CANADA-EUROPE TRANSATLANTIC DIALOGUE:
SEEKING TRANSNATIONAL SOLUTIONS TO 21ST CENTURY PROBLEMS

http://www.canada-europe-dialogue.ca

Commentary April 2011

Investment and the Canada-EU Comprehensive Economic and Trade Agreement: the oil sands controversy

Lorand Bartels and Caroline Henckels*

Introduction

After almost two years of negotiations on a Canada-EU Comprehensive Economic and Trade Agreement (CETA) the parties are hopeful that an agreement will be concluded later in 2011.[1] The CETA is an ambitious proposal which would regulate both trade and investment, as well as a number of other areas including movement of workers, trade in services, government procurement, intellectual property and SPS measures. The draft text also contains a number of provisions relating to sustainable development, the environment and labour standards.

The CETA has been controversial – mainly in Canada – because of its possible inhibiting effect on future Canadian regulation of the extraction of petroleum from oil sands (or 'tar sands'). This is a method of oil extraction that has significant adverse environmental effects, including higher levels of greenhouse gas emissions than regular oil extraction. The fear is that the CETA will give EU extraction companies (such as Shell and BP) rights against the Canadian government which will either require compensation to be paid for any regulations affecting these investments, or will have a 'chilling effect' on any such regulation.[2]

This concern as to the substance of the rules in the CETA is exacerbated by Canadian proposals that the CETA should include a system of investor-state arbitration, meaning that foreign investors are able to enforce their rights directly against the host state, even if their home state opposes the action. This is not an unusual system for Canada, which usually

* *The views expressed are attributable only to the authors in a personal capacity and not to any institution with which they are associated. Dr Lorand Bartels is a University Lecturer in Law, and Caroline Henckels is a PhD student, at the University of Cambridge.*

includes investor-state arbitration in its investment agreements. However, it is not universal, even among developed countries. Australia has consistently rejected this mechanism, even in its free trade agreement with the United States, preferring instead the traditional model of state-state dispute settlement. From the EU perspective, it is also significant that the EU has opted for investor-state arbitration, this being the first investment agreement negotiated by the EU in its own right under powers granted to it in the Lisbon Treaty on 1 December 2009.

These concerns do not come out of thin air. They are based on past challenges to rules similar to those in the CETA, in which investors successfully challenged environmental laws and other public policy measures. In general (*Methanex v United States* being a notable exception), arbitral tribunals have ruled in favour of the investor where an environmental measure has negatively affected an investment. Canada's experience with similar provisions of NAFTA has shown that government actions taken in pursuit of environmental and other public policy objectives are vulnerable to successful challenge by investors for being in breach of investment treaty obligations (see e.g. *SD Myers v Canada*, *Pope and Talbot v Canada*, *Ethyl Corporation v Canada*). The following discusses the draft text of the CETA (dated October 2010).

The CETA investment obligations

The object of the investment chapter is to provide international law protection to investors against improper forms of treatment including expropriation, improper interference with investments or arbitrary or discriminatory treatment. To this end, the draft text sets out a variety of investor protections. However, in a manner atypical of investment agreements, it does so only in relation to investments on which specific commitments have been made. This amounts to an adoption of the WTO GATS 'positive list' approach, rather than the 'negative list' approach common to most investment agreements, which is to cover all investments, except, in some cases, for some that are expressly not covered. The CETA list of covered investments is currently unknown.[3] The following proceeds on the basis that investments relevant to oil sand extraction will be covered.

With respect to covered investments, the parties are agreed on the inclusion of non-discrimination obligations (national treatment and most-favoured-nation treatment), and, taking a leaf out of the GATS, on restrictions on market access. Canada, however, seems to favour the inclusion of more traditional investment obligations on minimum standards (fair and equitable treatment and full protection and security), as well as on direct and indirect expropriation. The following discusses the application of these provisions to investments related to oil sands extraction, as well as the relevant exceptions.

Specific obligations

Non-discrimination obligations

The CETA prohibits measures that discriminate against foreign investors (national treatment), and between foreign investors (most favoured nation treatment). This does not mean just formal discrimination, but it includes *de facto* discrimination.

In principle, one might think that non-discrimination obligation should be uncontroversial. However, the obligation is not as neutral as it might appear. Non-discrimination rules always depend upon properly identifying the appropriate 'comparator'. In this case, the comparators are 'like establishments and investors'. If this term were, in a relevant case, defined narrowly – e.g. as 'oil sands extraction services' – there is unlikely to be much of a problem. However, if the relevant service is defined more broadly – e.g. 'oil companies' or even 'energy companies' – and the impact of the regulation is only to affect EU companies involved in oil sands extraction services, it is possible that there will be a finding of discrimination. Previous investment case law has shown tribunals' willingness to adopt a very broad approach to the comparator group (see *Occidental v Ecuador)*, although most tribunals prefer the approach that there be a competitive relationship or substantial equivalence between investors (see e.g. *SD Myers v Canada, Feldman v Mexico, Pope & Talbot v Canada, Corn Products v Mexico, UPS v Canada, Archer Daniels v Mexico).* It should be noted that most investment treaties provide that the appropriate comparator is one in 'like circumstances', so the approach taken in CETA may be an attempt to narrow the comparator group. But whether this will be successful remains to be seen.

Market access

More problematic is the market access obligation, which – on one reading – applies not only to discriminatory measures but also to non-discriminatory measures.

Following the GATS model, the CETA contains an obligation requiring the parties to accord investors of the other Party and covered investments treatment no less favourable than that provided for in their list of commitments. It also contains an obligation prohibiting certain specific measures in sectors in which commitments are undertaken. Relevantly, the prohibited measures include:

- limitations on the number of investments
- limitations on the total quantity of output.

Whether these market access limitations apply to services relevant to oil sands depends on the commitments made by Canada. It remains to be seen whether any such commitments are made.

If they are, however, then these obligations will apply. This may have serious implications for Canada's right to regulate for environmental reasons. This follows from *US – Gambling*, when the WTO Appellate Body interpreted these two provisions. The facts of this case concerned a US prohibition on online gambling, including cross-border online gambling. The important point is that the measure was arguably non-discriminatory. Notwithstanding this, the Appellate Body decided that any restriction on the supply of the service amounts to a violation of these two provisions. Based on this ruling, it is by no means impossible that a Canadian measure restricting a service relevant to oil sands would violate these prohibitions – even if the measure is non-discriminatory.

Canadian proposals

Canada has also proposed the introduction of the traditional investment obligations: minimum standards of treatment, and a specific prohibition on expropriation. There is little to be said about the minimum standards, which are essentially about fair treatment and physical security, but there is more to be said about the rules on expropriation.

The problem is as follows: a regulatory measure adopted for public policy reasons can have a negative impact on the value of an investment. This can be seen – and has been seen – as an indirect expropriation (also called regulatory expropriation), in contrast to direct expropriation, in which property is confiscated by the government. This has been a controversial issue in many investment cases.

In this respect, it is significant that Canada's proposal to include rules on expropriation contains a provision encapsulating the 'police powers' doctrine: that states may adopt non-discriminatory measures in pursuance of a legitimate purpose that negatively affect investments without needing to pay compensation.

This type of clause has become more common in recently concluded bilateral investment treaties,[4] as parties have sought to preserve their autonomy faced with the anxiety of regulatory regimes directed at public welfare being held to be expropriatory in nature. In principle, such a clause is to be welcomed. However, it only protects non-discriminatory measures. If a measure is found to be discriminatory (the likelihood of which is partly dependent on how broadly a tribunal interprets the criterion of 'likeness'), it may also amount to indirect expropriation, as the police powers doctrine does not protect against discriminatory measures, regardless of whether they are taken in pursuit of a legitimate public purpose.

Exceptions

The CETA obligations must be seen in the context of relevant exceptions. One – in Canada's proposal to the rule on expropriation – has already been mentioned. However, there are others that would apply to any finding of a violation of the other rules on market access, non-discrimination or the minimum standards.

While the draft text is unclear, it seems that the rules on investments may be subject to a general public policy exceptions clause modelled on Article XX GATT. This type of clause infrequently appears in investment treaties, and does not appear in NAFTA's investment chapter.

The scope of this proposed clause is, however, rather narrow. It states:

> For the purposes of Chapter X (Investment):
> (a) a Party may adopt or enforce a measure necessary:
> (i) to protect human, animal or plant life or health, which the Parties understand to include environmental measures necessary to protect human, animal or plant life or health,
> (ii) to ensure compliance with domestic law that is not inconsistent with this Agreement, or

(iii) for the conservation of living or non-living exhaustible natural resources;

(b) provided that the measure referred to in sub paragraph (a) is not:

(i) applied in a manner that constitutes arbitrary or unjustifiable discrimination between investments or between investors, or

(ii) a disguised restriction on international trade or investment.

It is worth noting that this particular provision represents a tightening of the requirement under the WTO equivalent: Art XX(g) GATT, where such a measure need only be 'related to' the conservation of exhaustible natural resources.

The application of this exception to services involved in oil sands extraction is unclear. It may be difficult to justify a regulation restricting such services as 'necessary' to the protection of 'human, animal or plant life or health'. Nor is it clear that a restriction based on environmental considerations is 'necessary' to the conservation of exhaustible natural resources: and this depends on whether there is another measure that achieves the same objective but is less restrictive of investor rights. It also depends on whether a tribunal, in a particular case, defers to the state's assessment of whether there are alternatives reasonably available, or requires the complaining investor to demonstrate that there is an alternative available that impairs to a lesser extent the protected right or interest.

Even if these hurdles can be overcome, the second paragraph requires that any measures at issue must be applied in a manner that does not constitute arbitrary or unjustifiable discrimination, or amount to a disguised restriction on international trade or investment. These rules, adapted from the introductory paragraph of Article XX GATT, are not benign. In *US – Gambling*, for example, the US demonstrated that its ban on online gambling was necessary to protect public morals, but failed the arbitrary and unjustifiable discrimination test because it permitted telephone bets on horse races.

A further clause provides that a party 'may take any action it considers necessary for the protection of its essential security issues.' While this provision appears to be largely self judging (in that it indicates that a party may itself decide that the particular action is necessary and the tribunal should largely defer to that assessment), 'security interests' is defined narrowly, along the lines of Article XXI GATT, to apply only in cases of war or other emergency in international relations, or other military/nuclear issues.

Other provisions relevant to environmental protection

The draft CETA text contains various other obligations relevant to environmental protection. It contains a provision, now common in trade and investment agreements, according to which the parties 'shall seek to ensure' that their laws and policies provide for and encourage high levels of environmental protection and 'shall strive to continue to improve' their laws and policies and their underlying levels of protection. This is a best endeavours clause, but this does not mean that it is non-enforceable, or never applicable, even if this would only be in extreme cases. But this clause also has a direct application to the oil sands issue, in that it makes it much easier for Canada to argue that a new environmental regulation is not only consistent with its obligations, but in fact undertaken pursuant to its obligation to 'strive to

improve' its levels of protection. Quite how this could apply in a given case however remains open to question.

A second, related provision, contains words to the effect that a Party shall not fail to effectively enforce its environmental laws, weaken or reduce levels of protection, or derogate from its laws in order to encourage investment. This obligation is stronger than the former, in that it enshrines at a minimum the existing level of protection, however it is limited to cases in which this is done to encourage investment. This provision guards against reductions of existing protections, but it is not directly relevant to the raising of new protections, which is the focus of this brief note.

A final set of exceptions exists in a set of final provisions setting out the relation of the CETA to other agreements. One of these states that the parties affirm their rights and obligations with respect to each other under the WTO Agreement and other agreements to which the parties are party, although the force of this provision is somewhat undermined by the parties' apparent agreement that the CETA should prevail over these agreements. On the other hand, there is a proposed rule for environmental and conservation agreements (taken from the NAFTA model), which states the opposite rule: that certain agreements specified in an Annex will prevail over the CETA. These agreements are CITES, the Montreal Protocol, the Basel Convention, the Rotterdam Convention, and the Stockholm Convention. Important though these are, none is directly relevant to oil sands extraction.

Conclusion

The result of this survey is that, as far as can be gleaned from the publicly available but unofficial text of the CETA, there is some concern that the agreement might restrict the ability of Canada to regulate oil sands extraction. While non-discriminatory regulations for environmental reasons are in most respects permitted, they may violate market access rules, read in the light of the WTO jurisprudence. And there is some question as to whether a measure might be considered discriminatory, even if it is adopted for an environmental purpose. In this event, the question is whether the measure could be justified on the grounds that it is 'necessary' to the protection of human, animal or plant life or health, or necessary for the conservation of living or non-living exhaustible natural resources. This is not especially easy to demonstrate; and even if it can be demonstrated, Canada would have to ensure that no other investments are arbitrarily or unjustifiably unaffected by the regulation. In light of previous decisions made by tribunals in relation to similar provisions, it appears that, despite what appear to be a number of 'environmentally-friendly' provisions, there are still some legitimate concerns about the extent to which the CETA will restrict the parties' rights to regulate in the public interest, including on oil sands.

---

[1] This note is based on the unofficial draft text dated October 2010 available at http://tradejustice.ca/en/section/3.

[2] See e.g. www.no-tar-sands.org.

[3] The draft text refers to Annex 7A (List of Commitments), which is not in the public domain.

[4] E.g. Australia-US FTA (2004) Annex 11-B, Article 4; US Model BIT (2004) Annex B, [4(b)]; COMESA Common Investment Area (2007) Article 20(8).)