Chapter 1
Investor-State Dispute Settlement (ISDS) in the Energy Sector:
A Poisonous Gift for Developing Countries?

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ABSTRACT

The creation of an international energy market has brought along new challenges. In order to palliate any abuse towards the foreign investors, a strong protection framework was developed: the so-called investor-state dispute settlement (ISDS) coupled with the arbitration. Recent cases have, however, highlighted that private institutions are becoming so powerful that they can prohibit states from implementing changes without being threatened by arbitral proceedings. This threat works as a limitation of state sovereignty. Currently, the system puts the interests of private corporations above the needs of the population. ISDS in the energy sector has always been a poisoned gift for developing countries.

INTRODUCTION

The increasing liberalisation of markets coupled with more developed technologies and a decrease in trade barriers have led to an international energy market. To fulfil the need of this market, energy companies have to invest massively to extract minerals, oil, and gas. Those investments are often situated in developing economies with sometimes unstable political regimes. In order to mitigate any abuse towards the foreign investors on the part of the host state, a solid protection framework was developed, called the investor-state dispute settlement (ISDS) (Garcia, Ciko, Gaurav, & Hough, 2015).

As Zhan (2016) noted, "Originally, the ISDS mechanism was designed to ensure a neutral forum that would offer investors a fair hearing before an independent and qualified tribunal, granting a swift, cheap and flexible process for settling investment disputes". Indeed, ISDS allows the foreign investors

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to bypass national jurisdiction and solve the dispute before a tribunal of supposedly neutral arbitrators selected by the parties (AMES, 2015). To best fit those requirements, arbitration has been regarded as the 'best option' because it is a "speedy disposition of differences through informal procedures without resort to court action." (Firmin vs. Garber, 1977). Arbitration is also regarded as fairer, as national courts could be biased towards the state. In addition to being considered more appropriate, arbitration is less expensive. However, this statement should be nuanced; arbitration is not always cheaper than litigation; it actually depends (Phelps Gay, 2018).

ISDS coupled with arbitration is regarded as providing strong protection for those foreign investors is necessary to avoid any unlawful exploitations and negative financial consequences (Gaitis *et al.*, 2017). Without such protection, states could easily expropriate investors without compensation and on dubious grounds. Indeed, those arbitral clauses are often found in bilateral investment treaties (BITs) or multilateral frameworks, such as the Energy Charter Treaty (ECT). Moreover, energy projects are characterised by complex and capital-intensive deals with long-term transactions and investments. Consequently, the energy sector has always been a fertile ground for investment disputes.

This standard protection has, nevertheless, sparked public outcry and opposition due to the outcomes it generates. Public perception is that foreign investors, which are often large corporations, are granted too much power. Additionally, private arbitral tribunals, which are often pro-investors, are not legitimate in balancing private profits with public interests. Consequently, the use of private arbitration in State-investors disputes is becoming increasingly questioned and faces great opposition, resulting in a legitimacy crisis.

In addition to being increasingly questioned, it is also regarded as disadvantageous, especially for developing countries and indigenous communities. The *Gold Reserve v. the Bolivarian Republic of Venezuela*[1] ruling probably best exemplifies this increasing problem. Similarly, the *Cosigo Resources v Colombia*, on mineral extraction, demonstrated the powerful nature of arbitration. In addition to being forced to pay millions in compensations, Colombia was prohibited from setting a natural reserve. These recent cases highlight that governments from developing states are in a weaker position compared to big international corporations. Additionally, those agreements put indigenous rights at risks because these native populations are often part of the contracts but are affected by them. In fact, private arbitration in investor-state dispute limits state sovereignty[2] in a hidden manner.

While protection of investors is necessary, such protection has evolved into a form of state sovereignty limitation as foreign investors can directly challenge a measure if such measure is believed to violate the said BIT (Salacuse, 2015). In fact, recent cases have highlighted that private institutions are becoming so powerful that they can prohibit states from implementing changes without being threatened by arbitral proceedings (Alvarez, 2011; Arato, 2015).[3] This phenomenon has been referred to as regulatory chill, whereby governments do not enforce or enact measures due to concern about potential litigations, therefore threatening the host state's regulatory power (Thakur, 2021; Tienhaara, 2018; Bonnitcha, 2014; Tienhaara, 2011). This article goes a step further and claims that arbitral clauses in ISDS limit state sovereignty to revoke previously granted concessions without incurring a duty to compensate. The potential to interfere with state sovereignty flows from the limitation on regulatory powers, which are an integral part of sovereignty (Van Harten & Loughlin, 2006). Indeed, under international law, states have a right to implement their economic, social and political system.[4] By signing an IIA, states are bound by some obligations towards foreign investors; however, such obligations should not be so extensive as to restrain the right to regulate important aspects without having to compensate foreign investors. The *Vattenfall v*

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