

The Potential Contribution of International Investment Protection Law to Combat Climate Change

By Anatole Boute*

The architecture of the Kyoto Protocol gives the private sector a central role to play. It will most probably continue to occupy an important place in the post-2012 climate regime. However, one essential aspect for private investors is often overlooked during the ongoing climate talks: the protection of low-carbon investments against regulatory changes by host countries. Investors' perception that the 'rules of the game' governing their investment could change may make it more difficult and more expensive to attract low-carbon investments thereby compromising the goal of emission reductions. This article identifies risks of regulatory changes that are inherent to the regulations designed to promote renewable energy sources and energy efficiency, as well as to implement the flexible mechanisms of the Kyoto Protocol. It analyses the extent to which the protection standards of international investment law offer adequate protection against these changes but also questions if these same standards represent a threat to the implementation of national climate policies.

The success of international efforts to combat climate change, to a large extent, depends on stabilising the greenhouse gas emissions of developing countries and economies in transition. Indeed, these states are expected to generate most future growth in CO₂ because of their rapid economic development and expansion of energy-intensive industries.¹ The energy

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¹ IPCC, *Fourth Assessment Report: The Mitigation of Climate Change* (Cambridge, 2007), p 253, available at www.ipcc.ch/pdf/assessment-report/ar4/wg3/ar4-wg3-chapter4.pdf. See also N Stern, *The Economics of Climate Change – The Stern Review* (Cambridge, 2006), p 169, available at www.hm-treasury.gov.uk/stern_review_climate_change.htm.

systems of these countries are in general very inefficient, and therefore they present huge opportunities for CO₂ abatement.² Private foreign investments have an important role to play in realising this potential by providing the required capital, as well as by transferring energy-efficient technologies and know-how.³

However, there are important barriers affecting the readiness of foreign investors fully to commit to these low-carbon investments,⁴ including the instability of the energy and climate regulations of developing and transition economies.⁵ Energy and low-carbon investments are highly capital-intensive and require long pay-back times. Investors in this sector will, therefore, be highly averse to changes to the 'rules of the game' that may affect the profitability of their investments.⁶ They generally internalise their perceptions of risks of fundamental regulatory changes by adding a risk premium, which increases the required return on investment⁷ and reduces the flow of investments.⁸

The current international climate regime aims to stimulate the transfer of foreign capital and technologies by creating the possibility for investors to benefit from additional financial resources (carbon finance) through

2 See D Farrell and J Remes, *Promoting Energy Efficiency in the Developing World* (The McKinsey Quarterly, February 2009), www.mckinseyquarterly.com/Promoting_energy_efficiency_in_the_developing_world_2295.

3 See International Institute for Sustainable Development, *Foreign Investment: Making It Work for Sustainable Development* (Winnipeg: IISD, 2002), www.iisd.org/publications/pub_fr.aspx?id=575, p 6.

4 The notion of 'low-carbon investment' is used in this article to refer to greenhouse gas emission reduction investments, such as projects implemented under the flexible mechanisms of the Kyoto Protocol but also, more generally, renewable energies, combined heat and power and energy efficiency projects implemented within the framework of the climate or environmental policies of the host countries.

5 See S Frankhauser and L Lavric, 'The Investment Climate for Climate Investments: Joint Implementation in Transition Countries', *Working Paper no 77 European Bank for Reconstruction and Development* (2003), www.ebrd.com/pubs/econo/wp0077.pdf. See also A Cosby et al, *Clean Energy Investment – Project Synthesis Report* (Winnipeg: IISD, 2008), p 14; B Brandzaeg and S Hansen, *Barriers to Investment in the Power Sector in Developing Countries – Power Sector Task Force Annex B* (Econ Analysis Nordic Consulting Group, 2005).

6 See Joint Paper by the Energy Charter Secretariat and the International Energy Agency presented to the 1998 G8 Energy Ministerial in Moscow. See also EURELECTRIC, *Ensuring Investments in a Liberalized Electricity Sector* (Brussels: EURELECTRIC, 2004), p 55.

7 Or by further discounting the value of future returns. See J Guasch and P Spiller, *Managing the Regulatory Process: Design, Concepts, Issues, and the Latin American and Caribbean Story* (Washington DC: The World Bank, 1999); S Banerjee, J Oetzel and R Ranganathan, 'Private Provision of Infrastructure in Emerging Markets: Do Institutions Matter?' (2006) 24 *Developments Policy Review* 175.

8 See K Neuhoﬀ and L De Vries, 'Insufficient Incentives for Investment in Electricity Generations' (2004) 12 *Utilities Policy* 253 at 264.