REGULATORY TAKINGS, STABILIZATION CLAUSES AND SUSTAINABLE DEVELOPMENT

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1. Framing the issue

As trade and investment liberalization intensifies, many low- and middle-income countries are stepping up efforts to attract foreign direct investment. At the same time, these efforts are increasingly subject to scrutiny in terms of their ability to support, or undermine, key sustainable development goals like poverty reduction, realization of human rights and environmental sustainability.

Legal arrangements are an important part of the overall package that a country can offer to potential foreign investors. They define the terms and conditions of foreign investment, the way its costs and benefits are shared and, ultimately, the extent to which it contributes to sustainable development goals.

To investors, legal arrangements are important to protect their assets and entitlements, and to ensure stability of the regulatory framework governing their activities. Once the bulk of a long-term and capital-intensive investment is made, the investor is a "hostage" of the host state: on the one hand, the financial viability of the investment project depends on the investor's ability to capture projected cash flows, while, on the other hand, the investor is vulnerable to host government action that may undermine such financial viability or even expropriate the investor's assets altogether.[2]

Legal arrangements to promote regulatory stability include provisions of general international law, such as those concerning the regulatory taking doctrine, and project-specific commitments embodied in foreign investment contracts between foreign investors and host states (stabilization clauses). Under the regulatory taking doctrine, regulation that undermines the investment's commercial viability may be deemed as a taking of property, and require the host state to pay compensation. Under commonly used stabilization clauses, the host government commits itself not to change the regulatory framework in a way that affects the economic equilibrium of the project, and to compensate the investor if it does so.

While these legal arrangements can help shelter investment from undue host state interference, they may also distort the pursuit of sustainable development - the policy imperative to balance economic, environmental and social considerations. For instance, the

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[2] Thomas Wälde and Abba Kolo, "Environmental Regulation, Investment Protection and "Regulatory Taking" in International Law", 50 *Int'l & Comp. L.Q.* 811 at 819 (2001).

requirement to pay compensation may make it more difficult for host states - particularly poorer ones - to adopt new regulation raising social and environmental standards, if this affects the economic equilibrium of the investment project or undermines its commercial viability. In other words, commitments on regulatory stability shelter the economic equilibrium of an investment project from changes in environmental and social standards, and may as a result "freeze" a non-optimal balance between social, environmental and economic considerations.[3]

These tensions between investment protection and sustainable development goals call for the development of innovative approaches that can reconcile the investors' legitimate need to ensure stability of the investment climate with efforts to maximise the contribution of foreign investment to the pursuit of sustainable development goals.

The past few years have witnessed growing debate on the implications of the regulatory taking doctrine for environmental and other regulation.[4] Less attention has been paid to constraints on host state regulation stemming from stabilization clauses. Very recently, both the academic literature and the work of human rights organizations have started to scrutinize the way in which stabilization clauses can constrain government efforts to pursue human rights goals.[5]

This paper examines the implications of the regulatory taking doctrine and of stabilization clauses for host state regulation in pursuit of sustainable development goals - specifically, for regulation raising the social and environmental standards applicable to investment projects. First, the paper recalls the key elements of the international law on regulatory takings, and compares them to the legal standards applicable under a selection of stabilization clauses. This analysis reveals that increasingly broad stabilization clauses tend to ensure a level of regulatory stability that far exceeds that accorded by general international law under the regulatory taking doctrine. Second, the paper analyzes options to mitigate the constraints on host state regulation by limiting the scope of stabilization clauses through a "compliance with international law" exception, and by building into these clauses some degree of evolution of applicable social and environmental standards.

2. The regulatory taking doctrine

Under international law, host states have the sovereign right to expropriate assets and to regulate activities within their jurisdiction, based on the principle of permanent sovereignty

[3] IIED & partners, "Lifting the Lid on Foreign Investment Contracts: The Real Deal for Sustainable Development", International Institute for Environment and Development (2006).

[4] See, for instance, Wälde and Kolo, *supra* note 2; Howard Mann and Konrad von Moltke, Protecting Investor Rights and the Public Good: Assessing NAFTA's Chapter 11 (2003); and Andrew Newcombe, *The Boundaries of Regulatory Expropriation in International Law* 20 I.C.S.I.D. Rev.—F.I.L.J. 1 (2005).

[5] As for the academic literature, see Sheldon Leader, "Human Rights, Risks, and New Strategies for Global Investment", 9 *J. Int'l Econ. L.* 657 (2006); and Olivier de Schutter, "Transnational Corporations as Instruments of Human Development", in P. Alston and M. Robinson, eds., Human Rights and Development: Towards Mutual Reinforcement, 403 (2005). As for the work of human rights organizations, see the reports by Amnesty International UK, "Human Rights on the Line: The Baku-Tbilisi-Ceyhan Pipeline Project" (2003); Amnesty International UK, "Contracting out of Human Rights: The Chad-Cameroon Pipeline Project" (2005); and Global Witness, "Heavy Mittal? A State within a State: The Inequitable Mineral Development Agreement between the Government of Liberia and Mittal Steel Holdings NV" (2006). Most recently, Andrea Shemberg has undertaken a study on stabilization clauses and human rights for the UN Special Rapporteur on Human Rights and Transnational Corporations and Other Business Enterprises; at the time of writing, that study had not yet been published. For a sustainable development perspective, see the brief "Lifting the Lid", *supra* note 3, and Lorenzo Cotula, Strengthening Citizens' Oversight of Foreign Investment: Investment Law and Sustainable Development - 4. Investment Contracts, International Institute for Environment and Development (2007).

of states over natural resources. This principle was affirmed in UN General Assembly Resolution 1803 of 1962 and is generally recognized as being a principle of customary law.[6]

However, international law sets conditions with which host states expropriating foreign investors' assets must comply. Namely, takings must be for a public purpose, in a non-discriminatory way, on the basis of due process, and against the payment of compensation. These requirements are spelled out in a large number of international instruments,[7] bilateral investment treaties,[8] and arbitral awards.[9] They are widely regarded as being part of customary international law, although controversy still exists on the international standard of compensation.

International law defines in very broad terms the "taking of property" to which these four conditions for lawful expropriation apply. In establishing whether a taking has occurred, the government's *intention* to expropriate and the form of government interference are "less important" than the *impact* of government action on the investor's assets.[10] Such an impact may include regulatory measures that substantially affect the *value* of the investor's property rights, in particular, regulatory measures that interfere with property rights "to such an extent that these rights are rendered so useless that they must be deemed to have been expropriated."[11] As a result, a taking may occur even where no formal transfer of ownership takes place, for instance, where the investor is "deprived of fundamental rights of ownership" through taxation or regulation, provided that this deprivation is "not merely ephemeral" ("regulatory taking" or "indirect expropriation").[12]

This broad definition of taking is explicitly affirmed in most recent investment treaties. For example, article 1110(1) of the North American Free Trade Agreement (NAFTA) requires compensation for both "direct" and "indirect" expropriation; the latter includes "measures tantamount to expropriation." In *Metalclad v.* Mexico (a NAFTA case), the arbitral tribunal held: "Expropriation under NAFTA includes not only open, deliberate and acknowledged transfer of title in favour of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use of reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State".[13]

In this specific case, the tribunal found that the arbitrary denial of a construction permit and the adoption of an "ecological decree" establishing a protected area in the project site amounted to indirect expropriation, as they prevented the operation of the investor's waste

[6] Articles 1 and 4 of UN General Assembly Resolution on the Permanent Sovereignty over Natural Resources (Resolution 1803 (XVII) of 1962). See also Texaco Overseas Petroleum Company and California Asiatic Oil Company v. The Government of the Libyan Arab Republic, [1977] 53 I.L.R. 389 [Texaco]; Amoco International Finance Corp. v. Iran, Iran-US Claims Tribunal [1987] 15 Iran-US C.T.R. 189 [Amoco]; Government of Kuwait v. American Independent Oil Co. (Aminoil), Arbitration Award, [1982] 21 I.L.M. 976 [Aminoil].

[7] For instance, UN General Assembly Resolution 1803, *supra* note 6 at para. 4.

[8] See, for example, NAFTA article 1110(1); ASEAN Investment Agreement, article VI(1); Energy Charter Treaty, article 13.1.

[9] For example, Case Concerning Factory at Chorzów (Claim for Indemnity), 1928 P.C.I.J. (ser. A) No. 17; British Petroleum Exploration Company (Libya) Ltd v. Government of the Libyan Arab Republic, [1973] 53 I.L.R. 329 [British Petroleum]; American International Group v. Iran, Iran-US Claims Tribunal, [1983] 4 Iran-US C.T.R. 96; and see also the Texaco, Amoco, and Aminoil cases, *supra* note 6.

[10] Tippetts, Abbett, McCarthy, Stratter v. TAMS-AFFA Consulting Engineers of Iran, Iran-US Claims Tribunal [1984] 6 Iran-US C.T.R. 219 at 225–226 [Tippetts].

[11] Starrett Housing Corp. v. Iran, Iran-US Claims Tribunal [1983] 4 Iran-US C.T.R. 122 at 154 [Starrett].

[12] Tippetts, *supra* note 10, at 225.

[13] Metalclad Corporation v. United Mexican States, ICSID (Additional Facility), Arbitration Award, 30 August 2000, 40 (2001) ILM 36, para. 103 [Metalclad].

management facility. The facility had obtained all of the necessary federal permits but was opposed by the municipality (which denied the construction permit) and by the state government (which issued the ecological decree).

Such a broad definition of expropriation has raised concerns over a "regulatory chill" - the idea that the obligation to pay compensation for regulatory change may make it more difficult for host states to regulate in "socially desirable" areas such as human rights or environment protection - including to comply with their evolving international obligations.

The international case law suggests that the threshold beyond which the obligation to pay compensation is triggered is quite demanding, however. In *Pope & Talbot v. Canada* (another NAFTA case), the arbitral tribunal argued that, for a regulatory taking to occur, a "substantial deprivation" of property rights must be shown, whereby the investor "will not be able to use, enjoy, or dispose of the property." Criteria to assess the extent of the deprivation include whether the investor is in control of the investment, whether the government manages the day-to-day operations of the company, whether the government interfered with payment of the project dividends, and whether the investor retains full ownership and control of the investment.[14]

The "substantial deprivation" test developed in *Pope & Talbot* seems equivalent to that of "radical deprivation" used in *Tecmed v. Spain*.[15] It was followed in several recent arbitral awards, including *CMS Gas Transmission Company v. Argentina,* which found that no expropriation had occurred;[16] *LG&E Energy v. Argentina*, which also found no expropriation;[17] *Siemens v. Argentina*, which found that host state measures did amount to expropriation;[18] *Enron v. Argentina*, which found no expropriation;[19] *Vivendi v. Argentina*, which found that expropriation had occurred;[20] *Sempra v. Argentina*, which found no expropriation.[21]

3. Stabilization clauses

3.1. Concept and content

Stabilization clauses aim to "stabilize" the terms and conditions of an investment project, thereby contributing to manage non-commercial (that is, fiscal, regulatory) risk. They involve a commitment by the host government not to alter the regulatory framework governing the project, by legislation or any other means, outside specified circumstances (e.g. consent of

[14] Pope & Talbot Inc v. The Government of Canada, UNCITRAL (NAFTA), Award on the Merits of Phase 2, 10 April 2001, para. 100.

[15] Técnicas Medioambientales Tecmed, S.A. v. Spain, Award, ICSID, ARB(AF)/00/2, 23 May 2003, 43 ILM (2004) 133, para. 115.

[16] CMS Gas Transmission Company v. The Argentine Republic, Award, ICSID Case No. ARB/01/8 (12 May 2005), 44 I.L.M. 1205 (2005), paras. 262-264.

[17] LG&E Energy Corp., LG&E Capital Corp. and LG&E International Inc. v. Argentine Republic, Decision on Liability, 3 October 2006, ICSID Case No. ARB/02/1, 46 ILM 36 (2007). This tribunal held that the substantial deprivation test is "not satisfied where the investment continues to operate, even if profits are diminished" (para. 191).

[18] Siemens A.G. v. Argentina, ICSID Case No. ARB/02/08, Award, 6 February 2007, available at http://ita.law.uvic.ca/documents/Siemens-Argentina-Award.pdf, para. 271.

[19] Enron Corporation and Ponderosa Assets, L.P. v. Argentine Republic, ICSID Case No. ARB/01/3, Award, 22 May 2007, available at http://ita.law.uvic.ca/documents/Enron-Award.pdf, para. 245.

[20] Compañia de Aguas del Aconquija S.A. and Vivendi Universal v. Argentine Republic, ICSID Case No. ARB/97/3, Award, 20 August 2007, available at http://ita.law.uvic.ca/documents/VivendiAwardEnglish.pdf, paras. 7.5.11 and 7.5.34.

[21] Sempra Energy International v. The Argentine Republic, ICSID Case No. ARB/02/16, Award, 28 September 2007, available at http://ita.law.uvic.ca/documents/SempraAward.pdf, para. 284.

the other contracting party, restoration of the economic equilibrium and/or payment of compensation).[22]

Stabilization clauses come in all shapes and forms. Early stabilization clauses committed the host state not to nationalise, and/or required the consent of both contracting parties for contract modifications ("intangibility clauses"). More recent stabilization clauses have evolved into diverse and sophisticated tools to manage non-commercial risk associated with the investment project.[23] Their scope has tended to broaden, so as to include changes in the regulatory framework falling short of expropriation or contract modification. This includes stabilization of specific aspects of the investment project, such as its fiscal regime or its tariff structure. But it also includes much broader commitments to stabilize the regulatory framework governing the investment project.

For instance, under the so-called "freezing clauses", the applicable domestic law is the one in force at the time the contract is concluded, to the exclusion of subsequent legislation; while under "consistency clauses" the domestic legislation of the host state only applies to the project if consistent with the investment contract.[24] Freezing and consistency clauses feature for instance in the contractual arrangements for the Chad-Cameroon oil development and pipeline project.[25]

"Economic equilibrium clauses" constitute another type of stabilization clause. They link alterations of the terms of the contract to a renegotiation of the contract in order to restore its original economic equilibrium or, in absence, to the payment of compensation. In other words, differently to freezing clauses, economic equilibrium clauses stabilize the economic equilibrium of the contract rather than the regulatory framework itself: regulatory changes are possible so long as action is taken to restore the economic equilibrium. Economic equilibrium clauses may also empower arbitrators to determine adjustments to the contract if negotiations fail.[26] Economic equilibrium clauses feature for instance in the 1997 AGIP/British Petroleum/Etal-Kazakhstan "Kashagan" Production-Sharing Agreement (PSA)[27] and in contractual arrangements for the West African Gas Pipeline (WAGP).[28]

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[22] On stabilization clauses, see Nagla Nassar, Sanctity of Contracts Revisited: A Study in the Theory and Practice of Long-Term International Commercial Transactions (1995); Thomas Wälde and George N'Di, "Stabilising International Investment Commitments", 31 *Texas Int'l. LJ* 215 (1996); Piero Bernardini, "The Renegotiation of the Investment Contract", 13(1) *I.C.S.I.D. Rev – F.I.L.J.* 411-425 (1998); Peter Muchlinski, Multinational Enterprises and the Law (1999); Klaus Peter Berger, "Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators", 36(3) *Vanderbilt Journal of Transnational Law* 1347-1380 (2003); A.F.M. Maniruzzaman, "Stabilization in Investment Contracts and Change of Rules by Host Countries: Tools for O & G Investors", Association of International Petroleum Negotiators (2007); Peter D. Cameron, "Stabilization in Investment Contracts and Change of Rules by Host Countries: Tools for O & G Investors", Association of International Petroleum Negotiators (2007); and Cotula, *supra* note 1.

[23] Wälde and N'Di, *supra* note 22.

[24] Charles Leben, La Théorie du Contrat d'État et l'Évolution du Droit International des Investissements 302 R.D.C. Collected Courses 201 (2003); Wälde and N'Di, *supra* note 22.

[25] E.g. articles 24 and 30 of the "Convention of Establishment" between the Republic of Cameroon and the Cameroon Oil Transportation Company (COTCO), approved with Law 97-16 of 7 August 1997 and signed in 1998 [Cameroon-COTCO Convention].

[26] Bernardini, *supra* note 22, at 420-421; Bergen, *supra* note 22, at 1370-1378.

[27] Section 40.2.

[28] West African Gas Pipeline International Project Agreement (IPA) between Benin, Ghana, Nigeria, and Togo, on the one hand, and the West African Gas Pipeline Company Ltd, on the other, signed on 22 May 2003 [WAGP IPA], article 36.

In recent years, use of economic equilibrium clauses has increased, compared to other types of stabilization clauses such as freezing clauses.[29] The reason for the growing popularity of economic equilibrium clauses is their greater flexibility and versatility. Despite their relative decline, freezing clauses are still used, however.[30] In some cases, freezing and economic equilibrium clauses are combined in the same contract - for instance, in the Chad-TOTCO Convention of Establishment for the Chad-Cameroon oil pipeline,[31] and in the Host Government Agreements (HGAs) for the Baku-Tbilisi-Ceyhan (BTC) oil pipeline.[32]

3.2. Legal value and effect

The legality and binding nature of stabilization clauses was upheld in *Texaco v. Libya*,[33] *Kuwait v. Aminoil*,[34] *AGIP v. Congo*,[35] *Revere Copper v. OPIC*,[36] and (implicitly) in *Methanex v. US*.[37] This view reflects the dominant position in international arbitration awards. In addition, the legal value of stabilization clauses may be reinforced by provisions in investment treaties, whereby a state commits itself to honour contractual undertakings *vis-à-vis* nationals of another state party ("umbrella clause").[38] In *CMS Gas Transmissions v. Argentina,* international arbitrators held that umbrella clauses make *iure imperii* violations of contractual stabilization commitments (to the exclusion of purely commercial disputes arising out of a contract) a breach of the investment treaty.[39]

Two qualifications need to be made, however. First, the *Texaco*, *Aminoil*, *AGIP* and *Revere Copper* awards all involved expropriations rather than lesser forms of regulatory change. Their authority on the legality and binding nature of stabilization clauses therefore relates to commitments not to nationalise rather than not to regulate. On the other hand, the legality and binding nature of stabilization clauses restricting the right to regulate, and the consequences of regulatory changes not amounting to expropriations have not yet been properly tackled in published arbitral awards. Economic equilibrium clauses do not seem to

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[29] See the AIPN studies by Maniruzzaman and by Cameron, *supra* note 22.

[30] Apart from the examples from the COTCO-Cameroon Convention cited above (*supra* note 25), see for instance Ghana's Model Petroleum Agreement 2000 (article 26) and the 1997 Niger-TG World Energy Incorporated Agreement for the Exploitation of Hydrocarbons in the Ténéré Block (article 7.1).

[31] "Convention d'Etablissement" between the Republic of Chad and the Tchad Oil Transportation Company (TOTCO), signed on 10 July 1998 and approved with Law 015/PR/98 of 1998, article 21.3.

[32] Host Government Agreement between the Government of Turkey and the MEP Participants, 19 October 2000, articles 7.2, 10.1(iii) and 21.1.

[33] The arbitrator held that "the right to nationalise is unquestionable today" and part and parcel of state sovereignty; but that contractual commitments not to nationalize are a manifestation and exercise of sovereignty — not its alienation. In other words, sovereignty encompasses the right of states not to exercise their right to nationalize and to enter binding commitments to that effect. *Texaco*, supra note …, paras. 59-73.

[34] *Supra* note 6.

[35] *AGIP Company v. People's Republic of the Congo*, Award, 30 November 1979, 21 I.L.M. 726 (1982) [AGIP].

[36] Revere Copper & Brass, Inc. v. Overseas Private Investment Corporation (OPIC), [1978] 56 I.L.R. 257 [Revere Copper].

[37] *Methanex Corp. v. United States of America*, Final Award, 3 August 2005, http://www.state.gov/documents/organization/51052.pdf. Although the case did not involve stabilization clauses, the tribunal stated: "As a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and which affects, inter alios, a foreign investor or investment is not deemed expropriatory and compensable *unless specific commitments had been given* by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulation" (para. IV.D.7, emphasis added).

[38] See, for example, Article 10(1) of the Energy Charter Treaty.

[39] CMS Gas Transmission Company v. The Argentine Republic, Award, ICSID ARB/01/8, 12 May 2005, 44 ILM 1205, paras. 296-303.

pose significant problems, as they do not prevent host state regulation so long as the economic equilibrium is restored. But freezing clauses establish a more fundamental limitation of state sovereignty, compared to commitments not to expropriate and to economic equilibrium clauses. Doubts on the ability of freezing clauses to prevent host state regulation have been expressed by several commentators.[40]

Second, legal validity under international law does not evade issues concerning the legality of stabilization clauses under the domestic law of the host state, including constitutional principles on the separation of powers and on the competence of the executive to enter into commitments that prevail over legislation adopted by parliament (freezing and consistency clauses). Issues concerning legality under domestic law are likely to vary across national legal systems. Where stabilization commitments are indeed 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. In *Revere Copper v. OPIC*, the arbitral tribunal held 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".[41]

Yet, if an analogy is made between treaties and contracts, insights may come from article 46 of the Vienna Convention on the Law of Treaties. 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, constitutional provisions such as the principle of separation of powers 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 with the host state.[42]

Beyond the legality of stabilization clauses, a key issue is the legal effect of such clauses if their provisions are violated. Violations may include outright expropriation in breach of an intangibility clause, or regulatory change in breach of a freezing clause. In the case of economic equilibrium clauses, parties are under an obligation to negotiate in good faith so as to restore the economic equilibrium following regulatory change; but they are not under an obligation to reach an agreement.[43] Therefore, while failure to agree does not breach the clause, violations may include refusal to renegotiate, or intentional obstructing of negotiations, accompanied by refusal to compensate as provided by the clause.[44]

Issues concerning the consequences of breaches of stabilization clauses have been tackled in some arbitral awards, although mainly with regard to expropriation. In this context, payment of compensation emerges as the main legal effect of such breaches.[45] The amount of compensation depends on a range of factors - the costs incurred by the investor because of the violation (e.g. higher costs caused by regulatory change in breach of a freezing clause); the investor's legitimate expectations generated by the presence of a stabilization clause (as held by arbitrators in *Liamco* and *Aminoil);*[46] the restoration of the economic equilibrium, in the case of economic equilibrium clauses.

[40] Berger, *supra* note 22, refers to the legal validity of freezing clauses as "questionable" (at 1360); in the same sense, see also Bernardini, *supra* note 22, at 415.
[41] Revere Copper, *supra* note 36, at 1321.
[42] I am indebted to Professor Sheldon Leader on this point.
[43] See Bergen, *supra* note 22, at 1363-1368. See also Bernardini, *supra* note 22, at 419.
[44] Bergen, *supra* note 22, at 1369.
[45] AGIP, *supra* note 35, at para. 88; Libyan American Oil Company (Liamco) v. The Government of the Libyan Arab Republic, 12 April 1977, 62 ILR 140.
[46] Liamco, *supra* note 45; and Aminoil, *supra* note 6.

The obligation to pay compensation for violations of a stabilization clause creates the need to determine the threshold beyond which this obligation is triggered. Given the great diversity of stabilization clauses, trigger events vary considerably depending on the specific contractual formulation. Under freezing clauses, the host state must usually pay compensation if it applies regulatory changes to the investment project. On the other hand, economic equilibrium clauses are only triggered where a minimum threshold is met - namely, where the economic equilibrium of the contract is affected. At this point, parties to the contract come under an obligation to negotiate in order to restore the economic equilibrium; failure to do so (or to comply with alternative routes provided by the clause) triggers a violation of the clause.

Some economic equilibrium clauses provide guidance for determining at what point the economic equilibrium can be deemed to have been affected. For instance, the clauses included in the WAGP and Kashagan contracts cited above refer to a standard of "material" impact ("material adverse affect" or "material decrease in project benefits or company value", in the WAGP IPA; "materially adverse effects" on economic benefits, in the Kashagan PSA). The economic equilibrium clause used in the BTC contracts, on the other hand, merely refers to regulatory change impairing implementation or adversely affecting value - without requiring these effects to be "material".

Compared to the regulatory taking doctrine and despite significant variation across contracts, stabilization clauses tend to significantly lower the threshold beyond which host states must pay compensation. Freezing clauses require payment of compensation for regulatory change regardless of its impact. Economic equilibrium clauses entail a shift from "substantial deprivation" of property rights to lesser impacts on the economic equilibrium of the project. Even the standard of "material impact" used in some economic equilibrium clauses appears to be significantly lower than the "substantial deprivation" standard. What is required for this threshold to be met is not government interference that affects the very viability of an investment project but, rather, less intrusive forms of government action that affect the cost-benefit equilibrium of the investment.

Thus, regulatory change including legislation, the judicial or administrative interpretation of existing provisions, and other measures that affect the economic equilibrium of the investment project would require the government to pay compensation, even if those measures per se do not amount to regulatory taking. That said, the amount of compensation payable for breach of a stabilization clause is not necessarily comparable to that payable under the regulatory taking doctrine. By definition, a regulatory taking entails a substantial deprivation of property rights. The amount of compensation reflects therefore the fact that an expropriation has taken place. On the other hand, stabilization clauses may trigger payment of compensation for lesser interferences in the economic equilibrium of the contract. Apart from extreme cases where breach of a stabilization clause amounts to expropriation, the aim is not to compensate the investor for expropriation but, rather, to restore the economic equilibrium of the contract. Compensation is therefore likely to be lower than compensation payable for a full expropriation.

4. Implications for host state regulation in pursuit of sustainable development

The previous section showed that increasingly broad stabilization clauses have evolved from commitments not to nationalise to more sophisticated arrangements restricting host state regulation through "freezing" or "economic equilibrium" devices; that these clauses tend to be upheld by international arbitrators; and that violations of these clauses require host states to pay compensation. These host state commitments to regulatory stability must be set against the backdrop of the remarkable changes in international social and environmental standards that have occurred over the past few decades.

A growing body of international law on environmental protection has emerged through an increasing number of international environmental treaties, reflecting, in part, the momentum generated by international conferences such as the 1972 UN Conference on the Human Environment in Stockholm and the 1992 UN Conference on Environment and Development in Rio, as well as through the increasing integration of environmental aspects in treaties with a broader remit.[47] The International Court of Justice (ICJ)[48] and other international dispute settlement bodies[49] have also begun to pay more attention to environmental issues. Activities that only a few decades ago were subject to very limited environmental regulation are now subject to stricter standards. In addition, international environmental law increasingly emphasises prevention and minimization of environmental damage, rather than compensation for damage incurred - as evidenced, for example, by the growing number of international provisions concerning environmental impact assessment.[50]

Similarly, international social standards have been raised considerably as a result of developments in international human rights and labour law. In the human rights field, international law has undergone major development since 1948, when the Universal Declaration on Human Rights (UDHR) was adopted. This has happened, among other things, through the adoption of new treaties, both at global level (particularly the 1966 UN Covenants) and at the regional level (e.g., in Africa, the 1981 African Charter on Human and Peoples' Rights and subsequent Protocols); through case law applying international treaties;[51] and through "General Comments" issued by UN bodies responsible for overseeing implementation of international treaties, which clarify the meaning of treaty provisions. The past few decades have witnessed a clarification of international human rights standards, the strengthening of international institutions responsible for overseeing them, and growing numbers of states becoming parties to international human rights treaties.

As international customary law crystallizes or an international treaty is ratified, the host state enters an international obligation to bring its domestic legal system in line with the new international standards. In other words, rising international standards (in terms of both

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[47] See, for instance, Article 32 of the 2000 ACP-EU Cotonou Agreement, and Article 19 of the 1994 Energy Charter Treaty.

[48] See, for instance, the Case Concerning the Gabčíkovo-Nagymaros Project (Hungary v. Slovakia), [1997] I.C.J. Rep. 92 (25 September), 37 I.L.M. 162 (1998) [Gabčíkovo-Nagymaros case].

[49] See, for instance, the World Trade Organization case United States—Import Prohibition of Certain Shrimp and Shrimp Products, Report of the Appellate Body, Doc. AB-1998–4, WT/DS58/AB/R (12 October 1998), 38 I.L.M. 121 (1998).

[50] See principle 17 of the 1992 Rio Declaration on Environment and Development, 13 June 1992, 31 ILM 874 (1992); the 1991 Convention on Environmental Impact Assessment in a Transboundary Context, 30 I.L.M. 800 (1991); Article 19 of the 1994 Energy Charter Treaty; Article 206 of the 1982 UN Convention on the Law of the Sea, 21 I.L.M. 1261 (1982); and Article 14 of the 1992 Convention on Biological Diversity, 31 I.L.M. 818 (1992). More generally, as the ICJ stated in Gabčíkovo-Nagymaros, "[i]n the field of environmental protection, vigilance and prevention are required on account of the often irreversible character of damage to the environment and of the limitations inherent in the very mechanism of reparation of this type of damage" (*supra* note 48, para. 140).

[51] For instance, in the oft-quoted "Ogoniland" case, the African Commission on Human and Peoples' Rights found that human rights like the right to food and to water were implicitly recognised in the African Charter on Human and Peoples' Rights; it clarified the content of explicitly recognised rights, such as peoples' right to freely dispose of their natural resources; and clarified the nature of state obligations with regard to economic, social and cultural rights; SERAC (The Social and Economic Rights Action Centre) and CESR (The Center for Economic and Social Rights) v. Nigeria, Communication No. 155/96, 27 October 2001, (2001) AHRLR 60 (ACHPR 2001).

content and scope of application) may require host states to take regulatory measures to ensure that their domestic legislation complies with the higher international standards.

Host state regulation raising social and environmental standards, including ratification of international treaties and domestic legislation to comply with evolving international obligations, may well fall within the scope of a stabilization clause. This is particularly case where regulatory change has the effect of raising the costs of an ongoing investment project - for instance, due to tighter requirements on compensation for takings of or damage to property, or due to increased protection of ecosystems or species affected by the investment project. As a result, a host state that adopts regulations raising social and environmental standards and seeks to apply such standards to ongoing investment projects would have to restore the economic equilibrium of the contract, or to compensate investors for the economic impact of such regulations. This legal liability may make it more difficult for host states, particularly poorer ones, to adopt legislation or ratify treaties raising social and environmental standards.

Alternatively, host states may exclude ongoing investment projects from the application of the regulatory change. In other words, they may still adopt new regulation but insulate from it investment projects covered by stabilization clauses. This method raises issues for the coherence of the overall legal framework, as similar investment projects may be governed by different rules. It raises problems in light of two factors:

- the often considerable size of investment projects where wide-ranging stabilization clauses are used, both in economic terms relative to the host state's national economy, particularly in poorer developing countries, and in terms of possible social and environmental impacts;[52] and
- the usually long duration of investment contracts, possibly spanning several decades (for example, twenty-five years renewable in the Cameroon-COTCO Convention and forty years in the BTC-Turkey HGA).

As a result of these two factors, applying new social and environmental standards only to future investment projects may delay the application of new regulation to a major share of economic activity for several decades.

Whether the outcome is "regulatory chill" or "selective regulation" that excludes ongoing investment projects, the operation of stabilization clauses may entail the continued application of social and environmental regulation below international standards for decades to come. This is particularly problematic in poorer developing countries where the national legal framework setting social and environmental standards at project inception may be not well developed. Besides the continued application of low standards for decades to come, this situation also shifts to the host state the risk of currently unknown social and environmental hazards which may be discovered in future and which may be prevented or minimized through new regulation.

[52] See, for instance, the considerable importance of the Chad-Cameroon pipeline project for the national economy of Chad and the important concerns raised by civil society on the project's social and environmental standards in both Chad and Cameroon. For example, see Centre pour l'Environnement et le Développement Broken Promises: The Chad-Cameroon Oil and Pipeline Project: Profit at Any Cost (2001); and Centre pour l'Environnement et le Développement, The Chad-Cameroon Oil and Pipeline Project: A Call for Accountability (2002). These concerns led to the establishment of two World Bank Inspection Panels; see http://web.worldbank.org/external/projects/main?pagePK=64283627&piPK=73230&theSitePK=40941&menuPK=228424&Projectid=P044305.

In addition, stabilization clauses may 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 their goal. This may entail, for instance, favouring compensation for environmental damage over injunctions to prevent damage from occurring in the first place. This situation can occur because injunctions may negatively affect the speed of project implementation (and therefore the economic equilibrium of the project) — for instance, by requiring that construction works be halted until compliance with new regulation is assured.[53]

In making it more costly for host states to raise social and environmental standards in line with evolving international law, and in favouring measures that are less costly to the investor even if they are less effective, broad stabilization clauses of the kind examined in this study may trigger tensions between different host government obligations — namely between the obligation to honour contractual commitments (*pacta sunt servanda*), possibly backed by umbrella clauses embodied in investment treaties, on the one hand, and the obligation to comply with evolving international (human rights, environmental) law, on the other. Their focus on safeguarding the economic equilibrium may also foster tensions between the three pillars of sustainable development - economic, social and environmental – and "freeze" suboptimal balances between these pillars.

In practice, legal claims are only part of the story in the long-term contractual relationships that typically characterise investment projects. Much depends on the balance of negotiating power between the different stakeholders involved in the project - foreign investors and host states, but also lenders, NGOs, local groups affected by the project, and others. Recent experience with renegotiation of investment contracts, particularly in the oil and gas sector, illustrates that even tight stabilization clauses may not prevent host state action backed by political determination and changes in the balance of negotiating power. Such balance of power tends to evolve as a result of changing circumstances, of the unfolding of the different stages of project implementation (from negotiation to construction through to operation and decommissioning[54]), and of the economic and political cycles characterising the relevant industry (e.g., as for the petroleum sector, changes in oil prices and in availability of capital and technology[55]).[56]

However, these considerations do not affect the relevance of the above discussion. Legal claims based on stabilization clauses provide "markers", "magnetic points" that may be relied on by the investor or the host state, thereby influencing their negotiating power and possibly affecting negotiation outcomes.[57] Using concepts developed by Tai-Heng Cheng, I would argue that broad stabilization commitments tend to shift negotiating power from the host state to the investor through four types of processes: "trigger", whereby investors are vested with enforceable entitlements; "drain", whereby the exercise of state sovereignty is constrained as a result of those entitlements; "transfer", whereby the power lost by host states does not "vanish" but is devolved to other actors such as foreign investors or arbitral

[53] As argued by Leader, *supra* note 5.
[54] For instance, the investor's negotiating power tends to decrease after the construction phase, when the investor depends on the host state honouring its commitments in order to be able to recover costs and make profits.
[55] Wälde, T., "Rule of Law and the Resource Industries Cycles: Acquired Rights vs the Pressures Inherent in the Political Economy of the International energy and Resource industries", forthcoming in *Journal of World Energy Law & Business*.
[56] For a more detailed discussion of negotiating power in investment projects, see Lorenzo Cotula, "Legal empowerment for local resource control: Securing local resource rights within foreign investment projects in Africa", London, IIED (2007), at 24-28.
[57] Wälde, *supra* note 55.

tribunals; and "restore", whereby the host state can ultimately restore its power (for instance through payment of compensation), but at a price that can be quite steep.[58]

The obligation to pay compensation under broad stabilization commitments may also affect negotiations between the host state and NGOs calling for tighter social and environmental standards to be applied to the investment project. The host state may resist NGO demands by claiming that it has "tied hands" as a result of its contractual obligations. This is particularly an issue where, lacking genuine commitment to improving social and environmental standards, the host state is ready to use these concerns as a lever for renegotiating the distribution of control and economic benefits;[59] but also to drop pursuit of those concerns once its higher-priority economic objectives are achieved.

This analysis suggests that, from a legal point of view, stabilization clauses may create a "regulatory chill" in social and environmental standards - and they may do so to a more significant degree than the regulatory taking doctrine. This conclusion does not change when the analysis of legal claims is brought together with an analysis of evolving power relations among stakeholders involved in an investment project - as stabilization clauses may affect the balance of negotiating power between those stakeholders in a way that makes it more difficult to improve applicable standards.

5. Reconciling stabilization and evolution in social and environmental standards

This section explores two options for reconciling regulatory stability with the need to allow an evolution in social and environmental standards: (1) limiting the scope of stabilization clauses through an explicit or implicit "compliance with international law" exception; and (2) following an evolutionary approach to the application of contract provisions, including stabilization clauses. These two options are complementary and mutually reinforcing. They aim to redefine the legal claims of the investor and the host state; but also, indirectly, to alter the balance of power between these actors in negotiations relating to changes in social and environmental standards. Through redefining legal claims and shifting negotiating power, the combined use of these options may ease some of the constraints on host state regulation stemming from stabilization clauses.

5.1. Limiting the scope of the stabilization clause

The first option entails limiting the scope of stabilization clauses through exempting "socially desirable" host state regulation from their remit. This option has been publicly discussed mainly with regard to human rights standards, but it can be applied to other (e.g. environmental) standards as well.

With regard to human rights, the merits of this approach have been discussed by Sheldon Leader.[60] According to this author, state sovereignty is limited by the international obligation to realize fundamental human rights. In providing commitments to the investor, the host state cannot impair the human rights held by individuals and groups that may be affected by the investment project. Therefore, stabilization clauses are valid and legally binding, but their scope is restricted in that they cannot impair the human rights held by third parties; and they cannot prevent genuine host state action to progressively realize human rights. In other words, this approach entails building a human rights exception into stabilization clauses, whether explicitly or implicitly; host state regulation to promote the full realization of human rights is outside the scope of the stabilization clause.[61]

[58] Cheng, T., 2005, "Power, Authority and International Investment Law", 20 *Am. U. Int'l L. Rev.* 465, at 470-499.
[59] See for instance the recent renegotiations in the Sakhalin and Kashagan petroleum projects.
[60] *Supra* note 5.
[61] Ibid.

This approach may be broadened beyond the human rights field to encompass a broader range of international law obligations concerning social and environmental standards. It is accepted that host states may commit themselves not to exercise their sovereign *rights*, such as the right to nationalise. As discussed above, this argument was central in the reasoning developed by the *Texaco* arbitrator to reconcile stabilization clauses with state sovereignty.[62] It must also be accepted, however, that states may not contract out of compliance with their *obligations* under international law. Indeed, it is well established in international law that state sovereignty is not unlimited, but qualified, among other things, by international obligations concerning the realisation of human rights and the protection of the environment.[63] Therefore, states cannot commit themselves not to exercise rights they do not have – such as a right to exercise sovereignty in a way that does not take account of international obligations. In other words, states cannot commit themselves not to take measures that they are required to take under international law. On the basis of this reasoning, the scope of stabilization clauses is limited by a "compliance with international law" exception, whether explicitly or implicitly.

An example of *explicit* exception is provided by the 2003 BTC Human Rights Undertaking. The undertaking is a unilateral commitment of the BTC consortium not to interpret the very broad stabilization clause that is included in the BTC contracts (cited earlier) in a way that prevents host state regulation from pursuing not only human rights but also environmental goals (as reflected in the formula "health, safety, and environmental" standards (HSE)), provided that such regulation meets specified requirements aimed at preventing host state abuse. While the undertaking is a unilateral commitment on the part of the consortium, it "constitutes a legal, valid and binding obligation" and cannot be revoked without the consent of the host states.[64]

Under the undertaking, the BTC consortium commits itself not to assert claims that are inconsistent with host state regulation, provided that this is "reasonably required by international labour and human rights treaties to which the relevant Host Government is a party from time to time [or] otherwise … required in the public interest in accordance with domestic law in the relevant Project State from time to time, provided that such domestic law is no more stringent than the highest of European Union standards as referred to in the Project Agreements, including relevant EU directives … those World Bank standards referred to in the Project Agreements, and standards under applicable international labour and human rights treaties".[65]

The undertaking also commits BTC not to seek compensation under the economic equilibrium clause "in connection with … any action or inaction by the relevant Host Government that is reasonably required to fulfil the obligation of the Host Government under any international treaty on human rights (including the European Convention on Human Rights), labour or HSE in force in the relevant Project State from time to time to which such Project State is then a party".[66]

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[62] *Supra* note 33.

[63] In environmental matters, this is explicitly stated in Principle 2 of the Rio Declaration on Environment and Development, *supra* note 50.

[64] The Baku-Tbilisi-Ceyhan Pipeline Company, "BTC Human Rights Undertaking," 22 September 2003, sections 3(e) and 6. The undertaking was published by the BTC as a response to pressure from human rights and environmental groups (including a report by Amnesty International UK, supra note 5). On the BTC Human Rights Undertaking, see de Schutter, *supra* note 5; and Leader, *supra* note 5.

[65] Ibid., at section 2(a).

[66] Ibid. at section 2(d)).

The BTC Human Rights Undertaking is an innovative tool seeking to strike a balance between ensuring the stability of the investment climate and enabling the host state to adopt legislation in pursuit of human rights or environmental goals. It does not repeal the broad stabilization clauses embodied in the BTC HGAs. However, it commits the BTC consortium not to invoke these clauses against any regulatory measures that are genuinely pursuing human rights or environmental goals. Reference to international treaties is used as a benchmark to define whether government action falls within the "exception" established by the undertaking. This is important to the investor since introducing exceptions to the stabilization clause creates the risk that such exceptions are used by the host state as a "Trojan horse" to introduce measures harming the investment project with only minimal links to (real or imagined) human rights or environmental concerns.

On the negative side, however, the undertaking is an ex-post tool, which was negotiated only *after* a very broad stabilization clause had been signed and as a result of civil society mobilization against that clause. While the undertaking does emphasize its binding nature, questions remain as to the value that international arbitrators would attach to it should a dispute arise. This is particularly so given that, far from being a mutually agreed amendment to the investment contract, the undertaking is a unilateral commitment entered into by the investor alone. Arguably, integrating a "compliance with international law" exception in the contract itself and during the negotiation phase would have been a preferable solution.

An interesting example of this solution, which is focused this time on environmental rather than human rights standards, is provided by the 1997 AGIP/British Petroleum/Etal-Kazakhstan "Kashagan" PSA. Here, the very broad economic equilibrium clause contains a specific exception for regulatory changes concerning environmental protection, provided that such changes are consistent with international environmental standards and are applied in a non-discriminatory basis (section 40.2). Under this clause, the investor is protected against the negative economic impacts of most regulatory change, but regulatory change required to comply with evolving international environmental law standards would not trigger the application of the stabilization clause.

Unlike the BTC Human Rights Undertaking, the Kashagan PSA provides no further clarification on the relevant international standards that are to be used as a benchmark for environmental regulation. Given the considerable debate that exists on several principles of international environmental law, including both on their content and the extent to which they can be deemed to have crystallized into customary law, this may weaken the strength of the environmental law exception and provide a source of disputes between the parties.

Similarly, the economic equilibrium clause included in Mozambique's Model Exploration and Production Concession Contract 2007 specifically excludes non-discriminatory legislation concerning the protection of health, safety, labour or the environment, or the regulation of any category of property or activity - provided that social and environmental standards are "reasonable and generally accepted in the international petroleum industry".[67]

The BTC undertaking, the Kashagan PSA and Mozambique's Model Exploration and Production Concession Contract illustrate ways of building explicit exceptions into stabilization clauses, whether *ex post* or *ab initio*. Explicit exceptions of this type remain rare - they are not included, for instance, in the Chad-Cameroon and WAGP contracts cited above. However, a "compliance with international law" exception must be deemed to have been implicitly included even in stabilization clauses where it does not feature expressly. This follows from the recognition that while host states can use stabilization clauses to commit themselves not to exercise their sovereign rights, they cannot use them to avoid compliance with their

[67] Article 27.13.

international obligations – as discussed above. In other words, what host states can commit themselves to with stabilization clauses is limited by their obligations under international law - including international human rights and environmental law.

At the very minimum, this implicit exception must be deemed to include changes in applicable standards flowing from the crystallisation of new norms of customary international law, and from the clarification or progressive development of the host state's existing treaty obligations (e.g. through case law or through the work of treaty bodies such as Conferences of the Parties or committees monitoring the implementation of human rights treaties). It should also include changes stemming from the ratification of treaties produced by international organisations of which the host state is a member - such as the United Nations or regional organisations. Indeed, although the host state is strictly speaking not under an international obligation to ratify the treaty, doing so may be part of its responsibilities as member of the relevant organisation - membership that was (or should have been) well known to the investor when negotiating the investment contract.

While a "compliance with international law" exception limits the scope of stabilization clauses even where it is not explicitly stated, express formulation is likely to improve clarity and certainty in contractual relations - not only with regard to the existence of such exception but also to its scope and conditions. Both the investor and the host state stand to gain from greater clarity and certainty. In this respect, a change in contractual practice is desirable, and the BTC, Kashagan and Mozambique examples may provide a starting point to develop new contractual formulations.

5.2. Evolutionary approach

"Compliance with international law" exceptions may be reinforced by another approach to enabling evolution of social and environmental standards in investment contracts. This second approach relates to the content and interpretation of stabilization clauses, rather than to their scope. It entails privileging those types of clauses that can more easily adjust to changes in applicable standards; and interpreting these clauses in an evolutionary way. This "evolutionary" approach may be used in conjunction with the first one - namely, with regard to changes in social and environmental standards that are *within* the scope of the stabilization clause.

In *Gabčíkovo-Nagymaros*, the ICJ held that, while new legal developments such as the emergence of new norms of international environmental law do not undermine existing treaty obligations, new developments must be taken into account in the implementation of those obligations. On this basis, the Court called on the parties to enter into negotiations to re-define the infrastructure project, particularly in relation to its environmental dimensions.[68]

The evolutionary approach applied to treaty obligations in *Gabčíkovo-Nagymaros* may also be applied to contractual obligations.[69] Thus, following *Gabčíkovo-Nagymaros*, developments in international law are to be taken into account in the implementation of *existing* contractual obligations, particularly through the renegotiation of the terms of the contract.[70] In *Aminoil*, a majority of the arbitral tribunal held that the concession contract at stake "ha[d] undergone great changes since 1948" when it was first signed. In particular, the host state had introduced new elements in the contractual relationship, and the investor had tacitly

[68] *Supra* note 48.

[69] As argued by Abba Kolo and Thomas Wälde, Renegotiation and Contract Adaptation in the International Investment Projects: Applicable Legal Principles and Industry Practices 1 *Transnat'l Dispute Mgmt* 1 (2004).

[70] Ibid.

acquiesced to these changes. The result was not “a departure from [the] contract” but, rather, “a change in the nature of the contract itself, brought about by time, and the acquiescence or conduct of the Parties”.[71] The stabilization clause, argued the majority, was not isolated from the contract but was part of it. Therefore, the clause lost its “former absolute character”.[72]

Contractual provisions on applicable “industry standards” in social and environmental matters may facilitate some degree of evolution in the interpretation of the contract. For instance, Article 13 of the Cameroon-COTCO Establishment Convention concerning the Chad-Cameroon pipeline[73] requires COTCO to conduct construction, operation, and maintenance works in accordance not only with domestic legislation as specified in the contract but also with “the international technical and safety standards prevailing in the petroleum industry relating on the one hand to the management and the protection of the environment and on the other hand to the protection of the population”. Formulae of this type are commonly used in foreign investment contracts.[74]

The weakness of these provisions is their vagueness — the wording is usually elusive and no international standards applicable in the petroleum industry have been clearly defined as yet. As a result, they offer limited or no possibility for enforcement by the host state. Yet the elusive wording may also be a strength, as reference to standards external to the contractual relationship introduces an element of flexibility. This flexibility can enable evolution in applicable social and environmental standards despite broad stabilization clauses. It may be argued that the content of the industry standards referred to in the contract must be defined in light of evolving international law.

Although this solution in itself does not enable the host state to regulate in breach of a stabilization clause, it may allow for international standards to apply to the project. It also sets a reference that has to be taken into account in any contract renegotiation process, and it may strengthen the type of “evolutionary” arguments applied in *Aminoil,* where substantial evolution in the overall contractual relationship within the context of a very long-term contract was held to have affected the strength of the stabilization clause itself.

Compared to freezing clauses, economic equilibrium clauses coupled with flexible clauses on social and environmental standards appear to lend themselves more easily to adjustments in applicable standards aimed at bringing these in line with evolving international law. While freezing clauses aim to “freeze” the regulatory framework applicable to the project, economic equilibrium clauses aim to preserve the economic equilibrium of the contract. Regulatory changes which would violate freezing clauses may still be consistent with economic equilibrium clauses if they do not alter the economic equilibrium of the contract, or if the parties restore that equilibrium once it has been affected. In this sense, economic equilibrium clauses are more conducive to adopting an evolutionary approach than freezing clauses.

This is particularly the case where economic equilibrium clauses feature “de minimis” exceptions that exclude the application of the clause to adverse effects are below a minimum threshold. The requirement that adverse effect be “material” for the clause to be triggered, as under the WAGP IPA and the Kashagan PSA cited above, illustrates this. Evolution of social and environmental standards that affects the project to a lesser extent than what can be deemed to be “material” would not trigger the operation of the clause.

[71] Aminoil, *supra* note 6 at para. 101.
[72] Ibid. at para. 100.
[73] *Supra* note 25.
[74] For instance, see also Article 19.8 of the WAGP IPA, *supra* note 28.

6. Conclusion

Under international law, host state regulation raising social and environmental standards may constitute a regulatory taking if it affects the viability of an investment project to such an extent that the investment must be "deemed" to have been expropriated. As a result, the host state would have to compensate foreign investors whose assets or interests are negatively affected by the regulatory measures.

Contractual guarantees (possibly backed up by "umbrella clauses" in investment treaties) may take commitments on regulatory stability a step further. Under increasingly broad stabilization clauses, changes in the social and environmental standards applicable to an investment project may require the host state to compensate the investor for losses incurred. Under freezing clauses, the obligation to compensate is triggered by the application of a regulatory change to the investment project. Under economic equilibrium clauses, that obligation is triggered by regulatory measures that affect the "economic equilibrium" of the project. In all the examples of stabilization clauses examined in this study, the threshold beyond which the host government must pay compensation is considerably lower than that which is applicable to regulatory takings under general international law (changes to the "economic equilibrium" of the project rather than "substantial deprivation" of property rights).

Broad stabilization clauses respond to the investors' need for stability of the regulatory framework, on which the commercial viability of investment projects depends. But they may also have a "chilling effect" on host state regulation, making it more difficult for host states, particularly poorer ones, to comply with evolving international law and improve the social and environmental standards applicable to investment projects within their jurisdiction — particularly when such efforts would raise project costs. In other words, stabilization clauses shelter the economic equilibrium of an investment project from changes in environmental and social standards, and may as a result "freeze" a non-optimal balance between social, environmental and economic considerations.

These tensions between investment protection and sustainable development goals are all the more important given that waves of privatisation in low and middle-income countries over the past two decades have resulted in private investment being increasingly relied on in the provision of public services. For instance, private investment in water supply in countries like Argentina and Tanzania have resulted in international arbitration proceedings between investors and host states. Water provision is a business opportunity and involves economic/commercial considerations; but it also raises important social and environmental issues - for instance, with regard to the realisation of the internationally recognised right to water.

Practical measures may be taken to avoid these negative consequences, and to reconcile the investor's legitimate need for regulatory stability with maintaining the capacity of the host state to regulate in pursuit of sustainable development goals. The scope of stabilization clauses must be deemed to be limited by a "compliance with international law" exception. Exceptions may be explicit, as in the BTC Human Right Undertaking, in the Kashagan PSA and in Mozambique's Model Exploration and Production Concession Contract. But while express formulation improves clarity and certainty, a "compliance with international law" exception must be deemed to exist even in absence of express formulation. An evolutionary approach to formulating and interpreting stabilization clauses may also enable a degree of evolution in social and environmental standards. This evolutionary approach entails preferring economic equilibrium clauses over freezing clauses; featuring flexible social and environmental standards clauses in the contract; and building "de minimis" exceptions (e.g. "material" impact) into the threshold triggering the application of economic equilibrium clauses.