may adopt differing interpretations of the scope of public welfare objectives<sup>6</sup>. This creates considerable uncertainty over whether

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<sup>5</sup> For example, see the Department of Foreign Affairs and Trade’s explanatory note on ISDS (available at <https://www.dfat.gov.au/fta/isds-faq.html>).

<sup>6</sup> It has been demonstrated that there are often significant inconsistencies between how ISDS tribunals interpret identical or similar treaty provisions. See UNCTAD (2013), *Reform of Investor-State Dispute Settlement: In Search of a Roadmap*, New York: United Nations, pp. 3-4; and Marta

certain policies will be protected by 11.B.5, potentially deterring Australian governments from undertaking desired regulatory reforms in the first place.

KAFTA's ISDS safeguards are undermined by this lack of a definition of public welfare objectives, and would be significantly strengthened if an explicit definition was provided.

#### **4. Policy recommendations**

ISDS safeguards in the proposed KAFTA text could be strengthened to protect Australian governments against regulatory risk through three impactful yet practicable reforms:

1. The agreement should conform to the higher standards established in the AANZFTA agreement of 2009 when dealing with the definition of indirect expropriation.
2. The agreement should strengthen protections against frivolous and unfounded claims, by incorporating provisions allowing expedited decisions when claims are manifestly without legal merit (similar to those in AANZFTA).
3. The agreement should explicitly define the concept of 'legitimate public welfare objectives' raised in 11.B.5.

Significantly, the third of these recommendations would not necessitate a change to the proposed text currently undergoing ratification. An 'exchange of side letters' – a common addition to free trade agreements used to clarify matters post-signing – could be used as a mechanism to implement this recommendation.

These reforms will substantially improve the quality of the KAFTA ISDS safeguards, reduce regulatory risk for present and future Australian governments, and give the Australian community greater confidence that KAFTA will not undermine the capacity of the Commonwealth to regulate and govern in the public interest. I encourage this Senate Inquiry to consider them amongst its recommendations.

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