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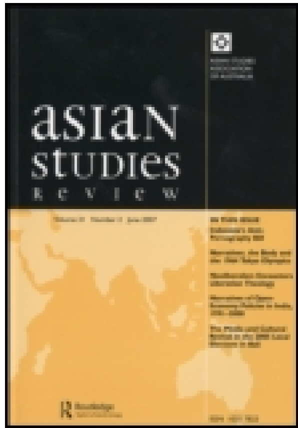

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Throwing the Baby Out with the Bathwater: Australia's New Policy on Treaty-Based Investor-State Arbitration and its Impact in Asia

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Throwing the Baby Out with the Bathwater: Australia's New Policy on Treaty-Based Investor-State Arbitration and its Impact in Asia

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Abstract: *Treaties allowing investors to initiate arbitration claims directly against host states for illegally interfering with cross-border investments are becoming increasingly common in Asia, but Australia announced in 2011 that it will no longer include such protections in future treaties. The backdrop to this decision includes keen interest from Asia in foreign direct investment (FDI) into Australia's resources sector, meaning that potential investors may not be significantly deterred by a lack of arbitration provisions in future treaties. This article argues, however, that Australia's policy shift risks undermining the entire investor-state arbitration (ISA) system, with the earliest impact being felt by major pending treaty negotiations by Australia with Japan, China and Korea (respectively); and that the shift may significantly reduce FDI flows or have other adverse effects. The article criticises the cost-benefit analysis of ISA protections in one pivotal study conducted in 2010 by an Australian Government think-tank, arguing that this assessment is insufficiently nuanced. Instead, the article presents a justification for more tailored and moderate changes to ISA provisions in future treaties. Its tentative interest-group analysis suggests, however, that there may be surprisingly few public or private constituencies that would prefer such moderate reforms, and that most may well prefer the more extreme position recently adopted by Australia, despite the damage that will be done to the ISA system as a whole. The article also argues that Australia's policy shift and think-tank analysis may make Asian countries more cautious about ISA, especially those (like the Philippines and Vietnam) which have traditionally been more cautious about this dispute resolution system.*

Keywords: *Asia and Australia*, *Japan*, *resources*, *international investment*, *investment treaties*, *free trade agreements*, *dispute resolution*

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Introduction

Treaties in Asia increasingly allow investors from home states to bring international arbitration claims directly against host states for illegally interfering with their investments. Yet Australia decided in 2011 to no longer include such protections in future treaties, even with developing countries, which are traditionally the main targets of such protections because of their less reliable laws and court procedures. The backdrop includes keen interest from Asia in foreign direct investment (FDI) into Australia's resources sector; Australia may not need to offer such treaty protections to entice foreign investors. Yet, as outlined in the first part of this article, the policy shift risks undermining the entire investor-state arbitration (ISA) system, beginning with major pending treaty negotiations by Australia with Japan, China and Korea (respectively). This may significantly reduce FDI flows and have other adverse effects in the broader Asian region, especially in the resources sector.

The impact of Australia's policy shift depends partly on the persuasiveness of rationales given by the Government's Productivity Commission (2010) regarding trade and investment treaty policy. The second part of this article therefore critically assesses the economic theory and evidence underlying the Commission's Report. Given problems identified by that analysis as well as the many complex implications of the Government's new policy stance, the third part outlines some less radical ways for Australia – and other countries in the region – to rebalance private and public interests in the ISA system. The fourth part argues that Australia's recent experience indicates more generally that nowadays there may be surprisingly few constituencies prepared to come out strongly in favour of refining the ISA system in those moderate ways. Within many other states, there are probably more public and private interest groups now wishing to see the ISA system curtailed – along the lines recently announced by the Australian Government or, indeed, even more restrictively.

The article concludes that many other states in Asia already negotiating investment treaties with Australia are also unlikely to achieve a relaxation in its policy stance. This also significantly complicates the attempts to create the first truly regional FTA through the Trans-Pacific Partnership Agreement (TPPA) negotiations. The treaty-based ISA system, despite its remarkable expansion world-wide over the last decade and signs of growing acceptance in Asia, may well therefore end up declining significantly in the region over the medium to longer term.

Investor-State Arbitration in Asia Meets Australia's New Policy

Japan has been negotiating a Free Trade Agreement (FTA) with Australia since 2007.[1] One major sticking point has been liberalisation of Australian access to the rich Japanese market for agricultural produce, but another potential problem has also been shaping up over liberalisation and protection of Japanese investors in Australia. In 2010 more foreign direct investment (FDI) came from Japan than from the People's Republic of China, although the latter drew much more public attention. This renewed wave of Japanese investment is more diversified than the wave of investment during the 1980s, when a strong yen and asset price inflation in Japan's "bubble economy" led to large investments in tourism and real estate in Australia and other developed countries. Recent large investments from Japan are focused on securing mineral resources – in

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the face of strong competition from Chinese investors and some emerging interest from India and Korea – and in Australia's food and beverages sector (Drysdale, 2009).

Australia's recent political controversy over a "super profits tax" on the mining industry, which contributed to the replacement of Prime Minister Kevin Rudd with Julia Gillard (Stuart, 2010), focused the minds of some Japanese investors on the vulnerability of FDI to domestic uncertainties, even in developed countries such as Australia. One way to reduce such uncertainties, especially in large-scale ventures involving natural resources development, is to elaborate substantive protections under international law by means of FTAs (or Bilateral Investment Treaties, BITs). Like China and Korea (Bath, 2011; Kim, 2011), Japan has accelerated its treaty negotiation program over the last decade (Hamamoto, 2011). Its FTA with Indonesia signed in 2007, for example, aims at liberalised access for Japanese investors in Indonesia's resources sector (Sitaresmi, 2011). Japan also increasingly presses treaty partners to agree to allow investors to bring arbitration claims directly against host states that allegedly breach such substantive obligations – for example, by expropriation, lack of transparency or fair and equitable treatment (FET). This represents a more efficient and less politicised dispute resolution mechanism from the perspective of investors, compared to the customary international law approach (also now elaborated in treaties as an alternative) whereby the investor's home state may be mobilised to bring an inter-state claim against the host state. Japan had been seeking such investor-state arbitration (ISA) provisions in its bilateral FTA with Australia, consistently with Japan's longstanding treaty practice, notwithstanding the fact that the devastating natural disasters of 11 March 2011 and the subsequent nuclear power plant emergency have slowed the pace and shifted the dynamics of those FTA negotiations.[2]

In April 2011, however, Australia released the 'Gillard Government Trade Policy Statement' (TPS), which ran contrary to the Japanese push for ISA provisions. The Government reaffirmed that Australia's trade policy should focus first on multilateral liberalisation – and indeed, in many cases, unilateral liberalisation measures – under the World Trade Organization (WTO) system, instead of bilateral or regional deals. The difficulty with this declaration is that the WTO system provides very limited protections for investors, offering some protections for certain services sectors, but generating a more limited range of direct remedies for investors than BITs or FTAs with investment chapters. WTO treaty violations (e.g. of "national treatment" commitments) rely on an investor persuading its home state to initiate an inter-state dispute resolution process, rather than allowing investors to bring claims directly against host states (as under ISA). Furthermore, the TPS blew cold on including ISA in any future FTAs or BITs:[3]

> The Gillard Government supports the principle of national treatment – that foreign and domestic businesses are treated equally under the law. However, *the Government does not support provisions that would confer greater legal rights on foreign businesses than those available to domestic businesses*. Nor will the Government support provisions that would constrain the ability of Australian Governments to make laws on social, environmental and economic matters in circumstances where those laws do not discriminate between domestic and foreign businesses…

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> *In the past, Australian Governments have sought the inclusion of investor-state dispute resolution [especially ISA] procedures in trade agreements with developing countries at the behest of Australian businesses. The Gillard Government will discontinue this practice*. If Australian businesses are concerned about sovereign risk in Australian trading partner countries, they will need to make their own assessments about whether they want to commit to investing in those countries.

These points resonated with the analysis of ISA in the Final Report of the study into Australia's Bilateral and Regional Trade Agreements commissioned by the Australian Treasurer (Productivity Commission, 2010). The Commission's Recommendation 4(c) had stated that the Gillard Government should "seek to avoid the inclusion of investor-state dispute settlement provisions in [treaties] that grant foreign investors in Australia substantive or procedural rights greater than those enjoyed by Australian investors".[4] Yet even this recommendation seemed to allow some scope for Australia to include ISA provisions in future treaties – notably, with countries with less developed legal systems. The Recommendation might have allowed Australia to cap substantive protections (e.g. against expropriation) entrenched in treaties – and underpinned by ISA rights – at the level of protection provided anyway under Australian domestic law. In effect, this would have allowed investors from Australia to take abroad – into the host-state party to such a treaty – the substantive protections entrenched by the treaty. Conversely, foreign investors into Australia from the treaty partner would not really have obtained much benefit from such a treaty regime, because they could obtain such substantive protections by suing the Australian Government in Australian courts anyway. But even such foreign investors would not have had to rely on pursuing the substantive protections through local courts in Australia; they too could instead have availed themselves of the treaty's ISA mechanism.

In fact, this sort of (quite one-sided) approach arguably characterised Australia's investment treaty practice up until the TPS. All its treaties included ISA protections *except* for the Australia–US FTA (AUSFTA, signed in 2004), the Australia New Zealand ASEAN FTA (AANZFTA, 2009) in relation only to the bilateral relationship between Australia and New Zealand, and the Investment Chapter added in February 2011 to Australia's "Closer Economic Relations" FTA with New Zealand dating back to 1982 (Mangan, 2011). Yet the omission of ISA in AUSFTA was arguably more tactical than part of a well thought out strategic plan,[5] and Australia did include ISA in FTAs with countries such as Singapore (2001) and Chile (2009) – which arguably have well-developed legal systems.

From pronouncements by Australian Government officials at public events since May 2011 (Nottage, 2013), it appears that the TPS was intended to be taken literally: Australia will no longer include ISA provisions even in treaties with developing countries.[6] Since there is far less incentive to protect one's outbound investors when negotiating with a country that has a developed legal system, this effectively means that Australia does not want ISA in any future treaties. That represents a very significant departure from Australia's practice for more than two decades. All treaties have contained ISA protections when the counterparty was a developing country, although the BIT with China only managed to incorporate limited rights to ISA as China had not yet developed into a major source of outbound investment (Eliasson, 2011).

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Australia's policy shift has complex and potentially wide-ranging ramifications, especially in the Asian region (Nottage, 2011, Part I). Asian countries' investment treaties have increasingly provided for ISA protections (Bath and Nottage, 2011), paralleling the growing acceptance of international commercial arbitration as a mechanism for resolving other types of disputes (Nottage and Garnett, 2010). Yet some countries in Asia arguably remain cautious about ISA and investment liberalisation more generally (Sornarajah, 2011). For example, India and Vietnam have not acceded to the 1965 Convention on the Settlement of Investment Disputes between States and Nationals of Other States (the ICSID Convention), which is promoted by the World Bank. The ICSID Convention facilitates enforcement of ISA awards rendered against a host state party to the Convention if the proceedings are conducted in accordance with ICSID Arbitration Rules, as may be provided by the host state as one option under an investment treaty. Also noteworthy is that Asian parties appear still to be under-represented in formal ICSID or other ISA case filings. Yet part of the reason for this seems to be greater "institutional barriers" facing Asian investors or host states that may be considering ISA proceedings (Nottage and Weeramantry, 2012). Overall, the growing acceptance of ISA in the Asian region may be significantly undermined by Australia's new policy stance, if its future treaties omit ISA provisions or regional partners go on to reassess their own general approach to ISA in light of the rationales officially given for the new policy.

This article therefore takes a closer look at the official reasons and other factors that account for Australia's new-found caution about ISA, and the potential implications for the region. Unofficially, one possible reason for the TPS going beyond the Productivity Commission's Recommendation is that the Gillard Government then ruled in an alliance with the Greens, who have long been cautious about trade and investment liberalisation. Coming down hard on ISA may have lessened the blowback from the TPS's reiteration of the Government's commitment to multilateral and even unilateral liberalisation measures. The Statement's opposition to ISA may also represent a reaction – arguably, an over-reaction – to a dispute with tobacco companies over Australia's Tobacco Plain Packaging Act 2011, which was supported enthusiastically by the Greens. That legislation generated (on 27 June 2011) the first-ever notice of intent to initiate arbitration against Australia under an investment treaty, namely the 1993 BIT with Hong Kong (Nottage, 2013). Yet this can hardly be said to explain Australia's actions: none of its regional neighbours reacted to the occasional claim under ISA by eschewing all ISA in future treaties.[7]

Another important factor in Australia's case, which has also not been highlighted in recent official pronouncements on ISA policy, may have been its ongoing mining boom – a major driving force behind Australia's growing *inbound* net FDI flows, especially since 2006 (Productivity Commission, 2010, pp. 31–32). The Government may well have questioned the need to offer ISA protections to foreign investors, if they are likely to invest anyway. Yet other Asia-Pacific countries enjoying abundant natural resources – such as Brunei, Indonesia, Chile or Canada – have not resiled from ISA provisions, and no mining boom can last forever anyway.

Another general consideration behind the Gillard Government's stance may be that even without ISA in new contracts, *outbound* Australian investors retain the benefit of ISA protections under 25 of 27 existing treaties concluded since 1988, and will continue to do so until one state party terminates the treaty after expiry of its initial (or

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otherwise automatically renewed) term. The TPS and subsequent pronouncements at public events indicate that the Government does not intend to initiate termination of old treaties (and perhaps then renegotiation of a new treaty without the arbitration provisions), despite its new-found aversion to ISA.[8] Thus, for example, the Government has apparently "politely declined" the invitation to agree to ISA in the pending negotiations to expand the TPPA. Originally signed in 2005 by four small Asia-Pacific economies, the new TPPA plans to add an Investment Chapter and include Australia, Peru, Vietnam, the US, Canada, Mexico and possibly Japan. Yet Australia already has treaties including ISA protections vis-à-vis all the developing country partners proposed for the expanded TPPA.

The short-term risk, however, is that a country such as Vietnam will follow Australia's lead and also refuse to countenance any ISA provisions. Vietnam is already attracting extensive inbound FDI, thanks in part to its high economic growth rate, yet it presents serious political and legal risks for foreign investors (Dang, 2011). If Vietnam refuses to accept ISA provisions, this may well jeopardise TPPA negotiations in the short term. This possibility arises because partners such as Singapore and the US have been pressing for a "high-quality" regional FTA as a model or core for further regional integration initiatives, and they have included ISA in (almost) all their other treaties. In the long term, moreover, many countries – especially in Asia – may rethink their attitude towards ISA protections in light of Australia's new stance, and begin to omit them in their future bilateral treaties. A core aspect of the regional and world-wide investment treaty regime, built up slowly and painstakingly in the absence of any comprehensive multilateral investment treaty regime (within the WTO system – or elsewhere), will then start to unravel. This could well have adverse or at least complex effects on cross-border investment flows, especially regarding large-scale resource development projects in Asia.

Whether this happens will depend partly on the persuasiveness of the official reasons given by the Australian Government for its policy shift relating to ISA, as well as possible parallels between Australia's political and economic environment and that in regional neighbours.

Economic Theory and Evidence behind Australia's Policy Shift

Possible benefits of ISA

The Productivity Commission (2010, p. 269) begins its case by positing that the "principal economic rationale" for granting ISA protections to foreign investors is to overcome market failure related to foreign investment, which it concedes may improve economic output, income and social services provision. It argues first, however, that governments are unlikely to take away favourable conditions initially offered to foreign investors by expropriating their assets, because of "reputational effects" – the fear of scaring off future investors. Second, the Commission dismisses the argument that foreign investors face systematic bias compared to local investors by pointing to two studies published in the mid-2000s that suggest foreign firms in fact enjoy *advantages* compared to local competitors (Huang, 2005; Desbordes and Vauday, 2007). Yet there are good reasons to doubt the wisdom of relying heavily on these studies. Both of them analyse results from the same survey, which was conducted

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back in 1999–2000. That era preceded the entry into force of anti-bribery legislation in many developed countries (Burnett and Bath, 2009), and so at that time foreign (Western) firms were freer to exercise political influence. The two studies in question also do not focus on parts of the world where investment flows are of large significance for Australia, such as South and East Asia. This therefore seems a shaky empirical basis for rejecting the idea that some problems and market failures encountered by foreign firms abroad might be due to host state interference. It also contradicts many qualitative studies that highlight many of those very problems, especially for foreign investors in countries such as China (Bath, 2011), Vietnam (Dang, 2011) and Indonesia (Butt, 2011).

As for the Commission's counter-argument that reputational effects discipline host states – an assertion that is not actually substantiated by any empirical study – this may be mostly true regarding outright expropriation. Yet it is only partially true regarding indirect or "creeping" expropriation, which can be caused by government action disproportionately impacting on foreign investors, or even outright breaches of the broader FET obligation under international law. The Productivity Commission (2010, p. 268) itself provides several examples where violations have been alleged by foreign investors, and sometimes expressly upheld by arbitral tribunals (see also generally Nottage, 2013). Putative "reputational effects" were obviously insufficient to deter the behaviour in such cases. Nor did such effects seem evident in the New South Wales Government's proposal in May 2011 to renege on a promise to maintain feed-in tariff rates payable to residents who had installed solar power panels (Nottage, 2011, Part II). The Government eventually abandoned the proposal, but mainly due to opposition from householders about such retrospective legislation, rather than from panel suppliers who might have qualified as aggrieved foreign investors under investment treaties.

Returning to the economic analysis of potential benefits from ISA, as sketched by the Productivity Commission (2010, p. 269), the Commission also points to some econometric research indicating instead that adding ISA in investment treaties has "no statistically significant impact on foreign investment into that country". Yet econometric studies depend on many things, including the estimation techniques adopted. Interestingly, one method used in the study upon which the Commission relied in fact finds a highly significant relationship (at the 99 per cent confidence level) between including ISA provisions in treaties and higher inbound FDI – namely, for Regional Trade Agreements (or FTAs), albeit not for BITs alone or for FTAs and BITs combined (Berger et al., 2010, p. 17). The selection of time frame is also often important. The study cited by the Commission looks at data through to only 2004, whereas treaties with stronger forms of ISA protections (e.g. treaties concluded by China, former communist countries of Eastern Europe, or ASEAN nations) probably represent a higher proportion of all treaties concluded over the last seven years. That can presumably be correlated with very strong growth in FDI flows, at least until the dip during the global financial crisis of 2008, which might well affect the results from a regression analysis re-run with more contemporary data.

The coding, choice and measurement of variables are also crucial. The study by Berger et al. (2010) codes ISA provisions into three levels in terms of their scope, based on the important study by Jason Yackee which focused on BITs. But recent arbitral

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jurisprudence suggests that there are in fact four levels of protection (Eliasson, 2011). We also need to be careful not to include too many dependent variables (risking problems of auto-correlation), but not to include too few (omitting major explanatory factors).[9] In addition, even with the crucial (dependent) variable in these studies – the amount of inbound FDI – researchers face great disparities in measurement across countries, especially over lengthy time periods.

Lastly, the most important thing about econometric analysis is that it deals in aggregates. A statistically significant result at the 95 per cent confidence level for an estimated relationship between the independent and dependent variables means that we would expect it *not* to be true in around five cases out of 100. What if those cases are disproportionately clustered around countries that are already – or may probably become – of greatest significance for Australia in terms of investment flows? As a better guide for real-life policymakers, like the Australian Government contemplating treaty negotiations, econometric analysis should focus on such existing or likely partner countries – including many throughout Asia. Adopting a stance based even on overwhelmingly consistent econometric evidence of global patterns – say, to omit or severely limit ISA provisions in investment treaties – is therefore a risky strategy for Australian policymakers.

Indeed, in discussing "implications for future policy" the Productivity Commission (2010, p. 276) itself cites a Submission from the Department of Foreign Affairs and Trade (DFAT) that seems consistent with this general point:

> DFAT submitted that it already "advocates a careful, case by case approach to the inclusion of Investors State Dispute Settlement (ISDS) in Australia's international agreements", taking into account matters including the nature of the partner country's legal system, stakeholder views, precedents and the promotion [of] bilateral investment flows.

The Productivity Commission (2010, p. 270) also acknowledges that ISA provisions

> could still benefit particular investors to the extent that they shift political risks associated with investments to host governments and/or provide an avenue for compensation "after the event". In consultations following the Draft Report, it was also suggested that [ISA] could provide additional leverage to businesses when negotiating with foreign governments prior to undertaking (or during the life of) foreign investments, were the businesses willing to threaten to pursue an arbitration case against a foreign government.
>
> However, as noted in chapter 7 [of this Final Report], the Commission received no feedback from Australian businesses or industry associations indicating that ISDS provisions were of much value or importance to them. Indeed, as far as the Commission is aware, no Australian business has made use of [ISA] provisions in Australian [investment treaties], including in its [FTAs].

Yet one Australian mining company recently succeeded in a claim under the Australia–India BIT (signed in 2000)[10] and an Australian-owned mining company (with interests

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also in Senegal and Indonesia) is presently bringing ICSID proceedings against The Gambia, after its iron sands licence was revoked and its British Managing Director was arrested in 2008.[11] That case is admittedly under arbitration provisions contained in an investment contract, since Australia has no investment treaty with The Gambia, but it highlights one dispute among several to have arisen in that region (Askew and Ayala, 3 June 2006). Despite such risks, the new TPS precludes including ISA provisions in any future treaties with African nations.

Overall, the Commission speculates that Australian businesses did not express interest in ISA provisions during their Review because investors have found other options to be relatively attractive. For example, it suggests the possibility of negotiating specific (pre-)investment contracts including dispute resolution clauses. The Commission (2010, p. 270) does nevertheless admit that this option "is more feasible for large businesses", citing the Gorgon Gas project in Western Australia as an example. The Commission also mentions political risks insurance against expropriation. Yet such coverage is usually unavailable for other protections (such as FET) or the lengthier periods provided by investment treaties. Indeed, in a strong dissent to the majority view on ISA presented by the Productivity Commission (2010, p. 320), Associate Commissioner Andrew Stoler argued that "this is analogous to arguing against the need for a fire department because homeowners can buy property insurance".

Despite the brevity and superficiality of its analysis the Productivity Commission (2010, p. 271) reached its Finding 14.1, which underpinned its near-unequivocal Recommendation 4(c) on ISA: "There does not appear to be an underlying economic problem that necessitates the inclusion of [ISA] provisions within agreements. Available evidence does not suggest that [ISA] provisions have a significant impact on investment flows".

Risks of ISA

Already unconvinced about significant benefits from ISA, the Productivity Commission (2010, pp. 271–72) then outlines various risks involved in Australia agreeing to them in its investment treaties, highlighted also by some Submissions to its Inquiry. These include the possibility of "regulatory chill" on public authorities; the undermining of democratic (legislative and other) processes; and the disadvantaging of domestic investors, thereby distorting efficient investment flows. However, as pointed out by Stoler in his dissent to the Productivity Commission (2010, p. 320):

> Opponents of [ISA] cite cases such as where governments may back off regulating cigarette packaging due to the threat of a suit by a foreign investor. In the Associate's view, the appropriate response to these concerns is to ensure that the [ISA]-related provisions of [an investment treaty] are drafted carefully enough that they preclude challenges to those regulatory areas that Australia wants to ensure are protected (for example, health-related policies). In addition, in the Associate's view, there is reason to believe that a little bit of "regulatory chill" might be a good thing, even in Australia.

Stoler's first point suggests that concerns about an incipient claim against Australia from the tobacco industry, which eventuated in June 2011 (Nottage, 2013), may have

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already been quite widespread in 2010. His proposed solution – better treaty drafting – is commendable and his final point is well illustrated by Australia's recent solar panel tariffs debacle, as previously outlined (Nottage, 2011). That is, treaties backed by ISA provisions might have made the NSW Government think more carefully before announcing its drastic policy reversal in the first place. Indeed, in this case international law would have reinforced, rather than undermined, democratic values within Australian society – namely, concerns about enacting legislation with serious retrospective effects – even if there is no outright constitutional prohibition on such enactments, and the "legitimate expectations" doctrine in domestic law may be somewhat narrower than in international investment law (Nottage, 2013). Admittedly, giving foreign investors (possibly) greater substantive rights underpinned by (probably) stronger procedural rights through ISA provisions theoretically might still "crowd out" local investors. Yet in the specific instance under question, it should be recognised that Australia is woefully behind the ball in developing its solar power potential, so attracting foreign investors and suppliers in this field should provide countervailing economic benefits.

More generally, for decades the Treasury and other parts of the Government have emphasised the broader efficiencies created by allowing foreign investors to compete in the domestic market (Crotti et al., 2010), yet the Commission does not mention this broader consideration in relation to ISA policy. Perhaps the Gillard Government considers that liberalisation and growth of inbound FDI in Australia over the last two decades means that marginal efficiency gains from further investment are likely to be small and diminishing, compared to the risks involved in accepting more inbound FDI. Alternatively, the Government may be betting on the mining boom continuing into the medium term, reducing the need to offer ISA protections to attract FDI into the resources sector. Yet neither proposition has been advanced – let alone fully argued – in the TPS or other major official pronouncements.

Rather, the Productivity Commission (2010, p. 272) went on to identify concerns raised about damages awards in ISA cases, including "the degree of freedom arbitral tribunals have in determining" amounts and the "potential for large claims" by foreign investors. It also emphasised various problems identified with arbitral procedure, ranging from the lack of appeals (for substantive error of law, presumably) and putative "institutional biases and conflicts of interest, inconsistency and matters of jurisdiction, a lack of transparency and the costs incurred by participants". The Productivity Commission (2010, p. 274) therefore concludes with Finding 14.2: "Experience in other countries demonstrates that there are considerable policy and financial risks arising from ISDS provisions".

At least the Final Report abandoned the assertion contained in the Commission's Draft Report that US investors had never lost an ISA claim, after contrary data was provided in Submissions.[12] Nonetheless, it still overstates the risks of being subjected to a claim. In fact, empirical studies suggest that damages claims are much less successful in terms of awards on both liability and damages, and incur fewer (direct) costs, than conventional critiques and anecdotes tend to assume (e.g. Frank, 2011). This final point accounts for most of the rationale provided by the Commission's Report, but it still leaves us to consider the various procedural problems highlighted by the Commission. These are real, but I argue next that they can be addressed through moderate and targeted reforms to the ISA system without rejecting it in toto.

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Alternative Means to Rebalance Private and Public Interests in ISA: Paths Not Taken

Compared to the Draft Report, the Productivity Commission (2010, pp. 274–76) devotes far more attention to measures for "reducing the risks" of ISA. These include:

- more precise definitions of more contentious terms, such as "expropriation" or "investment" and "most favoured nation" treatment related to ISA provisions;
- "time-limiting agreements" (e.g. where a "partner country is rapidly developing, such that its legal system can eventually resolve investment-related disputes" fairly anyway); and
- carve-outs for developed countries, as under AANZFTA – speculating that this might also be a way forward for the expanded TPPA negotiations.

The Commission also acknowledged my Submission that concerns about procedural rules in ISA

> can be reduced by the Australian Government through the inclusion of clauses in [investment treaties] that change the default rules of the ICSID or UNCITRAL. These changes could include requiring foreign investors to exhaust domestic legal channels prior to initiating arbitration, requiring that the existence of arbitration cases, documentation and awards be transparent and publicly available; and providing for arbitration appeals. One way to do so could be for Australia to develop a 'Model International Investment Agreement' that includes more tailored arbitration rules (sub. DR63, p. 1).
>
> Indeed, Australia followed this course in its agreement with Chile [2009], which contains considerably more detailed procedural requirements than for Australia's other agreements, including the requirement that investors attempt to consult with the host government prior to arbitration, the selection of arbitrators and the conduct of arbitration, as well as requiring transparency of arbitration documentation and any awards that are made.

The latter approach in fact represents only one of many possible reform strategies that had been submitted to the Commission.[13] The former approach, allowing institutions such as the Australian Centre for International Commercial Arbitration (ACICA) to develop tailored ISA rules for the Government to add in treaties as another option (Nottage and Miles, 2009), may be more flexible but have less immediate practical impact. A more intrusive procedural reform is to require "exhaustion of local remedies" in host state courts or administrative processes before allowing access to ISA, but specifying a time limit for local proceedings after which ISA can be invoked (as in many of China's investment treaties). Albeit at a cost, this would reduce – but admittedly not eliminate – the procedural advantages afforded by ISA to foreign over local investors, although foreign investors arguably often experience various comparative disadvantages when litigating in local courts.

Another reform option comprises carve-outs in treaties for various sectors, such as natural resources; or various types of measures, such as taxation measures – assisting

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countries like Australia interested, for example, in taxing mining companies more heavily. There can also be more broadly-worded exceptions preserving regulatory capacity, for example in relation to public health, as suggested by Associate Commissioner Stoler above. A flexible combination of these approaches, already seen in recent treaty practice world-wide (UNCTAD, 2010), seems the best way forward in terms of balancing the benefits and risks of ISA for countries such as Australia. At least on legitimacy grounds, it is arguably preferable to pressing for often one-sided obligations favouring only its investors abroad, or even (especially in the context of regional agreements) agreeing to reciprocal rights but only with partners with allegedly "developed" legal systems (as may have been envisaged by the Commission).

At least, one should consider the novel approach of allowing only inter-state dispute resolution but with the power of an investor to force its home state to initiate proceedings against the host state, as under a growing number of tax treaties – including several concluded recently by both Japan and Australia. North American investment treaties also often now provide for an interesting hybrid procedure that gives more weight to the state party while retaining some procedural rights for investors. They can initiate ISA proceedings alleging that a host state has implemented "expropriatory taxation" measures, but both states can curtail individual claims by agreeing that the measures do not constitute expropriation. This suggests a useful compromise dispute resolution process for other sensitive issues, such as public health regulations introduced by a host state (Burch et al., 2012). Unfortunately, however, the Australian Government did not examine such alternatives.

Instead, the Commission partly opened the door for the TPS to adopt a policy stance that completely eschews any form of ISA in Australia's future investment treaties. The Productivity Commission (2010, pp. 276–77) itself envisaged that investors could be left simply with the possibility of inter-state dispute resolution (not a right to activate it, as under some contemporary tax treaties: Burch et al., 2012), individually negotiated investor-state contracts or ad hoc legislative consent to arbitration (as in the Gorgon gas development), or otherwise only remedies provided by host state courts. The Commission suggested that investors may be able to obtain political risks insurance, if commercially viable. Yet such insurance is usually less extensive, especially for long-term resource developments, and often piggy-backs on government support.[14] Investors may also benefit from any general improvements in host states' legal systems thanks to overseas development assistance provided by home states, but this is typically only a long-term solution.

These non-treaty alternatives suggested by the Commission derive from an analysis that seems to have overestimated the (non-manageable) risks of ISA, while underestimating some of its general and specific benefits. It is therefore particularly worrisome that the Gillard Government in its TPS goes even further than the Commission's Recommendation, rather than adopting some more moderate and flexible approaches to addressing specific problems in the ISA system.

Private and Public Interest Group Incentives for ISA Reform

Australia's recent experience, however, suggests that few private or public interest groups are likely to have strong or unambiguous incentives to press for such a "middle way". Indeed, this may well prove to be true elsewhere, especially now that a developed

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country such as Australia has set off in a novel direction. This part sketches a broader "thought experiment" as to likely constituencies for ISA reform within contemporary nation states.

Private sector constituencies

Australia's private sector certainly made few submissions to the Commission's review in 2010, for example, and the Keidanren (Japan's key business federation) has not played a particularly large role in Japan's treaty practice regarding ISA (Hamamoto and Nottage, 2010). But perhaps this is unsurprising. *Large investors* can rely on informal links with host and home states to resolve cross-border disputes, and may also have the resources to take a longer-term approach. *Smaller investors* have even less knowledge of the pros and cons of ISA – thus creating a Catch-22 situation. Both types of firms are especially unlikely to be aware of the potential importance of ISA protections if their own home state has not yet been exposed to a claim.[15] Another factor may be the sectors from which the investors come, or in which they aim to invest. For example, a growing proportion of recent outbound investment from Australia also involves mining and resources (Productivity Commission, 2010, p. 33), and firms engaged in that type of business tend to have a high tolerance for various risks – making ISA protection less significant than for firms from other sectors, even if they do learn of its role.

As for *exporters*, they will generally be more interested in their government pressing for trade preferences in FTAs rather than strong investment chapters, although exporters nowadays are also increasingly investors or licensors of intellectual property (and so potentially already enjoying protections under investment chapters). *Domestic market oriented firms* are likely instead to *oppose* calls by foreign investors or their governments to "level the playing field" by allowing foreign investors to access the international arbitration process, not just idiosyncratic local courts. Even large *law firms* may be quite ambivalent, despite their greater access to the policymaking process than smaller law firms. After all, they disproportionately represent larger investors (with theoretically less need to press for ISA than small investors).[16] Admittedly, some large law firms increasingly promote ISA because growing ICSID caseloads represent potentially lucrative fees as advocates and arbitrators. It also raises law firms' profiles in the burgeoning and partly overlapping field of commercial (inter-firm) arbitration, but there remain many hundreds of investment treaties, many with ISA, and hence there remains plenty of work advising clients on how to structure investments to take advantage of such provisions. Likewise, the *academic community* appears to be split. Many specialists in international law are now appointed as consultants, experts or arbitrators in investor-state disputes. But many others are now making their mark as strong critics of the entire system.[17] As for *non-governmental organisations,* a growing voice in international rule-making, there are probably many more opposed to ISA than in favour – although those favouring it may sometimes be better funded or have significant influence on governments generally, such as pro-business groups.[18]

Public sector constituencies

Different parts of government can also be expected to adopt different views. A *foreign ministry* can be keen on treaty-based ISA because it can minimise time-consuming and

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expensive involvement in disputes reported by its own investors, and ISA may even avoid friction with host states. Home state investors obtain formal control over prosecuting claims themselves, so diplomats have more capacity to tell them to resolve disputes directly with their host states. If host states complain, the home state's diplomats can say that the matter is now out of their hands. Yet diplomats will probably want transparency obligations included in treaties (as in the Australia–Chile FTA) so they at least remain informed about claims lodged by their outbound investors. They can then mediate informally with the host state if necessary to maintain good diplomatic relations overall. On the other hand, foreign ministries can often have political incentives to conclude FTAs promptly for their political masters, and therefore prefer a negotiating position that minimises controversy associated with pressing for ISA provisions. Such reduced commitment to ISA seems more likely where, as in Japan (Mulgan, 2008), true negotiating authority is widely dispersed among government departments and political leaders – with multiple potential veto or blockage points.

A *justice ministry* often has the responsibility of defending international law claims brought against the government. Typically it would also provide legal opinions about the legality of governmental action, if asked beforehand. Particularly if the government takes action that generates a claim, that justice ministry might feel under threat. In any event it would need to spend time and seek resources to defend claims, which it might consider could have been allocated to more productive and less stressful pursuits. A justice ministry therefore may exhibit some reticence towards ISA, especially as it is a new and expanding field that demands careful monitoring of new developments and overall trends.

An exception to this general rule might be a justice ministry where many staff are very familiar with the legal and practical issues involved in foreign investment (e.g. because they have had experience in or coordinate closely private law firm practice) and/or they are likely to move into such legal practice (with law firms keen to retain the ex-officials' expertise in ISA proceedings in order to expand the services available to foreign investors). This pattern is found in the US Government (although the main government lawyers for its international law disputes are from the State Department), and this may be a significant factor behind the US policy of actively promoting ISA. Yet this phenomenon is probably unusual among countries world-wide, especially in the Asian region. It is not true in Australia and certainly not in Japan where government specialists in international law matters instead tend to serve within the public service for long periods. This does have the advantage of preventing a version of "regulatory capture" – biasing officials too much in favour of the ISA system because some might expect eventually to apply expertise in that field in the private sector – but the situation in countries such as Japan and Australia also means that such officials have fewer opportunities to experience how the ISA protections can help provide compensation to truly deserving foreign investors, or to constrain hasty or ill-conceived government policy measures that are likely to breach treaty obligations. Matters are unlikely to change much in the short to medium term because institutions and norms surrounding "government lawyering" tend to be path-dependent and resistant to change (e.g. Nottage and Green, 2012).

It is also possible that a justice ministry might favour ISA in a more general sense because it perceives overlaps with international commercial arbitration, which that

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ministry might also happen to be promoting. Yet there are significant differences between the two fields (Nottage and Miles, 2009), and different parts of the ministry may be charged with policy developments anyway. Certainly, despite its support of ACICA and arbitration law reform particularly over recent years, the Attorney-General's Department (and other parts of the Government) did not publicly voice this sort of argument to press for Australia to maintain a more proactive approach towards ISA.

There are few other parts of government that appear likely to strongly support ISA, either. A *commerce ministry*, such as the Ministry of Economy, Trade and Industry in Japan, may fall into that category. This ministry is keen to support its importers of natural resources from abroad to fuel Japan's world-class exporters of processed goods. But a commerce ministry would normally also have jurisdiction over less globally competitive industries, which it might want instead to shield from inbound FDI – by preserving "regulatory capacity", and opposing ISA for foreign investors. Other line ministries, such as a *ministry of agriculture*, are even more likely to take that approach, or (less cynically) to be concerned about treaty-based limits to their capacity for regulatory responses to emerging socioeconomic problems.

A *finance ministry* will also usually be very concerned about liability exposure from ISA claims from foreign investors. But what if this ministry, or a related entity, also has primary jurisdiction to develop policy about inbound investment (like the Department of Treasury in Australia) and to screen it in the national interest (through the Foreign Investment Review Board, FIRB, which advises the Treasurer)? What if it generally welcomes inbound FDI to promote allocative and dynamic efficiency? This should elicit a more positive view towards ISA.[19] Yet such a development seems likely to diminish as the local economy is progressively opened up to inbound FDI (perhaps reducing marginal efficiency gains) or if further economic studies begin to suggest that offering ISA does not significantly increase inbound FDI anyway (as asserted by the Commission).

Overall, therefore, this preliminary outline of both public and private sector (sub-) groups within nation-states which might potentially be interested in ISA indicates few obvious strong constituents for maintaining the present ISA system. A few commentators in Australia expressed surprise when the Commission's Final Report recommended a potentially major diminution in the likelihood of including ISA provisions in future treaties. Many more became concerned when the Gillard Government went even further with its TPS, especially as Australia's new policy seemed to be over-reacting to the notice of claim lodged by Philip Morris Asia in June 2011.[20] Yet perhaps a significant backlash against ISA should have been expected, in light of the various interest group dynamics sketched above. Policymakers in Asia should therefore consider this sort of broader backdrop and its practical implication for other parts of the region.

Conclusion

Overall, the somewhat belated emergence of ISA in Asia may well be halted by a domino effect around the region, initiated or accelerated by the Gillard Government's new policy stance. Major on-going FTA negotiations suggest that even international pressure may not create much incentive for Australia to rethink and adjust its new policy position. China, for example, will be very keen to conclude treaty negotiations with Australia to

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liberalise access for investments, particularly in the booming resources sector. Its recent treaty practice has been to include comprehensive ISA protections (Eliasson, 2011), which could offer particular comfort to Chinese investors in light of growing sensitivities in Australia – including some high-profile cases of FIRB blocking inbound FDI (Bath, 2011). Yet China may consider that omitting full-scale ISA may result in the Australian Government becoming more willing to let in Chinese FDI on a case-by-case basis – after all, if the Government subsequently interferes with investments from China, there exists reduced claim potential if ISA is omitted. The Chinese Government may also not lose much "face" by going along with Australia's new stance, because earlier Chinese treaties had omitted or limited ISA provisions too.

Like China and several other Asian countries, Japan is also desperate to invest in and secure natural resources from Australia, especially in the energy sector following the "3-11" disasters in June – which threw the nuclear power industry into disarray. Already, Japan has made an exception in its treaty practice by omitting ISA at the request of the Philippines, in the FTA signed in 2006 (Hamamoto and Nottage, 2010). This precedent should make its omission easier in the FTA being negotiated with Australia, which anyway has a more developed legal system, especially as Japanese investors have a much longer and very positive experience of operating in Australia. In addition, really for the first time, the media in Japan have recently started to question the merits of ISA provisions more generally. Some commentators point to Korea, where the main opposition party objected to ratification of the FTA signed in 2007 with the US (and ratified there this year), partly because of fears that US investors would disproportionately invoke ISA provisions contained in that treaty (Borowiec, 2011). A concern was that a similar situation might arise under the expanded TPPA, if Japan joined those negotiations (as became more likely from November 2011) and if ISA were to be included. Korea, too, in its FTA negotiations with Australia, may now back away from its longstanding policy of including ISA protections (outlined by Kim, 2011).

Thus, for various reasons but primarily to secure other investment and trade benefits from bilateral FTA negotiations pending with Australia, even these three major economies in Asia may break with their usual treaty practice nowadays. They may instead go along with the TPS stance of omitting ISA in their respective FTA negotiations with Australia. This would probably have ripple-on effects. For example, TPPA partners other than Japan and Australia – such as Vietnam or Malaysia – would be more likely to espouse reasons like those given by the Gillard Government or the Productivity Commission (2010) to press for omission of ISA. Even the US may accede to such a request in order to secure its first regional FTA in the Asia-Pacific region for geopolitical reasons – to counteract China's active "FTA diplomacy" in Asia over the last decade – as much as for economic reasons. Like the Gillard Government, arguably the Obama Administration may decide that it can partially appease leftist domestic opponents of ISA by omitting it in the TPPA. It may still satisfy US business interests by pointing to other benefits from that FTA – including expanded exports into Asia, to revive the lethargic American economy.

Perhaps such a brave new world, free of ISA rights, does have some benefits. Perhaps ISA provisions did not really contribute much to higher and sustainable investment flows – or they did but increasingly risked becoming counterproductive, now that many host countries have already benefited from expanded inbound FDI and are

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improving their domestic legal systems. Yet developing countries, in particular, still lack investment capital and often struggle to entrench the rule of law (Bath and Nottage, 2011). Resiling from ISA is more likely to be beneficial in the short term for countries such as Australia that are enjoying an exceptional mining boom, and which maintain protections for foreign investors thanks to existing treaties as well as a more developed legal system. Yet these conditions may well change over the long term, and meanwhile an aversion to ISA may spread among very different countries – particularly in Asia. Rebuilding the treaty-based ISA system will then prove difficult or impossible. A domino effect from Australia's new policy stance would certainly undermine the "bottom-up" or "step-by-step" approach towards developing a harmonised framework for protecting cross-border investment, which had been slowly emerging – in Asia and other parts of the world – after "top-down" multilateral initiatives foundered a decade ago.

The global financial crisis in 2008 and the Eurozone crisis in 2011 have certainly raised the broader question of whether any treaty-based framework can ever really secure regional or global socioeconomic stability. Yet a reversion to ad hoc inter-state political solutions seems unlikely to be conducive to economic activity, and risks either needlessly escalating disputes or dampening legitimate claims by investors against host states. A better approach is to rebalance legal and political mechanisms to meet contemporary needs and expectations (Nottage, 2009). Many reform options exist, including several in relation to treaty-based ISA (Burch et al., 2012). Australia and Asia should not throw out the baby with the bathwater.

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Notes

1. See http://dfat.gov.au/FTA/ajFTA/index.html.
2. See http://www.eastasiaforum.org/2011/07/30/Japan-s-3-11-disaster-and-the-FTA-negotiations-with-Australia/.
3. See http://www.dfat.gov.au/publications/trade/trading-our-way-to-more-jobs-and-prosperity.html (emphasis added).
4. See Productivity Commission, 2010, p. 285. Available at http://www.pc.gov.au/projects/study/trade-agreements.
5. Although it was subsequently justified due to Australia's confidence in America's well-developed legal system, Australian negotiators around 2003–04 would not have been unaware that Australia had traditionally been a net capital importer (thus opening itself up to more potential arbitration claims, from future US investors), while the US itself had been reassessing its own stance relating

to ISA in light of some recent claims brought by Canada under the North American Free Trade Agreement. See Nottage and Miles, 2009.

6. Conceivably, the Gillard Government could have argued that its Trade Policy Statement simply takes the Productivity Commission's Recommendation to a logical conclusion. That is, because ISA almost always gives foreign investors "greater procedural rights" than local investors (limited to local court proceedings against governmental interference with investment rights), the Commission was suggesting that Australia should eschew ISA completely. The Government has not, however, justified its stance in this way. Rather, it has acknowledged going beyond the Commission's Recommendation, emphasising Australia's preference for "non-discrimination" (cf Nottage, 2013). In any case, the Commission did not seem to intend to advocate abandoning ISA altogether; otherwise, it would have recommended precisely that.
7. Most such claims have also been brought (always against central governments) by well-resourced foreign investors, according to case filings at http://icsid.worldbank.org/ICSID/. See, for example, *Chevron v Bangladesh* (ICSID Case ARB/06/10), *Alstom Power v Mongolia* (ARB/04/10), *Impregilo v Pakistan* (ARB/03/3), *Fraport v The Philippines* (ARB/03/25), *SGS v Pakistan* (ARB/01/13) and *Mobil Oil v New Zealand* (ARB/87/2).
8. The ostensible reason is that such termination could prejudice the rights of existing investors. Yet Australia's treaties routinely provide that protections endure for 10–20 years after (unilateral) termination anyway; and states can also agree to terminate or revise treaties on agreed terms. See Nottage, 2013.
9. Compare, for example, the extra variables used in Crotti et al., 2010: this study then found significant effects on inbound FDI into Australia particularly from FTAs with investment chapters (albeit without differentiating between the levels of ISA protections contained in them).
10. See Robertson, 2012. On India's active investment treaty program nowadays, especially as it emerges as a major source of outbound FDI, see generally Ranjan, 2011.
11. *Carnegie Minerals (Gambia) Limited v Republic of The Gambia* (ICSID Case No. ARB/09/19) at http://icsid.worldbank.org/ICSID/.
12. See Submission No. DR62 (from Mark Kantor), reiterated in Submission No. DR63 (from myself), available at http://www.pc.gov.au/projects/study/trade-agreements/submissions; and http://www.eastasiaforum.org/2010/09/08/Australian-versus-Japanese-approaches-towards-investor-state-arbitration/. Unfortunately, following its usual practice, the Draft Report (July 2010) is no longer available on the Commission's website.
13. For a summary of these and more extensive alternative reform options, including major disadvantages associated with each, see Appendix A in Nottage, 2011 (available at http://ssrn.com/abstract=1860505).
14. Political risks insurance, both formal and informal (mobilising the home state), may be particularly problematic for small- and medium-sized investors, with less financial and political bargaining power. Conversely, such firms appear to be significant users of ISA: OECD, 2012, pp. 16–17.
15. This is likely to have been one factor behind the lack of Australian business sector input into the Commission's Inquiry over 2010. Peak business interest groups have become much more interested in ISA protections since the Philip Morris Asia claim against Australia was widely reported from mid-2011 (as outlined in Nottage, 2013). For an example of a large Australian firm that seemed capable of indirectly exercising diplomatic leverage to extract itself from a resources investment in Africa, see Askew and Ayala, 2006.
16. The picture is further complicated in countries such as Australia, as large law firms have generated an increasing proportion of fee income from litigation and other legal services provided to the Government since deregulation in 1999; see Nottage and Green, 2011. If foreign investors sought to retain such firms when claiming against the Australian Government, they might be reluctant to take on such cases as they might have a conflict of interest or it might jeopardise other potential work for the Government.
17. See, for example, the 'Public Statement on the International Investment Regime' (31 August 2010), available at http://www.osgoode.yorku.ca/public_statement/.
18. Consider the invitation-only workshop on ISA policy convened by the Commission on 29 September 2010, in response to various Submissions including some (like mine) critical of its Draft Report. It involved a few other academics (economists including Dr Emma Aisbett, one of the abovementioned 'Public Statement' signatories), some officials, and representatives from AFTINET

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(the Australian Fair Trade and Investment Network) and the Australian Council of Trade Unions. The business sector was not represented. See the participant list in Productivity Commission, 2010, p. 336.

19. See http://www.eastasiaforum.org/2009/07/24/China-national-security-and-investment-treaties/.
20. See, for example, *The ACICA News*, September 2011, especially pp. 10–19, available at http://acica.org.au/assets/media/news/TheACICANewsSeptember2011.pdf.

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