AFTINET updated briefing paper on Investor-State Dispute Settlement (ISDS)

June 2023
1. Background  
2. Evidence of ISDS impacts on foreign direct investment is ambiguous  
3. Experience of ISDS cases has led to ISDS legitimacy crisis  
4. ISDS cases on medicines, environment, indigenous land rights, minimum wage  
5. ISDS cases against government regulation of carbon emissions  
6. Clive Palmer isds case exposes abuse of ISDS forum shopping and need for review of current agreements with ISDS  
7. Australian mining companies’ use of forum shopping to sue developing countries impact on australia’s reputation and diplomatic relationships  
8. Growth in ISDS awards to billions and use of third-party speculative funding  
9. Conclusion and need to remove ISDS from existing agreements
Background

The Labor government elected in May 2022 has a policy against Investor-State Dispute Settlement (ISDS) in new trade agreements, and to review it in existing agreements.

The number of reported ISDS cases has been increasing rapidly, reaching 1,257 in June 2023.\(^1\)

ISDS originated in the post-World War Two decolonisation period and was originally designed as an international investment tribunal system to compensate foreign investors for nationalisation or expropriation of actual property, through bilateral investment treaties (BITs) between industrialised and developing countries.

But over the last half century, the ISDS system has developed concepts like “indirect” expropriation, “minimum standard of treatment” and “legitimate expectations” which do not involve taking of property and do not exist in most national legal systems. These concepts enable foreign (but not local) investors to sue governments for millions and even billions of dollars of compensation if they can argue that a change in domestic law or policy has reduced the value of their investment, and/or that they were not consulted fairly about the change, and/or that it did not meet their expectations of the regulatory environment at the time of their investment.

Unlike national legal systems, in which judges must cease to be practising advocates, ISDS tribunals do not have independent judges, but are *ad hoc* panels of part-time arbitrators who can continue to be advocates, with potential conflicts of interest. ISDS also lack the precedents and appeals in national systems which ensure consistency of decisions.\(^2\) The legal framework, lack of independent judges and lack of precedents and appeals mean the ad hoc tribunals often pay more attention to compensating investors than to whether the change in policy or regulation is in the public interest. This means that ISDS cases can enable foreign investors to undermine democratically determined regulation in the public interest.

In the post-war period, former colonial powers and wealthier countries, supported by business organisations, insisted on BITs containing ISDS with developing countries, and countries transitioning from centralised economies after 1991, arguing that ISDS was needed to protect foreign investors.

Trade agreements are generally enforced through State-to-State dispute processes. These enable states to bring a dispute to an agreed tribunal process if another state violates the legally binding commitments in the agreement. The tribunal findings are enforce through trade sanctions. ISDS is a separate additional dispute process giving individual corporations the right to initiate disputes.

The World Trade Organisation does not recognise or include ISDS in its trade agreements and it has only become a feature of broader regional and bilateral trade agreements since its inclusion in the North American Free Trade Agreement (NAFTA) in 1994.

The two institutions which provide ad hoc tribunals to ISDS arbitration systems, the United Nations Commission on International Trade Law (UNCITRAL) and the World Bank International Centre for

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Settlement of Investment Disputes (ICSID), have conducted reviews which recognise that there are flaws in the system.³

Australia has 15 bilateral investment treaties and 10 out of a total of 17 broader trade agreements which include ISDS. More recent agreements with the UK, India, the EU and the Regional Comprehensive Economic Partnership (RCEP) with 14 Asia-Pacific countries, have excluded ISDS. Previous agreements with New Zealand, the US, Malaysia, Japan, the Pacific Islands and a previous agreement with India have also excluded ISDS.⁴

**Evidence of ISDS impacts on foreign direct investment is ambiguous**

Supporters of ISDS claim that it gives confidence to investors and is likely to increase the level of foreign investment, especially in developing countries. However, a comprehensive review by Bonnitcha et al of the impacts of ISDS in BITS on Foreign Direct Investment (FDI) notes the complexity involved in measuring the impact of this single variable on foreign investment flows, which are impacted by many factors. They conclude that

> The studies’ results are mixed. A majority find that bilateral investment treaties have a positive and statistically significant impact on inward FDI in at least some circumstances. Amongst these the scale and impact varies remarkably with some reporting strong effects and others finding positive but only small effects. Among the studies reporting a positive effect of BITS on investment flows, some also come to apparently contradictory findings. Finally a sizeable minority of studies find there was no statistically significant effect of BIT adoption on FDI.⁵

A 2018 study of official FDI statistics in five countries whose governments had terminated BITS – Ecuador, Bolivia, South Africa, Indonesia and India found that that “investment flows from former BIT partner countries were more likely to increase rather than decrease after BIT termination,” and concluded that

> While the findings do not suggest terminating BITs directly boosts investment inflows, they do point to an extremely weak or non-existent relationship between BITs and the magnitude of investment inflows⁶

Brazil’s parliament has never endorsed BITs or trade agreements containing ISDS but it has experienced high levels of FDI.⁷

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Experience of ISDS cases has led to ISDS legitimacy crisis

Scholars have identified that ISDS has suffered a legitimacy crisis that has grown in the last decade, with lack of confidence in the system shared by both civil society organisations and by a growing number of governments.¹

Basic criticisms of the ISDS structure include: the power imbalance which gives additional legal rights to international corporations that already exercise enormous market power; the lack of obligations on investors; and the use of claims for compensation for public interest regulation.

Criticisms of the ISDS process include: use of ad hoc tribunals, a lack of transparency; lengthy proceedings; high legal and arbitration costs; inconsistent decisions caused by the lack of precedents and appeals; third-party funding for cases as speculative investments; and excessively high awards based on dubious and inconsistent calculations of expected future profits. Furthermore, arbitrators are not independent judges, but instead remain practising advocates with potential or actual conflicts of interest.

There have been increasing numbers of claims for compensation for public interest regulation. These include regulation of public health measures like tobacco regulation, medicine patents, environmental protections, indigenous land rights, regulation of the minimum wage and most recently, government action to reduce carbon emissions.

These cases can have freezing or delaying effects on regulation by other governments. The New Zealand government delayed its tobacco plain packaging legislation when the Philip Morris Tobacco company sued the Australian government over its plain packaging law. The Minister of Health said

“In making this decision, the Government acknowledges that it will need to manage some legal risks. As we have seen in Australia, there is a possibility of legal proceedings.”

“To manage this, Cabinet has decided that the Government will wait and see what happens with Australia’s legal cases, making it a possibility that if necessary, enactment of New Zealand legislation and/or regulations could be delayed pending those outcomes.”²

Some governments are withdrawing from ISDS arrangements. The EU and the US are now negotiating trade agreements without ISDS. ISDS has been excluded from the Regional Comprehensive Economic Partnership (RCEP) and the Australia-UK Free Trade Agreement (A-UKFTA). ISDS has also been excluded from the India-Australia Comprehensive Economic Cooperation Agreement, and the Australia-EU Free Trade Agreement (A-EUFTA) both currently under negotiation.

ISDS cases on medicines, environment, Indigenous land rights, minimum wage

There have been growing numbers of cases against health, environment (including laws to address climate change), Indigenous land rights and other public interest laws, which have contributed to the crisis of credibility for ISDS described above. Recent cases include the following:

¹ Langford and Potesta, p. 1.
² Turia, T., (2013) Government moves forward with plain packaging, February 20, NZ Department of Health
• The US Philip Morris tobacco company shifted assets to Hong Kong and used ISDS in a Hong Kong investment agreement to claim billions in compensation for Australia's plain packaging law. It took over four years and $24 million in legal costs for the tribunal to decide that Philip Morris was not a Hong Kong company, and the case was an abuse of process; and another two years to decide on costs, but the government only recovered half of the legal and arbitration costs.\(^\text{10}\)

• US Pharmaceutical company Eli Lilley used the ISDS provisions of NAFTA to claim compensation for a Canadian Supreme Court decision that found a medicine was not sufficiently different from existing medicines to deserve a patent, which gives monopoly rights for at least 20 years. Canada has a higher standard of patentability than the US and some other countries. The Canadian government won the case after six years and $15 million in costs, but the tribunal decision was ambiguous on some key points about Canada's right to have distinctive patent laws.\(^\text{11}\)

• The French Veolia Company sued the Egyptian Government over a local government contract dispute in which they claimed compensation for a rise in the minimum wage. This claim eventually failed but it took seven years and the costs to the Egyptian government have not been made public.\(^\text{12}\)

• The US Bilcon mining company won $US7 million in compensation from Canada because its application for a quarry development was refused for environmental reasons. The Canadian government unsuccessfully sought annulment of this decision on the grounds that it undermined Canadian environmental law.\(^\text{13}\)

• In 2022 the British oil company Rockhopper\(^\text{14}\) won 210 million pounds plus interest (estimated total A$360 million) from the Italian government because in 2015 Italy banned new oil and gas projects within 12 nautical miles of its coastline for environmental reasons. The amount included compensation for future lost profits, despite the fact that Rockhopper’s initial investment was only 33 million pounds.


Legal experts and the United Nations Conference on Trade and Development (UNCTAD) have recognised the danger of ISDS claims against a wide range of government actions taken during the COVID-19 pandemic, recommending means of preventing such cases.\(^\text{15}\)

**ISDS cases against government regulation of carbon emissions**

A comprehensive study published in the *Science* journal in May 2022\(^\text{16}\) shows increasing use of ISDS clauses in trade agreements by fossil fuel companies to claim billions in compensation for government decisions to phase out fossil fuels. The study’s authors recommend ISDS mechanisms be removed from trade agreements.

The Intergovernmental Panel on Climate Change (IPCC) May 2022 report *Climate Change 2022: Impacts, Adaptation & Vulnerability* also warns that ISDS clauses in trade agreements threaten action to reduce emissions and regulate fossil fuel energy companies.\(^\text{17}\) Examples include:

- The Westmoreland Coal Company\(^\text{18}\) sought compensation from Canada over the Province of Alberta’s decision to phase out coal-fired electricity generation by 2030. This US-based company, an investor in two Alberta coal mines, did so using ISDS provisions in the North American Free Trade Agreement (NAFTA). Its case was unsuccessful\(^\text{19}\) but only due to technicalities regarding changes in the company’s ownership.

- German energy companies RWE and Uniper have ISDS cases pending\(^\text{20}\) against the Netherlands (under the Energy Charter Treaty) over its moves to phase out coal-powered energy by 2030.\(^\text{21}\)

- In 2022, a Bond University academic reported that the Australian government was threatened with ISDS cases from Japanese and Korean energy companies resisting regulation of energy supply and prices.\(^\text{22}\)

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Clive Palmer ISDS case exposes abuse of ISDS forum shopping and need for review of current agreements with ISDS

ISDS forum shopping by international companies is the practice of setting up subsidiary companies in countries with trade or investment agreements that include ISDS if the parent company is from a country which does not have an ISDS investment treaty with the country where their investment is located.

For example, the US Philip Morris company could not use the Australia-US Free Trade Agreement because community campaigning kept ISDS out of that agreement. Philip Morris shifted assets to Hong Kong in order to use ISDS in the Australia-Hong Kong investment agreement.

Clive Palmer, an Australian mine owner, is using a similar ploy to claim to compensate for legislation passed by the Western Australian Parliament as part of a dispute with the WA government over licensing of iron ore projects. His claim had already failed in the High Court.23

Palmer shifted company assets to Singapore and is using ISDS clauses in Australia’s 2010 free trade agreement with New Zealand and ten ASEAN countries, including Singapore.

A review of the Australia-ANZ-ASEAN agreement is underway24 but it is too late to prevent this case even if ISDS is removed, which, like the Philip Morris case, could cost the government millions to defend, even if it wins.

It is not acceptable that an Australian company is able to bypass a High Court decision and use ISDS to launch a claim for $300 billion against the Australian government from Singapore.

Australian mining companies’ use of forum shopping to sue developing countries impact on Australia’s reputation and diplomatic relationships

Companies are continually receiving legal advice to set up subsidiary companies in jurisdictions where governments have ISDS agreements so they can use forum-shopping to maximise ISDS opportunities.

Australian subsidiaries are being used because Australia has so many BITS and FTAs with ISDS, which the Labor government has pledged to review.

The Australian mining company Tethyan Copper Company Ltd had an exploration licence with the intention of opening a mine in Pakistan. The Pakistan federal government refused to grant a mine licence because of anomalies in the way the provincial government had granted the initial exploration licence.

Using provisions in the Australia-Pakistan investment treaty, Tethyan Copper took legal action against Pakistan in 2012. In 2019 an international investment tribunal ruled that Pakistan should pay...

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Tethyan Copper US$5.8 billion in compensation. Tethyan is owned by the Canadian Barrick Gold Corporation and Chilean Antofagasta PLC. Neither Canada nor Chile has an investment treaty with Pakistan, so Tethyan used its Australian subsidiary to lodge the claim because of the Australia-Pakistan investment treaty.

The Pakistan award made headlines around the world because the compensation payout was more than 25 times the US$220 million the company had invested in the project and included an unknown payout for ‘lost future profits’. The amount is almost equivalent to the US$6 billion emergency loan the International Monetary Fund had just granted Pakistan to deal with its economic crisis, and therefore potentially cancels any benefit from the IMF loan.

The same Canadian company Barrick Gold announced on July 10, 2020, that its Australian subsidiary, Barrick (PD) Australia Pty Ltd, was using the ISDS provisions of a bilateral investment treaty between Papua New Guinea (PNG) and Australia to claim compensation for the PNG government’s refusal to grant an extension of the company’s expired 30-year lease at the controversial Porgera Joint Venture gold mine in the PNG highlands.

Canada does not have a BIT with PNG, so again Barrick’s use of an Australian subsidiary appears to be an exercise in forum shopping. There is a documented record of decades of environmental and human rights abuses at the Porgera mine. There have also been recommendations from human rights experts that the company should address these claims. Despite this record, Barrick sought compensation because its lease was not extended after its expiration.

After negotiations with the company in 2021, the PNG Prime Minister announced agreement with the company to renew the lease on terms which he claimed were more favourable to the local community and the PNG government. Critics disputed this and claimed that the ISDS threat had intimidated the government. Catherine Coumans of MiningWatch Canada, which worked with local landowners, said:

“It seems that the legal pressure Barrick has maintained on the COVID-19-ravished state has finally worn down the resolve of the PNG government to chart a course for the mine without Barrick. It will be important to see what kind of deal Barrick has offered local landowners, as most have been adamant that they want to see the back of this controversial company. Our

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partners in particular want to know that human rights claims for victims of violence by mine security will finally be dealt with equitably."31

The use of Australian BITS in forum shopping can contradict Australia’s commitments to human rights, undermine its aid and development programs in developing countries, and harm Australia’s reputation and relationships with developing countries.

**Growth in ISDS awards to billions and use of third-party speculative funding**

Leading international investment law expert and practitioner George Kahale criticized ISDS in an April 2018 lecture at the Brooklyn Law School titled “The wild, wild west of international arbitration law”32

Kahale states that “there really are no hard and fast rules” in ISDS claims for compensation. He cites examples of claims of billions of dollars based on false documents, methodologies for calculations of future lost profits which are unacceptable in World Bank accounting practice, and similar claims before different tribunals resulting in inconsistent decisions (Kahale p.14).

Kahale also notes the growth of third-party funding of ISDS cases, in which speculative investors fund cases in return for a share of the claimed compensation, and argues they fuel the growth of “surrealistic” claims and are “more about making money than obtaining justice” (Kahale p. 17).

Legal scholars Bonnitcha and Brewin have also noted:

> The possibility of large compensation awards has systemic implications. Investors with long-shot claims are more likely to proceed to arbitration if they expect to receive a large payout should their case succeed. The possibility of a large award also encourages third-party funding33

These findings have been reinforced by the increasing numbers of awards of billions of dollars against governments which are a substantial proportion of their national budgets and can damage their ability to provide essential services. There is no general right of appeal for substantive ISDS decisions. However, for ICSID tribunal decisions only, governments can apply to have the award annulled or reduced. This is rarely successful.

As of October 2019, there were 46 cases of awards over US$100 million, and 10 cases of awards over US$1 billion34

The second-largest compensation claim of US$5.8 billion against Pakistan was made to Australian mining company Tethyan in July 2019 as discussed above.

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34 Bonnitcha and Brewin p.1.
The award was 16 per cent of the entire Pakistan Budget for 2018-19, and almost equivalent to the US$6 billion emergency loan from the International Monetary Fund (IMF) granted just before the award.\(^{35}\)

Commentators have noted that there are fundamental flaws when the government of a developing country qualifies for an emergency loan from the IMF to prevent economic collapse, but an ICSID tribunal under the auspices of the World Bank determines that equivalent funds must then be paid to a global corporation for a dubious calculation of future lost profits, thereby nullifying any benefit to the population from the IMF loan.

These excessive awards based on flawed methodology have prompted calls for ISDS provisions for awards to be limited to the actual value of investments.\(^{36}\)

**Conclusion and need to remove ISDS from existing agreements**

ISDS is a flawed system which gives additional legal rights to international investors which already have enormous market power, using legal concepts not recognised in national systems and not available to local investors. ISDS cases have been used to claim compensation for legitimate public interest laws and policies on health, environment, indigenous land rights, minimum wages and government action to reduce carbon emissions. This has a freezing effect on essential regulation and undermines the democratic right of governments to regulate in the public interest. Even if governments win ISDS cases, they cost tens of millions to defend.

ISDS flawed processes include: use of *ad hoc* tribunals, a lack of transparency; lengthy proceedings; high legal and arbitration costs and inconsistent decisions caused by the lack of precedents and appeals. Arbitrators are not independent judges, but instead remain practising advocates with potential or actual conflicts of interest.

Clive Palmer’s claim to be a Singaporean investor to use ISDS in the Australia-New Zealand ASEAN FTA is just the latest example of international investors’ use of forum-shopping of trade and investment agreements. The US Philip Morris tobacco company also moved assets to Hong Kong and used ISDS in an Australia-Hong Kong investment agreement to sue Australia over our plain packaging laws. Australia’s large number of previous agreements with ISDS have also enabled international mining companies to use Australian subsidiaries in forum shopping exercises.

ISDS also enables excessively high awards based on dubious and inconsistent calculations of expected future profits, which can reduce significantly government funds for essential services, as occurred with the US $5.8 billion award against Pakistan. Third-party funding for cases as speculative investments which receive a percentage of the award encourages excessive claims, which are more about making money than obtaining justice.

Governments are responding to global movements against ISDS by excluding ISDS from new agreements. AFTINET commends the Labor government policy to exclude ISDS from future agreements and to review ISDS provisions in existing agreements. The Clive Palmer case shows the urgent need for these reviews to proceed as soon as possible.

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\(^{36}\) Bonnitcha and Brewin pp. 26-27