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Submission to Review of Australia's Bilateral Investment Treaties

Please find below a submission my personal academic submission to the Review of Australia's Bilateral Investment Treaties. As well as providing this submission, I would like to offer my expertise to discuss these issues further as appropriate.

Thank you for the opportunity to provide this submission.

Yours sincerely,

Emma Aisbett

Introduction and key reform proposal

The raison d'être for compensation rules and investor-state dispute settlement (ISDS) in international investment agreements (including BITs) is protection of foreign investments from predatory behaviour by host states – for example, a state's uncompensated seizure of a foreign investor's assets. Discrimination concerns can be addressed adequately through state-state dispute mechanisms, as is standard in trade agreements. Investment treaties should not provide foreign investors with generalised protection from unexpected regulatory change.

Current compensation and liability rules in BITs and other IIAs, however, treat all three issues in the same way. They give foreign investors rights to compensation when host states take action in response to changing circumstances or new policy priorities. These rights are superior to those enjoyed by domestic investors. The ability to frame plausible investment treaty claims in response to regulatory change gives foreign investors an unfair advantage compared to domestic investors. These sorts of protections are highly unpopular and threaten the legitimacy and sustainability of the entire investment treaty regime. The Phillip-Morris v. Australia tobacco plain packaging dispute is a case in point. (Australia won this case on jurisdictional grounds.)

In recent work, Jonathan Bonnitcha and I have proposed an amendment to compensation requirements under IIAs that maintains protection from host predation (i.e. opportunistic behaviour to capture directly or indirectly part of the investment) while allowing governments to set their own policy agenda and respond to new information about the state of the world. The application of this proposal in any given case calibrates compensation to the extent that host state conduct involves predation on the foreign investment – the proposal does not require a tribunal to decide whether it perceives the state's action as predatory.

In times of crisis such as we are currently experiencing, the importance of governments maintaining the ability to undertake measures in response to new developments has become painfully clear. **Our proposal is that a state should only have to compensate the investor if it breaches or modifies the domestic legal regime governing the investment, and that compensation should be the lesser of the investor's loss and the host state's gain from the host state not having had the new legal regime in place when the investment was made.** This proposal could be relatively easily implemented as an amendment relating to the calculation of damages in existing treaties.

Importantly, our proposal still protects foreign investors from predatory host behaviour. With nationalism on the rise around the world, claims that ISDS is unnecessary because all forms of expropriation and takings are rare become harder to support. Our compensation rule deters predatory behaviour by requiring that the host repay any gain it had from allowing an investment and then changing the rules surrounding it. For example, if a host sells a licence or concession to a foreign investor and then changes the rules to

render the associated investment unprofitable, the host must repay all fees and taxes as well as the value it gains from any infrastructure or other benefits from the investment that it retains. This requirement deters that host from taking such actions in the first place. In the language of economics, our rule provides a commitment device allowing hosts to overcome the (hold-up) problem caused by time inconsistency of optimal policy toward an investment.

In some cases where compensation is required under existing rules in IIAs, it would not be required under our rule, or it would be much less. This class of cases arises when the host's change in policy is driven new information – for example about the environmental, health or social cost of an investment – rather than by time-inconsistency of optimal policy. Rules which require hosts to compensate for this class of action often leave hosts worse off. They are also massively politically unpopular and constitute the major threat to the legitimacy and continuation of the investment treaty regime. Vattenfall v. Germany II is a key historical examples. The Spanish solar cases – where Spain was forced to lower feed-in tariffs in response to the 2008 Global Financial Crisis are another. Many cases surrounding revocation or failure to grant rights to natural resource extraction also fall into this category.

In conclusion, the Aisbett and Bonnitcha proposal ensures benefits to both host states and foreign investors compared to a world in which there is no investment treaties. As such it is likely to enhance the acceptance of the regime in countries that have historically been wary, as well as providing a much-needed legitimacy boost in countries that are re-considering their involvement with the regime. Given the twin challenges of rising nationalism and major health and economic crisis, a regime which protects investors from predatory host behaviour while allowing governments to respond to emerging policy issues is desperately needed. Amending existing treaties in line with our proposal could provide just such a regime.

Responses to specific questions

- In your view, are the existing BITs of benefit to Australian investors operating in these overseas markets? Please comment on their utility.

The evidence on whether and how BITs and other IIAs actually benefit foreign investors (Australian or otherwise) is surprisingly thin. In a paper published in the Review of World Economics (Aisbett, Busse & Nunnenkamp, 2016) we find evidence that investors into low- and middle-income countries value BITs for their perceived ability to deter host governments from taking unfavourable actions for the investor. Once a host has allowed a dispute to go through to arbitration (demonstrating it will not always be deterred), any investment gained at the time of BIT signing is lost.

There is also evidence that investors will only bring a case to formal dispute settlement as a matter of last resort, because they know it will seriously damage their relationship with the host government. This is probably why China, the largest recipient of foreign investment in the world, has only ever faced three ISDS disputes (according to UNCTAD). In general, Australian investors operating in growth markets in Asia are likely to be reluctant to make use of ISDS except when they are already exiting a market.

Finally, as discussed in the Introduction, the purpose of BITs is to solve host state's time inconsistency of optimal policy and prevent predatory/opportunistic behaviour (hold-up problems). For countries like Australia, with relatively high-quality governance and institutions, time-inconsistency of policy is not a problem, and hence BITs are not necessary from a "host" perspective. For the same reason, BITs/IIAs are not necessary means of protecting Australian investors in other well-governed countries.

- In your view, does the existence of a BIT impact on the flow of foreign direct investment and /or portfolio investment? Please comment, if possible, both generally and with reference to specific existing BITs.

There is a large academic literature addressing this question, to which I have made a contribution. While there is still much debate, and a substantial variation in the quality of the analysis, most recent papers find a positive correlation between BIT participation and foreign investment flows (see for example, Egger & Merlo, 2012). Although the better quality econometric evidence carefully avoids endogeniety caused by omitted variables, only one of the papers to date have addressed endogeneity caused by reverse causality. Reverse causality will upwardly bias the estimates of BIT impact if FDI increases between two countries mean BITs are more likely to be formed (see Aisbett, 2007 for explanation of the endogeneity issues plaguing the analysis of the relationship between BITs and FDI). Some counties, such as Germany, explicitly consider the growth rate of FDI in the decisions about which treaties to prioritise. The fact that none of the literature controls for this issue means that we cannot tell to which extent the positive correlation between BIT formation and FDI is due to BITs causing FDI or the other way around.

Another caveat on the common finding that BTIs and FDI are positively correlated is provided by papers which consider the relationship once disputes occur. Aisbett, Busse & Nunnenkamp (2016), show that the apparent increase in FDI from BIT formation is conditional on the BITs not leading to disputes – at least for low and middle income countries. Higher income countries seem to retain the induced FDI even after a dispute, though the relatively low number of disputes for this group of countries at the time of analysis means it is difficult to draw firm conclusions.

- Do you have concerns about Australia's existing BITs? If so, please comment on any specific provisions of concern.

As Australian experience has shown, the inclusion of ISDS in BITs and other IIAs is concerning, especially given current rules allow investors to seek compensation for legitimate public policy actions which harm their profits. This right for foreign investors is

particularly problematic in light of the increasing taste for interventionist policy in response to global climate imperatives (e.g. the low emissions Technology Investment Roadmap) and the COVID-19 crisis.

- If Australia took the approach of re-negotiating at least some of the existing BITs, do you have views on which clauses should be included in a renegotiated agreement?

As discussed in the Introduction, Jonathan Bonnitcha and I have a proposal for the reform of damages calculations which we believe could address many of the wide-spread concerns about BITs/ISDS while preserving their ability to deter and/or compensate predatory or opportunistic behaviour by hosts.

- In your view, would any concerns you have about any of Australia's existing BITs warrant termination of one or more BITs? Please comment, as relevant, both generally and with reference to specific existing BITs.

Australia should consider terminating any BITs which cannot be renegotiated to either: remove ISDS, or adjust damages/compensation calculations in line with the Aisbett-Bonnitcha proposal. Particularly BITs with countries with significant outward FDI should be considered for termination. Current-style BITs with FDI source countries are potentially costly to Australia since they are not necessary to attract investment, and yet constrain the ability of governments to respond dynamically to new or changed public policy imperatives.

- There are various models and approaches that different countries take in relation to international investment agreements. For instance, some models are concerned with investment facilitation rather than dispute resolution. In your view, is there a particular approach that is suited to meeting the interests of Australian industry and business?

Investment facilitation, as favoured by countries such as Brazil and India, is an efficient means of encouraging mutually beneficial foreign investment flows. By not involving legal protections, enormously costly and wasteful disputes are avoided for both parties.

However, investment facilitation ultimately does not provide an international commitment device, and hence cannot solve host's time-inconsistency of optimal policy and potential resulting hold-up problems leading to under-investment. Internationally enforceable compensation rules are a potential solution to time-inconsistency problems for host states. The Aisbett-Bonnitcha proposal retains the ability of BITs to provide a commitment device, while ensuring that compensation rules do not inhibit hosts' ability to respond to new information/situations.

- In light of the various policy options available,[2] what approach do you consider should be taken? Please comment, if possible, both generally and with reference to specific existing BITs.

Please see "Introduction and main proposal" above.

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