Investor State Dispute Settlement in Free Trade Agreements: An Australian Perspective

Roberto Bergami

Abstract: Investor State Dispute Settlement (ISDS) clauses in Free Trade Agreements (FTA) have gained increased prominence in response to recent activity from investors and governments alike. This has become a global issue given the number of new disputes and the explosion of FTA and regional trade agreements that have been spawned as a result of the stalled World Trade Organisation talks.

In 2013 alone 57 new ISDS cases were commenced, covering a wide variety of sectors, including: supply of electricity/gas; oil and mining; telecommunications; manufacturing; construction; tourism; banking; real estate services’ retail; media; and advertising. Whilst these cases will typically require prolonged settlement periods as they weave their way through negotiation and litigation, this does not alleviate concerns about ‘special’ investor provisions and what they mean for the recipient investment nation.

There are two main perspectives on ISDS. The first is the government that is seeking to entice foreign investment in such a manner that makes it attractive to would-be investors, but at the same time retain the right to ‘properly govern the nation, including making future changes for the benefit of the nation’s citizens. The second perspective is that of the investor who, understandably, is looking to have their inputs protected from potentially unfavourable future government policy changes.

This article provides a summary of Australian FTA, highlighting ones with ISDS provisions, concluding there is no clear convergence on competing perspectives of governments and investors and a solution to please all is unlikely to be forthcoming in the near future.

Key words: Foreign Direct Investment · International Economics · International Business · Free Trade Agreements

JEL Classification: F13 · F23

1 Introduction and Literature Background

This paper considers Investor State Dispute Settlement (ISDS) clauses in Free Trade Agreements (FTA) focusing on their application and desirability. Firstly, some background is provided in relation to the development of ISDS in the context of a more globalised economy and changing trade and investment patterns. This is followed by a brief literature review, prior to a short description of the methodology. The discussion of ISDS is provided next, from an Australian perspective that considers the changing attitudes on ISDS resulting from changes in government ideology, before reaching the conclusion. It should be noted this paper does not focus on the legalities of various systems, nor does it concentrate on the different type of ISDS clauses that may exist in the multitude of FTA around the globe, rather the approach taken is at a more ‘macro’ level, preferring to argue the points in principle, from a more ideological perspective and restricting detailed discussion to the Australian business environment.

Investor State Dispute Settlement (ISDS) refers to a mechanism for „the settlement of disputes between investors and the countries in which they are established [and] is a key aspect of investment protection under international investment agreements (IIA)“. IIA provisions are commonplace in FTA nowadays. In relative terms, ISDS are a new mechanism that only began to emerge in the mid-twentieth century and one that has had a different, and arguably beneficial, impact on settling disputes among nations. In fact, prior to ISDS „disputes that could not be resolved by direct investor-state dialogue or proceedings in domestic courts were either not settled or were handled by home State espousal of the claim via diplomatic processes or, at times, by the threat or use of military force“ (Organisation for Economic Co-operation and Development, 2012, p. 7).

As „trade and foreign direct investment tend to be correlated“ (Kirchner, 2008, p. 14), it has been argued „the principles for the protection of FDI [Foreign Direct Investment] and ISDS should be implemented multilaterally“ (Bundesverband der Deutschen Industrie e V., 2014, p. 4). Whilst there is currently no international standard for the development and application of ISDS, these have nevertheless increasingly been inserted into all types of FTA, as these

1 Dr. Roberto Bergami, PhD, Senior Lecturer, Practice of International Trade, College of Business, Victoria University, Melbourne Australia and Visiting Professor at Department of Trade and Tourism, Faculty of Economics, University of South Bohemia in Ceske Budejovice, email: Roberto.Bergami@vu.edu.au
move beyond tariff reduction commitments that, in many cases, take decades to fully implement. The more recent FTA generally "seek to facilitate trade and investment transactions ... [but at the same time] contain commitments to liberalise and/or protect investment flows between the parties" (United Nations Conference on Trade and Development, 2007, p. 3). The main thrust of ISDS is the protection of investors against discrimination, expropriation or nationalisation, and by providing a minimum standard of treatment through particular processes specified in FTA.

It is generally accepted that the failure of the WTO to move beyond the stalled Doha round of multilateral negotiations has been the major catalyst for the 'explosion' of FTA around the world generally, and particularly in Asia-Pacific. This has given rise to a complex web of agreements that also reflect changing patterns of trade around the world, moving away from the traditional North-South co-operation to a greater South-South co-operation environment. This shift also reflects the changing nature of membership of new agreements. Historically, these were "concluded principally among countries at similar levels of economic development, [whereas] they are now negotiated with greater frequency between developed and developing countries" (United Nations Conference on Trade and Development, 2007, p. 3). The complexity of such arrangements can be seen at Figure 1, in what is now commonly referred to as the 'Asia-Pacific FTA Noodle Bowl'.

**Figure 1** Asia-Pacific FTA Noodle Bowl

The increase in ISDS disputes in the past two decades has been exponential, as shown in Figure 2, creating considerable recent debate in the international trade community, with varying viewpoints about the outcomes of such disputes, with particular concerns over the process of dispute resolution. The major viewpoints are summarised below.

According to Townsend (2013), one of the main issues with ISDS is that they may provide investors with the authority to challenge the laws made in an investor-recipient nation through an international court of arbitration, thereby allowing foreign investors "to by-pass domestic legal systems and have their case heard by an external party". There a number of tribunals that may hear ISDS processes, including the International centre for Settlement of Investment Disputes (ICSID), the United Nations Commission on International Trade Law (UNCITRAL), and the International Chamber of Commerce (ICC). Referral to an independent third party (ICSID, UNCITRAL, ICC) may well be regarded as a desirable approach under a rogue state or dictatorship, where a fair hearing of the dispute between investor and state is unlikely to occur within that domestic legal system. Under such circumstances, referral to such third parties may be regarded as a reasonable investor expectation. However, Townsend (2013) notes the increasing trend for investors to evoke ISDS clauses by countries with robust legal systems that are neither rogue states, nor dictatorship, such as Australia, for example. In this regard, Townsend (2013) alludes to the plain packaging tobacco dispute that will be discussed in greater detail in the section following the methodology.
Ikenson (2014) argues strongly against the existence of ISDS, let alone their inclusion in FTA. According to this author, ISDS clauses:

- protect multinational corporations by creating institutions that protect them from the consequences of their business decisions;
- pander to the whims of multinational corporations who receive better than national treatment by virtue of disputing outside national legal systems, and
- encourage frivolous disputes by creative lawyers.

Conversely, Trackman (2012) concludes that government choice of domestic courts "is also about states exercising normative preferences based on macro-economic and political assumptions" (p. 1011). This author argues these assumptions are not valid as governments play both sides of the investment pendulum: on the one hand they want to have their corporations protected in foreign jurisdictions and, on the other hand, they would object to being challenged on domestic soil by a foreign entity, yet there is a need to attract FDI at the same time – there is natural conflict of interest in such an environment, that casts doubt on the ability of government to oppose ISDS clauses in FTA outright.

According to the findings of a study by Bergar, Busse, Nunnenkamp & Roy (2012), the relatively low economic strength of a nation „may indicate that minor host countries were harder pressed to agree to stronger ISDS provisions“ (p. 268), ultimately ending up as a respondent. There has been a general skew in cases filed against developing and transition nations, as shown in Figure 3, with these nations accounting for just under three quarters of all cases. To date, the „overwhelming majority (85 per cent) of ISDS claims were brought by investors from developed countries“ (Investment and Enterprise Division - UNCTAD, 2014). There is much money at stake in these disputes – the Al-Kharafi v. Libya case was the second highest known award in history at USD 935 million.

Figure 2 Known ISDS Cases (at as end of 2013)

Source: Investment and Enterprise Division - UNCTAD (2014, p. 7)

The patterns in Figure 3 may explain a recent refocus on ISDS clauses, where, instead of refusing to consider these outright, a trend appears to be emerging favouring clarification and limitation of ISDS application through better clause re-drafting. This appears to be consistent with patterns that, according to Henry (2013), have emerged within Asia-Pacific Economic Co-operation (APEC) member economies. Henry (2013) concludes economies are paying more atten-
tion to carving out certain areas of public policy such as environmental health and welfare, but „seldom with the full breadth of the WTO GATT and GATS exceptions“ (p. 217). Henry (2013) claims there is evidence that wording of ISDS clauses has considerably harmonised in recent agreements in APEC, but unfortunately this has not extended to strengthening the agreements in such a way as to support consistent outcomes. There is further evidence of clause redrafting in the Transatlantic Trade and Investment Partnership (TTIP) negotiations by the European Union public consultation process, claiming it will be „introducing modern and innovative provisions clarifying the meaning of this investment protection standards that have raised concern in the past: fair and equitable treatment ... and indirect expropriation“ (European Commission, 2014).

Having provided a concise summary of the most relevant literature, a brief explanation of the method employed in the research follows.

## 2 Research Method

The method employed for this research is a high level review of Australian FTA implemented over the past decade, and those that have been signed and are awaiting domestic approval for implementation. The aim is to quantify how many of these agreements incorporate ISDS clauses and the extent to which they represent two way trade and investment flows. Based on this information, the discussion focuses on Australia’s only experience with an ISDS dispute in over 30 years and the sort of question and issues this has highlighted in terms of future ISDS clauses in FTA negotiations.

## 3 Research Results

Australia has a number of FTA, most of which have become effective in the past decade. Australia led the world with the historic Australia New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) in 1983, but did not negotiate any further FTA until the start of the century. Table 1 provides a summary of the current operating FTA, as well as FTA that have been signed, but not yet operational, identifying those having ISDS provisions.

### Table 1 FTA, Trade and Investment Between Australia and Other Nations

<table>
<thead>
<tr>
<th>Partner nation(s)</th>
<th>FTA Type</th>
<th>Year</th>
<th>ISDS Provisions</th>
<th>Percentage of Total Trade¹</th>
<th>FDI AUD Millions²</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Export %</td>
<td>Import %</td>
</tr>
<tr>
<td>New Zealand</td>
<td>Bilateral</td>
<td>1983</td>
<td>No</td>
<td>3,7</td>
<td>3,1</td>
</tr>
<tr>
<td>Singapore</td>
<td></td>
<td>2003</td>
<td>Yes</td>
<td>3,4</td>
<td>5,8</td>
</tr>
<tr>
<td>Thailand</td>
<td></td>
<td>2005</td>
<td>Yes</td>
<td>1,9</td>
<td>3,9</td>
</tr>
<tr>
<td>US</td>
<td></td>
<td>2005</td>
<td>No</td>
<td>4,9</td>
<td>12,8</td>
</tr>
<tr>
<td>Chile</td>
<td></td>
<td>2009</td>
<td>Yes</td>
<td>0,1</td>
<td>0,4</td>
</tr>
<tr>
<td>Malaysia</td>
<td></td>
<td>2012</td>
<td>No</td>
<td>2,2</td>
<td>3,4</td>
</tr>
<tr>
<td>South Korea¹</td>
<td>TBA</td>
<td></td>
<td>No</td>
<td>7,2</td>
<td>3,2</td>
</tr>
<tr>
<td>Japan¹</td>
<td>TBA</td>
<td></td>
<td>No</td>
<td>16,6</td>
<td>6,6</td>
</tr>
<tr>
<td>ASEAN &amp; NZ:²</td>
<td>Regional</td>
<td>2010</td>
<td>Yes</td>
<td>11,4 (Excludes New Zealand)</td>
<td>17,7 (Excludes New Zealand)</td>
</tr>
<tr>
<td>New Zealand</td>
<td>Regional</td>
<td>2010</td>
<td>Yes</td>
<td>11,4 (Excludes New Zealand)</td>
<td>17,7 (Excludes New Zealand)</td>
</tr>
<tr>
<td>Singapore</td>
<td>Regional</td>
<td>2010</td>
<td>Yes</td>
<td>11,4 (Excludes New Zealand)</td>
<td>17,7 (Excludes New Zealand)</td>
</tr>
<tr>
<td>Myanmar</td>
<td>Regional</td>
<td>2010</td>
<td>Yes</td>
<td>11,4 (Excludes New Zealand)</td>
<td>17,7 (Excludes New Zealand)</td>
</tr>
<tr>
<td>Brunei</td>
<td>Regional</td>
<td>2010</td>
<td>Yes</td>
<td>11,4 (Excludes New Zealand)</td>
<td>17,7 (Excludes New Zealand)</td>
</tr>
<tr>
<td>Vietnam</td>
<td>Regional</td>
<td>2010</td>
<td>Yes</td>
<td>11,4 (Excludes New Zealand)</td>
<td>17,7 (Excludes New Zealand)</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Regional</td>
<td>2010</td>
<td>Yes</td>
<td>11,4 (Excludes New Zealand)</td>
<td>17,7 (Excludes New Zealand)</td>
</tr>
<tr>
<td>Philippines</td>
<td>Regional</td>
<td>2010</td>
<td>Yes</td>
<td>11,4 (Excludes New Zealand)</td>
<td>17,7 (Excludes New Zealand)</td>
</tr>
<tr>
<td>Thailand</td>
<td>Regional</td>
<td>2010</td>
<td>Yes</td>
<td>11,4 (Excludes New Zealand)</td>
<td>17,7 (Excludes New Zealand)</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Regional</td>
<td>2010</td>
<td>Yes</td>
<td>11,4 (Excludes New Zealand)</td>
<td>17,7 (Excludes New Zealand)</td>
</tr>
<tr>
<td>Laos</td>
<td>Regional</td>
<td>2010</td>
<td>Yes</td>
<td>11,4 (Excludes New Zealand)</td>
<td>17,7 (Excludes New Zealand)</td>
</tr>
<tr>
<td>Cambodia</td>
<td>Regional</td>
<td>2010</td>
<td>Yes</td>
<td>11,4 (Excludes New Zealand)</td>
<td>17,7 (Excludes New Zealand)</td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td></td>
<td></td>
<td>40</td>
<td>39,2</td>
</tr>
<tr>
<td>Total Trade and Investment Subject to FTA ISDS</td>
<td></td>
<td></td>
<td></td>
<td>16.8</td>
<td>27.8</td>
</tr>
</tbody>
</table>

Notes:
1. South Korea and Japan FTA signed, but yet to be ratified domestically – no start date announced yet
2. ASEAN (including New Zealand) is the only Regional FTA signed by Australia to date. This became effective as member nations ratified the FTA domestically. Australia has concurrent bilateral and regional FTA with Singapore, Thailand, Chile and ASEAN-New Zealand.
3. 2012 figures reported
4. 2013 figures reported

Source: Australian Department of Foreign Affairs and Trade and own processing
As can be observed from Table 1, ISDS provisions to date cover the minority of trade and FDI flows, reflecting the negative balance position Australia has with ISDS partner nations. However, Australia also has another 21 Investment Protection and Promotion Agreements (IPPA) with: Argentina, China, Czech Republic, Egypt, Hong Kong, Hungary, India, Indonesia, Laos, Lithuania, Mexico, Pakistan, Papua New Guinea, Peru, Philippines, Poland, Romania, Sri Lanka, Turkey, Uruguay and Vietnam (Department of Foreign Affairs and Trade, 2013). As much of the FDI data is not published, it is not possible to further explore the ramifications of these IPPA. However, the only ISDS dispute Australia has been involved in as a respondent is via the IPPA with Hong Kong, that is discussed below.

**Australia's single ISDS Experience as a Respondent**

On 1 December 2011, the *Tobacco Plain Packaging Act 2011* (TPPA) became law in Australia. This was one of the measures devised by the Gillard Labour government to reduce the rate of smoking, regarded as one of the leading causes of preventable death in Australia. It is important to understand the Australian environment in relation to smoking and general society attitudes towards it, is influenced by laws and regulations. Smoking in Australia appears to be less prevalent and entrenched than in areas such as Europe. Legislation to control smoking in public places has been in force for a number of years. In Australia, it is illegal to smoke in any public place, including: any form of public transport (bus, tram, train, aircraft and taxi); any indoor office space; restaurants; shopping centres; cinema theatres; government buildings; schools, universities and other educational institutions; and hospitals. In other words, where individuals congregate publicly smoking is not permitted. When office workers wish to smoke they have to leave the building and smoke outside. Governments at all levels (federal, state and municipal) have been very active in trying to portray smoking as an unacceptable form of social behaviour, pointing out „the social costs of tobacco exceeded $31 billion in 2005, but it is impossible to put a value on the grief suffered by the hundreds of thousands of families who have lost a child, a spouse or a parent in what should have been the most productive and rewarding years of their life“ (Moodie, 2009, p. v).

Against this backdrop, and based on a World Health Organisation recommendation (Tienhaara & Ranald, 2011), TPPA became law, in what is commonly regarded as an example of legislation in the public interest. TPPA requirements for tobacco products are plain paper packaging, with health warnings, but no branding. Trouble with one foreign investor, however, was brewing long before TPPA became law. In fact on 27 June 2011, Phillip Morris Asia (PMA) challenged the Australian government under various articles of the 1993 Agreement between the Government of Australia and the Government of Hong Kong for the Promotion and Protection of Investments (Hong Kong Agreement). The legislation was challenged firstly with two proceedings through domestic courts beginning in 2011. The High Court of Australia (the highest court) on 15 August 2012 found TPPA not to be contrary to s51 (xxxi) of the Constitution. On 5 October 2012 the High Court held „there had been no acquisition of property that would have required provision of „just terms’ under s51(1xxxi) of the Constitution“ (Attorney-General's Department, 2012).

Whilst domestic court proceedings were progressing PMA submitted a formal notice of arbitration served to the Australian government on 21 November 2011. This process has not yet concluded and documents are not currently available to the public. The actions of PMA have raised concerns, with some pointing out this behaviour seems odd as „the ostensibly American company is engaged in a similar dispute with Uruguay, although in that case it claims to be a Swiss investor“ (Tienhaara & Ranald, 2011). The „long reach” of the multinational enterprise can be clearly seen in these cases. A subsidiary can be strategically used in pursuing claims, where that is „conveniently’ located in a jurisdiction that is a party to some form of treaty with ISDS provisions. This not only demonstrates the power and influence of the multinational and its pursuits of profit maximisation as the predominant reason for its existence, but it also calls into question its social corporate responsibility.

The fall-out from the ISDS case has certainly polarised views and challenged the status quo in Australia. The TPPA is legislation for the public interest with a number of benefits, as mentioned above. Smoking causes illness and increases the cost of health care to the community the smokers are part of. The foreign multinational enterprise seems content to reap the rewards of selling tobacco products, as it pursue profit maximisation, but of course is not interested in contributing to the increased health costs the government has to bear, as a result of smoking related illnesses. Instead, the foreign multinational enterprise claims it brings economic wealth to that community because its operations generate employment. Furthermore, when a government tries to reduce smoking for the benefit of its citizens, the foreign multinational enterprise objects and tries to put a stop to this, or else it may hurt its investment. It is difficult to see any consideration of social corporate responsibility principles being applied by the enterprise, quite the opposite.

**4 Conclusions**

ISDS clauses have gathered increasing prominence in discourses around the world as new agreements are being forged and activists are becoming more engaged and vocal about warning of the dangers, loosely worded, or too far-reaching, ISDS clauses may bring. The usefulness and legitimacy of ISDS have certainly been brought into question recently, as
ISDS have turned into „arguably the most controversial issue in international investment policy making“ (Investment and Enterprise Division - UNCTAD, 2014, p. 24).

It is neither easy nor clear to predict what Australia’s position will be in the future in terms of including or negotiating ISDS clauses in FTA. The Gillard government, when in power, was adamant that ISDS would no longer feature in FTA, as a result of the PMA case. Of course, as governments change, so do policies, and not necessarily along ideologically predetermined old party-lines. As an example, the Howard Liberal government refused to incorporate ISDS clauses in the US-Australia FTA, but the current Abbott Liberal government has just, rather secretly, agreed to ISDS provisions in the Korea-Australia FTA due to be implemented soon. Although it is claimed these ISDS clauses carve out specific areas, such as pharmaceuticals, it remains to be seen whether enterprising lawyers can work their way around these clauses and potentially undermine government sovereignty.

Ultimately, a better solution than what has so far been devised needs to be found. From the Australian perspective, it is clear that inward FDI is an important part of the economy and a significant source of capital. The difficulty is in achieving a balance between happy foreign investors and putting citizens’ interests first. There is a need to attract inward FDI, but this should not be done at any cost, in either the short or long term.

There are significant challenges looming on the horizon for Australia. Negotiations with China are at an advanced stage and the current Australian government wishes to conclude these rather quickly, but secrecy seems to be the order of the day in relation to these negotiations. The danger for Australia is that its economy is very intertwined with that of China in what may be seen as an unhealthy mix. In 2013 Australian exports to China represented 36.1% of total (about 80% of which was primary resources such as iron ore, coal, gold and copper), and imports were 19.6% of total. Australian outward FDI was AUD M6350, but inward FDI was AUD M20832. These figures reflect the considerable investment in energy sectors, particularly mining, that have already been made by China. These have raised concern, for if the buyer (China) controls the supply lines (Australian mines), future export prices will not be controlled from the Australian end. Changes to FDI rules have already been made in response to state owned enterprise investments.

Perhaps a solution may be to devise a standard set of ISDS clauses for global application, with more limited avenues for claims, especially where these may be against public interest. Certainly one recommendation would be to involve the public in open and transparent consultation, as after all, democratically elected governments are meant to be there to serve their constituents.

References


