

# **What is Energy Investment Law and Why Does it Matter?**

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by

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## **Introduction**

It is widely accepted that foreign investment is critical for sustainable development,<sup>1</sup> and more so with respect to the oil and gas industry due to its capital intensive and long gestation period. Although international law recognizes national sovereignty over natural resources, nonetheless, international law places limits on the exercise of such sovereign rights in a situation where it causes harm to other states or when it is pursued in an unsustainable manner.<sup>2</sup> Thus, there is an emerging sustainability law that impacts on energy investment.<sup>3</sup>

The main sources of energy that are the subject matter of specific international regulation are oil and gas, and nuclear energy. Other sources of energy, such as coal and renewables are hardly regulated by international instruments due partly to the perception that: the effects of their operations are confined within national borders; they constitute an insignificant percentage of the global energy mix and/or they cause relatively less damage to the environment so as to attract little international attention. However, the development and use of oil and gas, and nuclear energy pose more serious environmental,

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<sup>1</sup> Although there is unanimity on the definition of the term ‘sustainable development’, which has caused some commentators to describe it as a “flag under which many armies are marching,” nonetheless it is widely accepted that it comprises four elements or dimensions: economic development, environmental sustainability, social development and good governance. P.S. Elder, *Sustainability*, 36 *McGill Law Journal* 831, 834 (1991); K. Ginther et al (eds), *Sustainable Development and Good Governance* (1995); Vale Columbia Centre et al, *Investment Promotion Agencies and Sustainable FDI: Moving Towards the fourth Generation of Investment Promotion* 10 (2010), available at <http://www.vcc.columbia.edu>

<sup>2</sup> P. Cameron, *International Energy Investment: The Pursuit of Stability* (2009) 28-32; P. Park, *Energy Law and the Environment* (2002) 49-56.

<sup>3</sup> P. Sands, *International Law in the Field of Sustainable Development: Emerging Legal principles*, in Winfred Lang (ed) *Sustainable Development and International Law* (1995) 53-66.

health, social and cultural consequences throughout the value chain; they may result in oil spills, pollution and degradation of the environment, the displacement of local communities or accidents.<sup>4</sup> This paper focuses the North American Free Trade Agreement (NAFTA) and the Energy Charter Treaty (ECT), two multilateral trade and investment treaties that are of direct relevance to the energy sector and how it might be developed in a sustainable manner. Other relevant international instruments include: the Law of the Sea Convention 1982; the Climate Change Convention 1992; the Biodiversity Convention; the United Nations Framework Convention on Climate Change (UNFCCC) 1997; the Kyoto Protocol 1997, and the increasing network of bilateral investment treaties.<sup>5</sup> This paper focuses only on NAFTA and the Energy Charter Treaty because, generally speaking, the key provisions on investment in both treaties are similar to those contained in most other investment treaties, and more specifically, both contain explicit provisions on sustainability; finally, while the ECT deals exclusively with the energy sector, NAFTA contains a chapter expressly dealing with Energy. The paper briefly highlights the historical background and main objectives of those involved in creating agreement, the main provisions on energy investment and sustainability and their impact, and the current challenges relating to the enhancement of sustainability using these agreements.

### **1. Historical Background and Objectives**

After fourteen months of negotiations, NAFTA was signed by the Presidents of the United States, Canada and Mexico on October 7, 1992 and the Treaty came into effect on January 1, 1994. NAFTA builds upon the Canada-United States Free Trade Agreement of 1989. However, before the Agreement came into effect, a Supplementary Agreement was reached in August 1993 upon the insistence of President Clinton so as to address concerns over protection of the environment and workers' rights, which were not sufficiently addressed in the original NAFTA. It is a comprehensive trade and investment

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<sup>4</sup> E. Smith et al, *International Petroleum Transactions* 3<sup>rd</sup> ed (2010); Z. Gao (ed), *Environmental regulation of Oil and Gas in the 21<sup>st</sup> Century and Beyond: An Introduction and Overview*, in Z. Gao (ed) *Environmental regulation of Oil and Gas* (1998) 3; Park, *supra*, note 2; N. Horbach, *Lacunae of International Nuclear Liability Agreements*, in N. Horbach (ed) *Contemporary Developments in Nuclear Energy Law* (1999) 43.

<sup>5</sup> On the network of such treaties and their significance to international investment law generally, see Cameron, *supra*, note 2; K. Vandevelde, *Bilateral Investment Treaties* (2010).

agreement that affects all aspects of doing business in Canada, Mexico and the United States. It seeks to eliminate barriers (such as tariffs) to free flow of goods and services, removes restrictions to investment, and strengthens intellectual property rights among the three countries. It was envisaged by the contracting states as an effort towards creating establishing a free trade area in the North American continent similar to the European Union and the European Free Trade area so as to enhance the competitiveness of the region in global trade and investment.<sup>6</sup> For the Canadian Government, the main objectives for signing NAFTA are to gain access for Canadian goods, services and capital to Mexico on an equal footing with the United States, and to make Canada attractive to foreign investors wishing to invest in the North American market.<sup>7</sup> From the United States' perspective, NAFTA would help provide closer and more stable sources of energy supplies from Canada and Mexico and reduce its over-reliance on the more unstable oil from the Middle East.<sup>8</sup>

The ECT is the result of a political initiative in Europe in the early 1990s following the end of the Cold war and the disintegration of the Soviet Union. The then Dutch Prime Minister initiated the process by suggesting the creation of a European Energy Community, based upon which the European Energy Charter, a non-binding political declaration, was signed in the Hague in 1991 by fifty-six states. The Charter “represents a political commitment to co-operate in the energy sector, based on the principles of development of open and efficient energy markets.”<sup>9</sup> The participants to the Charter did acknowledge the need for a binding international legal framework for effective co-operation in the sector and so negotiations for the ECT started in late 1991. The ECT and the Protocol on Energy Efficiency and Related Environmental Aspects (PEEREA) were signed in Lisbon on 17 December 1994 and came into force on 16 April 1998. Although the United States and Canada participated in the negotiations, they did not sign the

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<sup>6</sup> E. Smith & D. Cluchey, *GATT, NAFTA and the Trade in Energy: A US Perspective*, 12 *J.E.N.R.L.* (1994) 27, 31 & 34.

<sup>7</sup> O. Saunders, *GATT, NAFTA and the North American Energy Trade: A Canadian Perspective*, 12 *J.E.N.R.L.* (1994) 4, 8-9.

<sup>8</sup> Smith & Cluchey, *supra*, note 6, 33

<sup>9</sup> H. Corell, *Introduction to the Energy Charter Treaty*, in C. Ribeiro (ed), *Investment Arbitration and the Energy Charter Treaty* (2005) 1, 5.

Treaty. As the name suggests, the ECT is a sectoral agreement; it deals solely with the energy industry and covers issues of trade, investment, transit and environment.

The main goals of the initial negotiation by the parties was to help the eastern European countries make a transition to a market economy by injecting western investment into their energy sector, which would help in ensuring security of energy supplies to Western Europe. In this regard, the ECT “plays an important role as part of an international effort to build a legal foundation for energy security, based on the principles of open, competitive markets and sustainable development.”<sup>10</sup> For the Eastern European and resource rich countries, “the main attraction of the Treaty was to appear attractive, to be seen to play the rules of the global economy, reduce their political risk perception and not to be left out of possibly significant energy policy dialogue.”<sup>11</sup> Overall, the “fundamental aim of the ECT is to strengthen the rule of law on energy issues by creating a level playing field of rules to be observed by all participating governments, thereby mitigating risks associated with energy-related investment and trade.”<sup>12</sup> To date, the ECT has been signed or acceded by fifty-four members while twenty-four countries act as observers.

## **2. Energy Investment**

With regard to energy, NAFTA article 602 states that the Agreement, “applies to measures relating to energy and basic petrochemical goods originating in the territories of the Parties and to measures relating to investment and to the cross-border trade in services associated with such goods..” However, with respect to the Mexican energy sector, NAFTA falls short of achieving the objective of creating a common energy market and liberalization of the sector. Due to historical and constitutional reasons, limitations are placed on foreign involvement in Mexico’s energy sector and such policy is reflected in NAFTA. Chapter 6, Annex 602.3 reserves to the Mexican state or its state

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<sup>10</sup> Energy Charter Secretariat, About the Charter, available at: <http://www.encharter.org.>; A. Fatouros, An International Legal Framework for Energy, 322 RDC-Collected Courses (2006) 411; Corell, *supra*, 7.

<sup>11</sup> T. Walde, The Energy Charter Treaty: Expanding the Liberalisation of Energy Industries, [www.transnational-dispute-management](http://www.transnational-dispute-management.com) (TDM) 2004, p. 5.

<sup>12</sup> Energy Charter secretariat, *supra*, note 10; A. Konoplyanik & T. Walde, Energy Charter Treaty and its Role in International Energy, 24 J.E.N.R.L. (2006) 523.

entities all activities relating to exploration and exploitation of oil and gas, ownership and operation of pipelines, all foreign trade, transportation, storage, and distribution of Mexican crude oil and natural gas. Thus, NAFTA may have less impact on energy trade and investment in Mexico as it does in the United States and Canada, which “are bound to permit the free flow of energy goods and investments and of services throughout the energy sector” in accordance with the Agreement.<sup>13</sup> This has the effect of constraining the ability of future Canadian governments from reverting to the old nationalistic and protectionist energy policy of the 1980s as reflected in the National Energy Programme of 1980.<sup>14</sup> Even with regard to Mexico, there are possibilities for foreign investment in the non-basic petrochemicals and certain aspects of electricity generation sectors, which are not subject to the constitutional restriction on investment.<sup>15</sup>

The Energy investment under NAFTA chapter 6 is reinforced by chapter 11, which is the most important chapter that defines the rights and obligations of investors and the state parties. Similar to other investment treaties, including the ECT (Part III, Articles 10-17), NAFTA chapter 11 provides for the definition of protected ‘investment’ and ‘investors’, and the standard of treatment to be accorded such investments and investors from other member states. The standards of treatment include national and most favoured nation treatment, fair and equitable treatment, full protection and security. Other provisions that address more specific situations include: conditions on expropriation of covered investment, guarantees on rights of free transfer of payments related to an investment, prohibition on performance requirements, and provisions intended to promote transparency or access to courts. These substantive provisions are backed by investor-state or state-state dispute resolution provisions. The first vests in the foreign investor a direct of action (through international arbitration) against the host state for alleged violation of the investor’s substantive rights, and the second a dispute settlement mechanism between the two state parties concerning the interpretation or application of

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<sup>13</sup> L. Herman, NAFTA and the ECT: Divergent Approaches with a Core of Harmony, 15 J.E.N.R.L (1997) 129, 132-133;

<sup>14</sup> Saunders, *supra* note 7, 6-8, & 23.

<sup>15</sup> *Ibid*, 24.

the treaty.<sup>16</sup> Over the years, several cases have been brought by foreign investors seeking to challenge measures adopted by host states that were alleged not to be in conformity with their international investment treaty obligations under the applicable treaty.<sup>17</sup>

### **3. Sustainable Development**

Both NAFTA and the ECT contain provisions on sustainability. In its preamble, the NAFTA state parties signal their support to among other objectives promote sustainable development. In order to achieve this objective, the treaty permits each contracting state to take appropriate measures to ensure that investment activity in its territories is implemented in a manner consistent with environmental protection provided such measures are consistent with the overall objectives of NAFTA. Furthermore, the state parties declare that “it is inappropriate to encourage investment by relaxing domestic health, safety, or environmental measures” (Art. 1114(2)).

Furthermore, the NAFTA Side Agreement on Environmental Co-operation provides for sanctions for lax enforcement of domestic environmental laws and standards. The provisions are to ensure that trade and investment activities in the member states’ territories are conducted in a sustainable manner by preventing a “race to the bottom” approach by member states. Thus the Side Agreement expresses the willingness of the parties to promote sustainable development based on co-operation and mutually supportive environmental and economic policies, enhanced compliance with and enforcement of environmental requirements, the promotion of transparency and public participation in developing environmental norms and the promotion of economically effective environmental measures (Article 1). Under the Side Agreement, members of the public, including non-governmental organizations (NGOs), are allowed to challenge a state party if it fails to effectively enforce its environmental laws or regulations. The Side Agreement establishes the Commission for Environmental Cooperation, the institutional framework to receive petitions from members of the public and if necessary, investigate the claims and prepare a factual record, which might be published by the Council. The

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<sup>16</sup> Vandevelde, *supra*, note 5, Chapters 4-8; Fatouros, *supra* note 10, 417-429; Konoplyanik & Walde, *supra* note 12, 532-541, 545-548.

<sup>17</sup> See generally, Vandevelde, *supra*, note 5; J. Salacuse, *The Law of Investment Treaties* (2010).

process has been utilized by many individuals and organizations to a varying degree of success. Hence, it has been described as a “‘spotlighting’ instrument intended to enhance governmental accountability and transparency.”<sup>18</sup>

Similarly, Article 19 of the ECT enjoins member states to “strive to take precautionary measures to prevent or minimise environmental degradation” and to “take account of environmental considerations throughout the formulation and implementation of their energy policies.” The treaty also requires the member states take specific actions relating to the promotion of market-based price reform and fuller reflection of environmental costs and benefits, the encouragement of international co-operation, information sharing on environmentally sound and economically efficient energy policies, the promotion of environmental impact assessment activities and monitoring, promotion of public awareness of relevant environmental programmes, and research and development on energy efficient and environmentally sound technologies, including the transfer of technology. Although these are not binding legal obligations, but rather are ‘soft’ law, they nonetheless may have indirect legal implications, such as by “justifying regulatory measures subject to the scrutiny of the investment protection regime.”<sup>19</sup> Furthermore, the Protocol on Energy Efficiency and Related Environmental Aspects (PEEREA) requires member states to formulate policy principles aimed at improving energy efficiency, reduce negative environmental impact, and foster international co-operation between member states. The implementation of the PEEREA would provide transition economies with good practices and an opportunity to share experiences and policy advice on energy efficiency issues with their western counterparts.

#### **4. Impact and Current Challenges**

According to the United States Government, NAFTA has achieved its core goals of expanding trade and investment between the three countries. It asserts that “from 1993 to

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<sup>18</sup> D. Markell, The Role of Spotlighting Procedures in Promoting Citizen participation, Transparency, and accountability, 45 Wake Forest law rev. (2010) 425, 426; J. Knox, The Neglected Lessons of the NAFTA Environmental Regime, 45 Wake Forest Law rev. (2010) 391.

<sup>19</sup> T. Walde, International Disciplines on National Environmental Regulation: With particular Focus on Multilateral Investment Treaties, in Permanent Court of Arbitration (ed), International Investments and Protection of the Environment (2000)29, 47.

2007, trade among the NAFTA nations more than tripled, from US\$297 billion to \$930 billion” and that “business investment in the United States has risen by 117 percent since 1993, compared to a 45 percent increase between 1979 and 1993.”<sup>20</sup> With respect to the energy sector, the business and legal climate in Canada and Mexico have become more hospitable to foreign energy-related investment as a result of NAFTA.<sup>21</sup> With regard to sustainable development, it has been noted that the NAFTA regime “has had its greatest success as a regional effort to promote sustainable development. It has contributed to stronger environmental protections, especially in Mexico” and it has formed a basis for subsequent United States Free Trade Agreements to include environmental protection provisions.<sup>22</sup> However, the success of the Side Agreement on Environment has been spotted by concerns over the fairness or neutrality of the process, the slow pace of the procedure and the apparently ‘toothless’ character of the mechanisms.<sup>23</sup> Furthermore, one of the strongest challenges facing NAFTA, the ECT and other investment treaties relates to how to reconcile the obligations of the state parties towards foreign investors on the one hand and the needs for regulatory autonomy in the areas of environmental protection and human rights. The absence of clear guidelines in the investment treaties on how to resolve such potential conflicts poses a serious legal and policy challenge to state parties and foreign investors who have to rely on the interpretative decisions of arbitral tribunals.<sup>24</sup>

## 5. Conclusions

Some general conclusions can be drawn from the above overview of Energy Investment Law: (1) although every country has sovereignty over its natural resources and the right to develop the same in accordance with its environmental laws and regulations, modern investment treaties such as NAFTA and the ECT may constrain a member state’s

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<sup>20</sup> Office of the United States Trade representative, NAFTA Facts, 2008, available at: [www.ustr.gov](http://www.ustr.gov).

<sup>21</sup> Smith & Cluchey, *supra* note 6, 54-58.

<sup>22</sup> Knox, *supra* note 18, 392.

<sup>23</sup> Markell, *supra* note 18, 440-454; Knox, *ibid*, 397-398.

<sup>24</sup> B. Kingsbury & S. Schill, Public Law Concepts to balance Investors’ Rights with State Regulatory Actions in the Public Interest – the Concept of Proportionality, in S. Schill (ed), *International Investment Law and Comparative Public Law* (2010) 75-104; K. Vandevelde, A Comparison of the 2004 and 1994 U.S. Model BITs, in K. Sauvart (ed) *Yearbook on International Investment Law & Policy 2008-2009* (2009) 283 – 315; Knox, *supra*, 403.

discretion; (2) modern investment treaties vest substantive and procedural rights in foreign investors to challenge egregious host state measures before international tribunals in a manner never before known under general international law; (3) it is not yet settled how to strike a proper balance between energy investment and sustainable development, hence the uncertainty in the legal relationship between foreign investors and host states; and (4) modern investment treaties, such as NAFTA and the ECT, have contributed to a greater or lesser extent to improving the investment climate in the energy sector of the state parties.