

### BRIEFING 4:

## Foreign investment contracts

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This is the fourth of a series of briefings which discuss the sustainable development issues raised by legal arrangements for the protection of foreign investment. The briefings are based on legal research by IIED and its partners.<sup>2</sup> The goal is to provide accessible but accurate information for human rights, development and environmental organisations working on issues raised by foreign investment in low- and middle-income countries.

Briefing 4 sets out some of the ways in which foreign investment contracts can impact on sustainable development.

Foreign investment contracts underpin many investment projects. They have important implications for how the costs and benefits of investment are distributed. They can also have far-reaching implications for the livelihoods and natural environments of people affected by investment projects. Yet foreign investment contracts are little understood outside the small circle of lawyers, government officials and corporate executives directly involved in their negotiation.

Foreign investment contracts are agreements between a foreign investor (or a local subsidiary of a foreign investor) and a state (or a state-owned entity). They set the terms and conditions for an investment project in the territory of that state.<sup>3</sup>

Foreign investment contracts raise important sustainable development issues, in terms of both process and content. In terms of process, the lack of transparency that often characterises contract negotiation is a concern. As for content, commitments found in foreign investment contracts (e.g. stabilisation clauses) typically extend investment protection beyond the requirements of general international law. In turn, this can create a “chilling effect” on host state regulation in pursuit of sustainable development goals (see Briefing 3 for an introduction to the concept of “chilling effect”).

### Process: transparency and public participation

Most foreign investment contracts are negotiated behind closed doors, and are not accessible to members of the public even after they are signed. This opacity undermines the ability of individuals and groups affected by the investment project to have a say on whether and under

#### BOX 4.1. Examples of foreign investment contracts

The nature and content of investment contracts vary considerably from sector to sector, country to country and project to project. Common types of investment contracts include:

- **Concession Agreements:** investor-state contracts enabling the investor to exploit natural resources or run utilities or other public services in exchange of payment of royalties.
- **Production Sharing Agreements (PSA):** contracts commonly used in the petroleum sector and concluded between the investor and the host state or a state-owned oil corporation (in which oil ownership is vested). While there are many different variants of PSAs, the investor participates in activities through providing financial and technical services to the state-owned corporation (e.g. it funds exploration, development and production). In return, it receives a share of oil/gas to recover costs and make a profit.
- **Build-Operate-and-Transfer (BOT) Agreements:** These agreements concern the construction of infrastructure like airports, ports, dams, power plants and water supply systems. The investor undertakes the construction and financing of the infrastructure, and operates and maintains it for an agreed period of time (which is usually quite long, e.g. 50 years). During such period, the investor can charge tolls, fees and other charges for the use of the infrastructure. At the end of the agreed period, the facility is handed over to the government.

Source: Bernardini, 1996, with additions.

what conditions the project should be undertaken. When public consultations do take place, they all too often happen after key decisions have already been taken.



This lack of transparency contrasts with the principles of access to information and of public participation in decision-making. In relation to environmental matters, these are affirmed in international declarations (principle 10 of the 1992 Rio Declaration) and treaties (e.g. the 1998 Aarhus Convention on Access to Information, Public Participation in Decision-Making and Access to Justice in Environmental Matters). Public scrutiny on contract negotiations is all the more important since some kinds of contractual provisions, such as stabilisation clauses, can effectively restrict the exercise of state sovereignty. Lack of public scrutiny is also a breeding ground for corruption, and for deals that do not take into account the interests of third parties (Ayine et al, 2006).

Greater transparency may be achieved through parliamentary scrutiny of proposed contracts (for instance, as provided for by the Constitution of Ghana) and through the publication of the contract in the official gazette (as was done for the COTCO-Cameroon Establishment Convention on the construction and operation of the Chad-Cameroon pipeline). However, parliamentary scrutiny is not always effective; for example when parliament is controlled by the ruling party. Similarly, publication of investment contracts in official gazettes is unlikely to make a significant difference in places where illiteracy rates are high, or where the majority of the population does not speak the official language (Ayine et al, 2006).

Environmental impact assessment (EIA) procedures may offer a hook for greater scrutiny of investment projects – but not of the contracts themselves. In the Chalillo Dam case (*BACONGO v Department of the Environment and Belize Electric Company Ltd*), a civil society organisation challenged an investment project by seeking judicial review of the environmental impact assessment that preceded it. However, while EIA-related processes may enable greater scrutiny of environmental issues, they are less likely to be of help with regard to human rights and other social aspects (Ayine et al, 2006).

## The content of foreign investment contracts: stabilisation clauses

The content of foreign investment contracts also raise sustainable development issues. This is illustrated by the use of stabilisation clauses. These aim to “stabilise” the terms and conditions of an investment project, thereby contributing to management of non-commercial (i.e. fiscal, regulatory or political) risk. They work by committing the host government not to alter the regulatory framework governing the project, by legislation or any other means, without the consent of the other contracting party; or, if it does so, to restore the economic equilibrium of the project or pay compensation.

Recent use of stabilisation clauses is largely confined to investment projects in low- and middle-income countries. This can be attributed to factors such as investors’ lack of confidence in the legal system of low- and middle-income countries; to the desire of these countries to attract foreign investment; and to their (typically) weaker negotiating power (Waelde and Ndi, 1996).

Stabilisation clauses are particularly common in large natural resource, energy and infrastructure projects, where high fixed costs require large capital injections in the early

stages of the project, and where long timeframes are needed before the project becomes profitable. Stabilisation clauses are also associated with the use of financing techniques whereby creditworthiness and debt security are based, not on the investor’s overall assets but, on the revenue expected to be generated by the investment project (“project finance”). As debt repayment depends on the materialisation of projected cash flow, project finance operations typically involve contractual arrangements, such as stabilisation clauses, to minimise risk and distribute it among the entities involved in the project (Hoffman, 2001).

Stabilisation clauses include a range of different arrangements, such as:

- “Intangibility” clauses, which state that the contract can only be modified with the consent of the parties, and/or which explicitly commit the government not to nationalise the investment;
- “Freezing” clauses, whereby the applicable domestic law for the contract is frozen in time as the law in force at date of the conclusion of the contract, and the contract is not affected by subsequent legislation inconsistent with that initial body of law;
- “Consistency” clauses, whereby the domestic legislation of the host state only applies to the project if “consistent” with the investment contract;
- Clauses containing stabilising commitments on specific issues, such as clauses stabilising the fiscal regime, or clauses stabilising regulation of the tariff structure in public utility projects;
- Economic equilibrium clauses, which link alterations of the terms of the contract to renegotiation of the contract in order to restore its original economic balance, or to payment of compensation.

## The legal effect of stabilisation clauses

International arbitrators have held that stabilisation clauses are lawful, valid and binding under international law (*Texaco, Aminoil, AGIP and Revere Copper* cases). Although there was controversy over the legality and binding nature of these clauses in the 1970s and 80s, it is now widely accepted that stabilisation clauses are lawful and binding as a matter of international law. The legal value of stabilisation clauses may be further reinforced by provisions in bilateral investment treaties, whereby state parties commit themselves to honour contractual undertakings vis-à-vis nationals of the other state (“umbrella clause”; see Briefing 2).

Under international law, if the host state interferes with the regulatory framework in violation of a stabilisation clause, it must compensate the investor (see e.g. *Liamco, Aminoil, AGIP*). The amount of compensation is linked to:

- The costs incurred by the investor because of the new regulation; and
- The expectation that the regulatory framework applicable to the investment project would not change; itself an expectation generated by the presence of a stabilisation clause.

#### BOX 4.2. Examples of stabilisation clauses

The 2003 International Project Agreement (IPA) between Benin, Ghana, Nigeria and Togo on the one hand, and the West African Gas Pipeline Company on the other, for the construction and operation of the West African Gas Pipeline (WAGP) features an economic equilibrium clause (article 36). Under this clause, if regulatory change (including legislation, court decisions and ratification of international treaties) “has a material adverse effect on the Company”, or if it “causes the benefits derived by the Company from the Project [...] or the value of the Company to the shareholders to materially decrease”; then the state must “restore” the Company and/or the Shareholders to the same or an economically equivalent position it was or they were in prior to such change. In default, it must pay “prompt, adequate and effective compensation”.

On the other hand, the 1998 COTCO-Cameroon Establishment Convention for the construction and operation of the Chad-Cameroon oil pipeline contains a “freezing” and a “consistency” clause. These commit Cameroon “not [to] modify [the] legal, tax, customs and exchange control regime in such a way as to adversely affect the rights and obligations of COTCO”, and not to apply to the project any legislative, regulatory or administrative measures inconsistent with the Convention (articles 24 and 30).

affected by regulatory measures – even if these measures *per se* do not amount to a “regulatory taking”. Even public-purpose and non-discriminatory regulation (including legislation, ratification of international treaties, or judicial or administrative interpretation of existing provisions) that does not entail substantial deprivation of property rights may require payment of compensation if it breaches a government commitment not to regulate (or not to apply new regulation to the investment project).

#### Implications for regulation pursuing sustainable development goals

Rules on the legality and effect of stabilisation clauses can have important implications for the ability of governments to adopt regulatory measures pursuing sustainable development goals. This issue was first brought to public attention by two reports by Amnesty International UK

The obligation to pay compensation exists even where regulation does not amount to regulatory taking (in which case compensation would be required under general international law rather than under the contract; see Briefing 3). This is because, depending on their wording, stabilisation clauses may substantially lower the threshold above which government interference attracts payment of compensation.

Compared to the tests for determining whether a regulatory taking has occurred and must be compensated (outlined in Briefing 3), stabilisation clauses can be significantly more interventionist in three main areas:

- Tests concerning the character of government interference: stabilisation clauses may require payment of compensation even when the regulation pursues a public purpose goal and is non-discriminatory (see e.g. *Methanex*).
- Tests concerning the impact of government interference: stabilisation clauses tend to entail a shift from the “substantial deprivation of property” test familiar under the regulatory taking doctrine to lesser impacts on the economic equilibrium of the project. The problem is that what is required for this threshold to be met is not government interference that affects the very viability of an investment project, but less intrusive forms of government action that affect the cost-benefit equilibrium of the investment project.
- Tests concerning interference with the “reasonable expectations” of the investor: the presence of a stabilisation clause itself creates expectations that must be taken into account in determining the amount of compensation (*Liamco*; *Aminoil*).

To sum up, stabilisation clauses are deemed as lawful and binding under international law, and their violation requires host states to compensate investors negatively

#### BOX 4.3. Challenging stabilisation clauses under domestic law

Although the legality and binding nature of stabilisation clauses under international law is well established, there is some degree of controversy as to the legality of stabilisation clauses under the domestic law of the host state, particularly its constitution. For instance, stabilisation clauses may conflict with constitutional norms on the separation of powers, whereby the government cannot enter contractual arrangements that undermine the operation of legislation adopted by parliament – unless the contract itself is incorporated by parliament into domestic legislation.

However, challenges to stabilisation clauses based on the national constitution face a number of hurdles. First, courts have not been very sympathetic to this type of challenge. In Venezuela, for instance, the Supreme Court of Justice recently dismissed a petition challenging the constitutionality of stabilisation provisions (case referred to in Maniruzzaman, 2007).

Second, even if domestic courts were to declare stabilisation commitments unconstitutional, the implications of this may be complicated by the longstanding principle of international law whereby states cannot plead the provisions of their domestic legal system to justify non-compliance with, or legal challenges to, their international obligations. This principle was explicitly referred to in the *Revere Copper v OPIC* arbitration, which found that “under international law the commitments made in favor of foreign nationals are binding notwithstanding the power of Parliament and other governmental organs under the domestic Constitution to override or nullify such commitments”.

One way around this second hurdle may be to draw insights from article 46 of the Vienna Convention on the Law of Treaties, which sets out the general rules of international law applicable to treaties between states (rather than to investor-state contracts). While confirming the general principle that states cannot invoke domestic law rules, this provision also contains an exception for “rules of [...] internal law of fundamental importance”. Arguably, certain constitutional provisions do constitute internal rules of fundamental importance, which the host state cannot violate through entering into investment contracts and which a diligent investor should be aware of before concluding such contracts (as argued by Leader, pers. comm.).

(2003 and 2005), concerning the Baku-Tbilisi-Ceyhan (BTC) pipeline and the Chad-Cameroon pipeline, respectively, and their implications for the protection of human rights.

Where regulation in pursuit of sustainable development goals has the effect of raising the costs of an ongoing investment project (for instance, due to tighter requirements on environmental pollution), it has the potential to fall within the scope of stabilisation clauses found in individual investment contracts. As a result, a host state that adopts regulation raising environmental or human rights standards and that seeks to apply such standards to ongoing investment projects would have to compensate investors for the economic impact of that regulation. This may make it more difficult for host states – particularly poorer ones – to raise the regulatory standards applicable to investment projects (Amnesty International UK, 2003 and 2005).

Alternatively, host states may seek to exclude ongoing investment projects from the application of new regulation. However, this raises problems in light of two factors:

- The often considerable size of investment projects where wide-ranging stabilisation clauses are used, both in economic terms relative to the host state's national economy, particularly in poorer countries; and in terms of possible human rights and environmental impacts.
- The duration of some investment contracts, which may span several decades.

As a result of these two factors, applying new regulation only to future investment projects has the potential to delay the application of that regulation to a major share of national economic activity for perhaps several decades. This is particularly problematic in poorer countries where the national legal framework regulating environmental protection and human rights at the inception of the investment project may not be well developed. In this context, the operation of stabilisation clauses may in the worst cases lead to continued application of low standards for decades to come.

In the human rights field, applying new standards only to future investment projects would also violate the non-discrimination principle enshrined in human rights treaties, as citizens more directly affected by the investment project would be granted a lower level of protection than others (Amnesty International UK, 2003).

Stabilisation clauses may also create distortions in legal policy, with host states favouring ways to pursue sustainable development goals that are less costly for ongoing investment projects – even if they are less effective in pursuing those goals. This might mean, for instance, that a state favours pursuit of compensation for environmental damage over injunctions to prevent damage from occurring in the first place. This is because injunctions may negatively affect the speed of implementation of investment projects, for instance through requiring that construction works are halted until compliance with new legislation is assured (as argued, with regard to human rights, by Leader, 2006).

## The need for new tools

The analysis summarised in this briefing highlights the need to reconcile stability of the investment climate (itself a

legitimate need of investors); with evolution in the human rights, environmental and other relevant standards applicable to investment projects.

With regard to human rights standards, for instance, the scope of stabilisation clauses must be seen as restricted by the host state's obligation to comply with international human rights treaties: clauses negotiated between the investor and the host state cannot impair the human rights held by third parties, nor prevent genuine host state action to progressively realise human rights. In other words, stabilisation clauses must be read as having an (explicit or implicit) human rights exception (Leader, 2006).

One way of operationalising this exception is illustrated by the 2003 BTC Human Rights Undertaking, relating to the contracts for the construction and operation of the BTC oil pipeline. The Undertaking is a unilateral commitment of the BTC consortium not to invoke the very broad stabilisation clause included in the BTC contracts in a way that prevents host state regulation pursuing human rights goals; provided that such regulation meets specified requirements aimed at preventing abuse.

In the Undertaking, these requirements are determined through reference to international human rights treaties. This benchmarking is important to the investor, since introducing exceptions to the stabilisation clause creates the risk that such exceptions are used by the host state as a "Trojan horse" to undermine the tightness of the stabilisation clause – for instance, through claiming unsubstantiated human rights or environmental concerns to justify measures that negatively affect the investment project.

The BTC Undertaking is an *ex post* tool: it was negotiated only after a very broad stabilisation clause had been signed, and as a result of civil society mobilisation. While the language of the Undertaking itself emphasises its binding nature, questions remain as to the value that international arbitrators would attach to it should a dispute arise. Integrating a human rights or sustainable development exception in the contract itself during the initial negotiation phase would be a preferable solution.

In addition to restricting the scope of stabilisation clauses to exempt regulation pursuing sustainable development goals, these clauses may be drafted as "double-sided". They may require restoration of the economic equilibrium not only for host state regulation that negatively affects the project, but also for regulatory change that improves the economic benefits generated by the investment – an approach already followed in some jurisdictions.

Innovative tools such as the BTC Undertaking illustrate how a better balance can be reached between providing safeguards for foreign investors and enabling the host state to pursue sustainable development goals. However, it must be borne in mind that the negotiation of foreign investment contracts takes place in contexts characterised by asymmetries in the negotiating power of host states and investors, and by host states not always prioritising human rights and sustainable development concerns. Transparency and civil society scrutiny of these negotiations are therefore important to ensure that sustainable development concerns are fully taken into account. ●

#### BOX 4.4. What can you do?

- Monitor your government's negotiation of investment contracts, and promote public debate;
- Use the opportunities offered by the law to challenge and influence investment contract negotiations, including environmental impact assessment, parliamentary ratification/approval of investment contracts, or judicial review;
- Step up efforts to build citizens' capacity better to hold governments to account on these issues.

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The briefings also draw on Dominic Ayine, Hernán Blanco, Lorenzo Cotula, Moussa Djiré, Candy Gonzalez, Nii Ashie Kotey, Shaheen Rafi Khan, Bernardo Reyes and Halina Ward, 2005, "Lifting the Lid on Foreign Investment Contracts: The Real Deal for Sustainable Development", London, IIED, Sustainable Markets Group Briefing Paper.

3 Foreign investment contracts are not to be confused with investment treaties, which are concluded between two or more states to regulate establishment and treatment of investment by nationals of one state in the territory of the other state(s) (on these, see Briefing 2).

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