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A review of the limitation of legitimate expectation principle in FET Claims in energy regulatory disputes: Can a balance be achieved?

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Abstract

This article explores the intricate interplay between the right of states to regulate in the context of environmental regulations aimed at decarbonization and an investor's right to investment protection, particularly focusing on the Fair and Equitable Treatment (FET) standard in international investment law. With the increasing importance of environmental regulations such as the US Greenhouse Gas Standards and Guidelines for Fossil Fuel-Fired Power Plants, in the transition to cleaner energy sources, the potential economic impacts on investments and resulting investment disputes could be huge, making the balancing of these competing interests a topical issue. The article delves into the prominence of the FET standard in investment protection and its evolution in international investment law. It argues that the limitation on the legitimate expectation element of the FET standard in modern times poses challenges in balancing states' rights to regulate with the protection of foreign investments in decarbonization disputes. The author asserts that recent developments in international investment law, exemplified by treaties like the EU-Canada Comprehensive Economic and Trade Agreement (CETA) and the United States-Mexico-Canada Agreement (USMCA), signal a shift towards prioritizing states' right to regulate over investment protection.

By analyzing the limitations on legitimate expectation and investment protection in modern times and the implications for energy investments in the era of decarbonization, the article aims to shed light on the complexities of reconciling the competing interests of states and investors in the evolving landscape of international investment law. Ultimately, this author contends that achieving a balance between these interests is increasingly challenging and may require a reevaluation of the prevailing norms in investment protection.

Keywords: Legitimate Expectation; Fair and equitable treatment; Investment Protection; Right to Regulate; Decarbonization; International Investment Law.

1. Introduction

In this era of decarbonization and transition to cleaner energy sources, salient regulations and global cooperation by countries are integral to addressing climate change and achieving net zero emission targets. The Greenhouse Gas Standards and Guidelines for Fossil Fuel-Fired Power Plants introduced by the US Environmental Protection Agency is one such regulation that seeks to decarbonize the US power industry. While the promulgation of environmental regulatory measures is an expression of a state's right to regulate, these regulations could have huge economic impacts on investments and result in investment disputes. Hence, such measures create an interplay between the right of states to regulate and an investor's right to investment protection safeguarded by investment guarantees such as Fair and Equitable Treatment (FET) under international investment treaties. The right to regulate is the legal right that permits a state to regulate in derogation of its international obligations or commitments under an investment treaty or agreement without incurring a duty to compensate.

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On the other hand, the FET standard is the most invoked investment protection standard in investment disputes due to its considerable success rate in ISDS proceedings and its ability to offer better protection than other standards (including the expropriation protection standard). Authors have argued that the FET standard was designed to "fill gaps that may be left by the more specific standards in order to obtain the level of investor protection intended by the treaties." "The FET's prominence in investment treaties and investor-state arbitrations has reached the point where it can be said that the FET has replaced expropriation as the most important standard in the protection of foreign investment."

The prominence of the FET standard in international investment law could primarily be attributed to legitimate expectation, the most popular element of the FET standard. However, the success previously enjoyed by the FET standard in investment promotion in earlier treaties and arbitral awards may begin to dwindle due to the limitation of the legitimate expectation principle by arbitral tribunals and recent investment treaties such as CETA and USMCA. This article discusses the limitation on legitimate expectation, the most popular element of the FET standard, as a limitation of the FET standard in balancing the right to regulate with investment protection in decarbonization disputes. I argue that this would have implications for energy investments in this era of decarbonization and clean energy transition. Equally, this limitation on legitimate expectation reflects a new dawn in international investment law – recent treaties and modern tribunals represent a shift from the earlier practice of prioritizing investment protection in earlier treaties and investment awards to cutting back on investment guarantees previously enjoyed by investors, thereby giving primacy to states' right to regulate over investment protection. This article concludes that the balancing of these two competing interests is fictional and almost an impossible task for a tribunal due to the limitations on investment protection in modern times.

2. Legitimate Expectation

Legitimate expectations are assurances given to investors by host governments to safeguard their investments or ensure that they receive or continue to receive certain benefits throughout the investment. These assurances could be contained in the investment contract itself, host state law, government policy, and representations or promises by host governments. For example, an investment contract or law that guarantees tax incentives to investors in the power industry can create a legitimate expectation.

Dolzer notes that "the protection of legitimate expectations by the FET standard will today properly be considered as the central pillar in the understanding and application of the FET standard." Some tribunals have also described legitimate expectation as the "most important function" of the FET treaty standard. Henckels describes the importance of legitimate expectation in protecting investments under the FET standard as follows:

"The doctrine of legitimate expectations provides a remedy to claimants where government conduct conveys an understanding that the individual will receive (or continue to receive) a substantive benefit, and the government subsequently acts inconsistently with its prior conduct. The conduct at issue may include formal decisions, promises or representations, and existing laws, policies, and practices."

Legitimate expectation is not limited to assurances or guarantees given to investors by the host government alone in international investment law. Tribunals have also held that regulatory stability can constitute legitimate expectation. The concept of regulatory stability presupposes that an investor has the right to expect that the legal framework of an investment that exists at the time of investment will not be altered significantly by the host state. This form of legitimate expectation could be found in earlier arbitral awards and treaties that broadly promoted investments.

However, the extent to which investors' expectations can prevent a change in the legal regime has caused tribunals and treaty drafters to reconsider the advancement of this form of legitimate expectation, noting that it could undermine the right to regulate. This form of legitimate expectation has been greatly curtailed in treaties and awards and is almost moribund in modern times.

The next section discusses the forms of legitimate expectation: (a) Legitimate Expectations based on the stability of the legal framework and (b) Legitimate Expectations based on specific representations, to understand how tribunals interpret these forms of expectations and to stress the importance of legitimate expectation as a central pillar of the FET standard. This is followed by the restrictions on legitimate expectations by tribunals and recent treaties to argue that the limitation on legitimate expectations impacts the efficiency of the FET standard and a tribunal's ability to balance states' right to regulate with investment protection effectively.

2.1. Legitimate Expectation based on stability of Legal Framework (Regulatory Stability)

Potesta notes that FET claims based on regulatory stability have been justified because the FET standard incorporates "an element of stability of the regulatory framework." Equally, the Energy Charter Treaty (ECT) expressly recognizes this host state's obligation to provide for legal stability. There are two main grounds for the breach of the obligation of regulatory stability. Firstly, the obligation exists as an independent obligation under the FET standard. Secondly, regulatory stability is also part of protecting an investor's legitimate expectation.

Tribunals in earlier investment cases fashioned the obligation of regulatory stability as integral to investment protection. The obligation of regulatory stability primarily evolved through interpreting the FET standard by considering the preambles in early Bilateral Investment Treaties (BITs). These preambles in early BITs enumerate the purpose of BITs as the promotion of investment. Hence, tribunals in these cases believed that the duty to maintain a stable legal and business framework was vital to achieving the objectives of these earlier treaties. Accordingly, earlier treaties and awards prioritized investment protection over the right to regulate, by broadly interpreting treaty preambles and provisions to ensure investment promotion.

Thus, in Occidental v Ecuador, the tribunal found a breach of legitimate expectation where the introduction of a government measure tied the claimant's take in a production sharing contract to a change in oil prices. The Tribunal explained that "there is certainly an obligation not to alter the legal and business environment in which the investment has been made." The tribunal held that the law's introduction "modified unilaterally and in a substantial way the contractual and legal framework" that existed when the investment was made.

Similarly, in CMS v. Argentina, the tribunal interpreted the preamble of the applicable BIT to hold that a 'stable legal and business environment is an essential element of fair and equitable treatment.' Legitimate expectations based on regulatory stability can be invoked alone but can also be invoked with legitimate expectations created by specific representations.

The case of Tecmed v. Mexico has been credited for enumerating the elements of legitimate expectation. The tribunal in Tecmed opined that legitimate expectation confers basic expectations on an investor that a host state would act in "a consistent manner, free from ambiguity and totally transparent" in its dealings with an investor. The dispute concerned the denial of the investor's request to renew an open license to operate a landfill in Mexico. Initially, landfill licenses were illimited, but Mexico later restricted the duration of such permits to a year.

As a result, landfill operators had to renew their operating licenses yearly. The investor renewed the license in 1996 and 1997, but the Mexican government denied its 1998 renewal request. In its defense, the Mexican government maintained that the site was improperly maintained and that further operation on the site would threaten public health and the environment. Although both parties had agreed to relocate the landfill to a new site, the relocation never materialized. The claimant argued that the agreement to relocate to a new site did not justify the failure to renew its license. Accordingly, the investor brought a claim for violation of the FET since the government act disrupted its expectation of continuity of investment and ability to recover its investments.

In holding that the Mexican government violated the investor's legitimate expectation, the Tecmed tribunal noted that the FET is an expression of states' regulatory right and part of the good faith principle of international law. While bad faith from the state is not required for a violation of the FET, the good faith principle requires:

"Contracting Parties to provide international investment treatment that does not affect the basic expectations that were taken into account by the foreign investor before investing. The foreign investor expects the host State to act consistently, free from ambiguity, and totally transparently in its relations with the foreign investor so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations. Any and all State actions conforming to such criteria should relate not only to the guidelines, directives, or requirements issued, or the resolutions approved thereunder, but also to the goals underlying such regulations. The foreign investor also expects the host State to act consistently, i.e., without arbitrarily revoking any preexisting decisions or permits issued by the State that were relied upon by the investor to assume its commitments as well as to plan and launch its commercial and business activities. The investor also expects the State to use the legal instruments that govern the actions of the investor or the investment in conformity with the function usually assigned to such instruments, and not to deprive the investor of its investment without the required compensation. In fact, failure by the host State to comply with such a pattern of conduct with respect to the foreign investor or its investments affects the investor's ability to measure the treatment and protection awarded by the host State and to determine whether the actions of the host State conform to the fair and equitable treatment principle."

Accordingly, the tribunal interpreted the good faith principle to include legitimate expectation. According to the Tecmed tribunal, legitimate expectation requires a host state to act consistently, transparently, and without ambiguity, ensuring that an investor is aware in advance of the administrative and regulatory policies that apply to its investment so that it may comply with such laws. It is for this reason that some academics have criticized Tecmed for imposing a daunting list of obligations on the host state to ensure the protection of investments. Douglas captured this point succinctly in noting that "[t]he Tecmed standard is actually not a standard at all; it is rather a description of perfect public regulation in a perfect world, to which all states should aspire but very few (if any) will ever attain."

However, one of the issues surrounding a legitimate expectation based on regulatory stability is the question of time. When must the expectations exist for an investor to invoke the protection of the FET? Salient treaty provisions in IIAs and BITs do not address this question. However, arbitral tribunals have held that investors' expectations must rest on the existing conditions at the time of the investment. Hence, tribunals would consider the legal regime in existence at the time of the investment in assessing the treatment of an investor to determine whether there has been a violation of the FET.

In Gami v Mexico, the tribunal explained that its duty was to consider how the legal regime in place at the time of the investment impacted the specific investor. "NAFTA arbitrators have no mandate to evaluate laws and regulations that predate the decision of a foreigner to invest…The duty of NAFTA tribunals is rather to appraise whether and how preexisting laws and regulations are applied to the foreign investor". Hence, a tribunal would consider the legal regime in place when the investor decided to invest and how those laws were applied to the investor in considering a breach of legitimate expectation.

However, beyond a tribunal's assessment of the moment a legitimate expectation is created, tribunals have held that such expectations can only be protected in specific situations. Tribunals often consider the impact of the change in the legal framework on investment as well as the way the change or modification of the legal framework was made by the host state. Thus, if how the modification of the legal framework was done is unreasonable or discriminatory, this could lead to a violation of the FET. These two requirements, which tribunals consider in their assessment of legitimate expectations based on the stability of a legal framework, will now be considered.

2.1.1. The Degree of Impact of the Modification of Legal Framework on Investment

The severity of the impact of a change in the legal framework on investments is one of the factors considered by arbitral tribunals in determining a violation of legitimate expectation. Thus, a tribunal would consider whether the change in the legal framework has significantly impacted the investor's investment. This is almost like the test of 'substantial deprivation' in expropriation claims. A breach of legitimate expectation is also one of the factors considered in expropriation claims. The major difference between the FET and expropriation standard is that 'substantial deprivation' need not be established to be successful in FET claims.

Hence, in Occidental v Ecuador, the arbitral considered the severe impact a change in legal framework had on the investor's investment. In that case, the investor and the respondent entered a Participation Contract for the exploration and production of oil and gas. The party's participatory interests depended on a fixed production volume that did not account for changes in oil prices. It was agreed that the investor would bear all the risk of low oil prices but would also take no less than what its participation permits in case of an increase in oil price.

However, before and after the conclusion of the participation agreement, the host state (respondent) agreed in other oil contracts with other investors to tie the participation percentages in such investments to fluctuations in oil price. Consequently, during the 2005 surge in oil prices, the respondent sought to amend the participation agreement with the investor (claimant) to include a fiscal mechanism that would tie participation percentage to changes in oil price. However, the renegotiation was unsuccessful. Subsequently, in 2006, the respondent (Ecuador) passed Law 42, which made participation in oil revenues dependent on oil prices, in stark contradiction to the participation contract, which made oil revenues dependent on the production volume without reference to the oil price.

In determining the existence of legitimate expectations, the tribunal noted that:

"[T]he investment made by Occidental in Ecuador after the execution of the Participation Contract were based on the explicit representations made by Ecuador to Occidental during the negotiation of the Agreement, which crystallized in the participation agreed by the parties on the fiscal framework for sharing the oil produced in relation to the participation interests. The investor, OEPC, was justified in expecting that this contractual framework would be respected and certainly not modified unilaterally by the Respondent."

The tribunal then went on to consider whether these expectations were violated by considering the severity of the effect of the change in the legal framework on the claimant's investments. In describing the severity of Law 42 on the investor's investment, the tribunal in Occidental opined that "Law 42, by taking 50% of OEPC's revenues from Block 15 production above the agreed reference price, modified radically the participation of the parties."

Accordingly, by passing Law 42, the respondent "modified unilaterally and in a substantial way the contractual and legal framework that existed at the time the Claimants negotiated and entered into the Participation Contract and thereby violated Clauses 5.3.2 and 8.1 of the Participation Contract". Hence, the modification of the legal framework by the respondent "struck at the very heart of [Occidental] acquired rights under the Participation Contract by changing the agreed upon Participation of Clause 8.1 to reduce [Occidental's] agreed upon share in production".

2.1.2. Manner of Implementing a Change in Legal Framework

Another factor considered by tribunals in determining a violation of legitimate expectation is the manner or approach taken by the host government in changing the legal framework. This factor includes a consideration of how the change to the legal or fiscal regime was implemented. The tribunal may consider whether the modification was unreasonable or discriminatory.

In Parkerings v Lithuania, the investor (Parkerings)entered into an agreement with the municipal city of Vilnius for the construction and maintenance of a parking system. It was agreed that the investor would have the exclusive right to operate the parking system for 13 years, collect parking fees, and enforce parking regulations through the clamping of vehicles. The investor was entitled to a portion of the parking fees as its service fee. The investor was also entitled to receive 70% of the unclamping charge. However, the Lithuanian government introduced a series of changes to the applicable laws of the investment, which prevented the investors from making reasonable returns on their investments. New laws on fees, charges, and clamping were introduced. For example, the new law on clamping required police officers to clamp in the presence of an employee of the Vilnius municipality using clamping devices provided by the Municipality. The investor alleged that the change in the legal framework prevented it from receiving an important part of its income.

In determining whether there was a breach of the FET, the tribunal explained that it is important to consider the "basic expectations that were taken into account by the foreign investor to make [the] investment." In other words, the FET is breached "when the investor is deprived of its legitimate expectation that the conditions existing at the time of the Agreement would remain unchanged." In describing the criteria for determining a breach of legitimate expectation and the FET, the tribunal in Parkerings held that the FET standard prohibits a host government from acting "unfairly, unreasonably or inequitably in the exercise of its legislative power." However, the investor was unable to show that the State had acted "unfairly, unreasonably or inequitably in the exercise of its legislative power." It "failed to demonstrate that the modifications of laws were made specifically to prejudice its investment."

In Charanne v Spain, the dispute concerned a modification of the legal regime in Spain's renewable energy sector. In 2007, Spain created a special regime for the renewable energy sector to encourage and promote renewable energy generation. The regime was created by legislative acts which included incentives (bonuses and feed-in tariffs) for investors. However, due to the tariff deficit, Spain took a series of measures in 2010,2012, 2013, and 2014, which reduced and reversed the special regime established for the producers in the renewable energy sector. The claimant argued that Spain unlawfully altered the legal framework it relied upon to make its investment.

The tribunal held that Spain had not violated the investor's legitimate expectations since Spain made no specific representations to the investor that existing laws applicable to the investment would remain unchanged. Nevertheless, the tribunal concluded that a transformation of the legal framework could breach an investor's legitimate expectations if such changes are capricious or unnecessary and lead to a "sudden and unpredictable elimination of the essential characteristics of the existing framework."

Also, the proportionality test is often employed by tribunals to evaluate the way the change was conducted. Using the proportionality standard, the tribunal could consider the suitability of the measure to the objective the government seeks to achieve. Whether the measure is less restrictive on the investor's rights, whether the consequence of adopting the measure is disproportionate to the aimed policy objective, and the legitimacy of the pubic purpose pursued are all questions the tribunal could consider in applying the proportionality test to determine a violation of the FET and balance the right to regulate with investment protection.

2.2. Legitimate Expectation Based on Specific Representations/Commitment

Another form of legitimate expectation often invoked by investors and recognized by tribunals is the specific representation given by the host state to an investor. Dolzer and Schreuer captured the importance of this form of expectation in assessing a violation of the FET standard succinctly:

"Specific representations play a central role in the creation of legitimate expectations. Undertakings and representations made explicitly or implicitly by the host state are the strongest basis for legitimate expectations. A reversal of assurances that have led to legitimate expectations will violate the principle of fair and equitable treatment".

The relevance of specific representation was stressed in Methanex v United States. In that case, a Canadian producer of methanol challenged a Californian law that restricted the production of gasoline containing methanol additives on environmental grounds. The investor alleged that the United States violated its NAFTA FET obligation to the investor, arguing that the ban was unfair as it destroyed its market and discriminated in favor of the United States domestic ethanol producers. In dismissing the claim, the tribunal stressed that the investor had not been given any specific representations by the United States that it could reasonably have relied upon to conclude that such changes to the regulatory framework would not occur.

In recent times, tribunals have taken a cautious approach to finding a breach of legitimate expectation based on alteration of the legal framework alone, in the absence of specific commitment or representation. Similarly, the UN Trade and Development (UNCTAD) UNCTAD opines that the finding of a violation of legitimate expectation based on a change in legal framework alone is unjustified and undermines the right of states to regulate. Potesta explains that the justification for this approach is that " if the state has renounced to exercise its regulatory power, this is such an extraordinary act that must emerge from an unequivocal commitment." For example, such commitment can be in the form of a stabilization clause, which is included in a state contract between the host state and the investor. However, in the renewable energy sector, such clauses are rare due to the existence of other risk allocation provisions in renewable energy contracts (e.g., take or pay clauses in power purchase agreements).

Specific representations could be addressed to an investor specifically. They could also take the form of rules that are not addressed to a specific investor but are formulated with the specific aim of inducing investments. Hence, specific representations could include licenses, state contracts, laws creating a special regime, etc. Thus, in Enron v. Argentina, no specific undertakings were given to the investors. However, the tribunal found that guarantees included in domestic legislation constituted an assurance or promise to investors and were found to amount to legitimate expectations.

Tribunals have clarified certain requirements that a specific representation must meet to constitute a valid representation. These requirements will now be discussed.

2.2.1. Requirements for a Valid Specific Representation

Because a specific representation can restrict the ability of a host State to regulate, tribunals require that such representation be legitimate. Such a promise, guarantee, or assurance should come from a competent authority, be given directly to a designated or specific investor or group of investors, and have a legal force.

2.3. Representation from a Competent State Authority

For a specific representation to constitute a legitimate expectation, it must come from the arm of government that has the actual authority or power to give such assurances, representations, or guarantees to a foreign investor. It is, therefore, important for the foreign investor to do its due diligence to ensure that it is dealing with the competent host State authority for the host State to be liable for a breach of legitimate expectation. Identifying the competent state authority could be problematic, as different arms of the government regulate different activities pertaining to an investment.

Thus, in Metalclad Corp. v. United Mexican States, the arbitral tribunal had to identify the competent authority that induced the claimant into investing in Mexico. In that case, Metalclad (claimant) incorporated a subsidiary for the construction of a hazardous waste landfill in the municipality of Guadalcazar located in San Luis Potosi State (state). Before purchasing the subsidiary, the federal and state governments assured the Claimant that it would be issued all necessary permits for the construction of the landfill. Indeed, the state-issued operating permits and federal construction permits were issued to the claimant, and the construction project was approved. However, Guadalcazar's municipality council denied the claimant a municipal construction permit on environmental grounds. Mexico argued that it was only the municipality that had the authority to issue a construction permit.

In rejecting Mexico's argument, the tribunal held, "even if Mexico is correct that a municipal construction permit was required, the evidence also shows that, as to hazardous waste evaluations and assessments, the federal authority's jurisdiction was controlling and the authority of the municipality only extended to appropriate construction considerations." Accordingly, "Metalclad was entitled to rely on the representations of federal officials and to believe that it was entitled to continue its construction of the landfill." As a result, the denial of the municipality permit was held to be improper and constituted a violation of the FET since "Mexico failed to ensure a transparent and predictable framework for Metalclad's business planning and investment."

2.4. Legal force and Specificity of Undertaking

Tribunals often consider the specificity of an undertaking or a representation to constitute legitimate expectation. Such guarantees, undertakings, or representations could take different legal forms, including a law, an investment or license agreement, a political statement, a letter, or a combination of different legal forms. Whichever legal form such representations take, the language and content of such representations must be properly worded and specific to induce a designated foreign investor(s) into investing in a country to constitute a legitimate expectation.

It is trite that political speeches or statements issued by an arm of a state have the least legal value and are less likely to constitute legitimate expectations. Thus, in El Paso v Mexico, the investor relied on a general message jointly issued to the Congress by the Energy Minister (Minister Cavallo) and Argentine President on the legal certainty that the enactment of the Electricity Law would create. The tribunal held that such a statement did not have the required specificity to constitute a legitimate expectation:

"A declaration made by the President of the Republic clearly must be viewed by everyone as a political statement, and this Tribunal is aware, as is every individual, of the limited confidence that can be given to such political statements in all countries of the world."

Similarly, in PSEG v. Turkey, the tribunal held that a general policy encouraging investment "did not entail a promise made specifically to the Claimants about the success of their proposed project."

Equally, tribunals have held general legislative statements to engender reduced expectations, particularly in a high political risk. This is because the enactment of such instruments, by nature, is subject to subsequent modification and possibly withdrawal and cancellation in a volatile political climate.

Both the content and the wording are considered by tribunals when determining the legal force of a representation given by the host state. Tribunals have held that the content of a representation must specifically induce an investor into investing in the host state. Thus, where a claimant alleges that a host state's representation induced it to invest, the tribunal would look at the content of such act(s), series of acts, representation(s), or commitment(s) to determine if the host state specifically and willfully induced the investor into investing.

2.5. Restriction on Legitimate Expectation by Tribunals and Treaties

In recent times, tribunals have been reluctant to uphold a claim of legitimate expectation based on the stability of a legal framework without establishing that a specific representation was given to the investor by the host state. This is the approach taken by NAFTA tribunals and some non-NAFTA tribunals. Eckardt explains that "under FET standard within NAFTA, the protection of the investor's expectations is only accepted if the reasonable and justifiable expectations derive from specific assurances, like a contract, for example." Accordingly, under NAFTA, legitimate expectations are not only required to be legitimate and reasonable but the expectations must also be derived from specific assurances. This approach is indeed a limitation on legitimate expectations based on the stability of the legal framework. The implication is that a FET claim based on the stability of the legal framework would fail in the absence of specific assurances or representations.

This issue was considered in the Packerings v Lithuania. The tribunal explained that an investor's expectation is legitimate if it receives an explicit guarantee or promise from the host state or if, implicitly, the host government made representations or assurances that the investor relied on in making its investment. In instances where the host state made no representation or assurance, the tribunal explained that the circumstance surrounding the conclusion of the investment agreement would determine the legitimacy of the investor's expectation, in addition to the conduct of the State at the time of the investment.

The tribunal further considered the interplay between the right to regulate and legitimate expectation and the limitation on the right to regulate. It explained that a State's regulatory right is "an undeniable right and privilege to exercise its sovereign legislative power." "A State has the right to enact, modify or cancel a law at its own discretion." According to the tribunal, in the absence of a stabilization clause, "there is nothing objectionable about the amendment brought to the regulatory framework existing at the time an investment was made." Indeed, investors know that laws will evolve over time. Nevertheless, the tribunal acknowledged that "an investor has a right to a certain stability and predictability of the legal environment of the investment." But an investor would only "have a right of protection of its legitimate expectations provided it exercised due diligence and that its legitimate expectations were reasonable in light of the circumstances."

While the tribunal acknowledged that the changes to the legal framework of the investment had an impact on the investor's expectations "as it was deprived of its right to receive part of its expected income," the tribunal noted that the Lithuania government did not give the investor any specific assurance that "no modification of the law, with possible incidence on the investment, would occur." Moreso, the investor was unable to show that the State had acted "unfairly, unreasonably or inequitably in the exercise of its legislative power." It "failed to demonstrate that the modifications of laws were made specifically to prejudice its investment.".

The situation is more complicated when a change in the legal framework is so severe or radical that, in the absence of specific representations, it constitutes a violation of FET. In El Paso v Argentina, the tribunal suggests the possibility that a total alteration in the legal framework, without specific representations, can constitute a violation of the FET:

"There can be no legitimate expectation for anyone that the legal framework will remain unchanged in the face of an extremely severe economic crisis. No reasonable investor can have such an expectation unless very specific commitments have been made towards it or unless the alteration of the legal framework is total."

While the tribunal did not clarify what it would require for a change in the legal framework to be total, the tribunal evaded this problem by holding that the series of measures taken by Argentina, which cumulatively altered the legal framework, violated the FET standard.

Similarly, the tribunal in Total v Argentina reached a similar conclusion as the El Paso tribunal. After noting that general legal instruments are not exempted from subsequent changes, the tribunal also introduced an exemption:

"There can be no legitimate expectation for anyone that the legal framework will remain unchanged in the face of an extremely severe economic crisis. No reasonable investor can have such an expectation unless very specific commitments have been made towards it or unless the alteration of the legal framework is total."

However, it remains unclear whether NAFTA would recognize the stability of the legal framework to constitute legitimate expectations in such cases due to the requirement for specific representations to constitute legitimate expectations. It should be noted that the BITs dealt with in Total and El Paso awards are non-NAFTA BITs. These BITs recognize legitimate expectations based on the stability of the legal framework.

Nevertheless, the above cases also confirm that even in non-NAFTA cases, legitimate expectations based on regulatory stability are insufficient to constitute a violation of the FET standard in recent times. Hence, the restriction on this form of investor's expectation can impact the balancing of state and investor's competing interests. Thus, a FET claim based on the failure to apply the existing laws applicable at the inception of an investment could frustrate investment expectations, making investments vulnerable. However, legitimate expectations should be restricted but too much restriction could also render investment guarantees like the FET useless.

2.6. Restrictions on Legitimate Expectation in Recent Treaties

The legitimate expectation based on regulatory stability has been equally limited by the provisions of recent treaties. For example, Article 8.10(4) of CETA provides:

When applying the above fair and equitable treatment obligation, a Tribunal may take into account whether a Party made a specific representation to an investor to induce a covered investment that created a legitimate expectation and upon which the investor relied in deciding to make or maintain the covered investment, but that the Party subsequently frustrated.

The use of the word "may" in the opening sentence of Article 8.10(4) suggests that a CETA tribunal is not mandated under CETA to consider legitimate expectations created by specific representations in determining a breach of the FET. Also, legitimate expectation based on regulatory stability is not recognized as a form of legitimate expectation. Rather, CETA recognizes specific representations made to investors alone as capable of constituting legitimate expectations. The European Parliament explains that the provision requires that an "investor must be able to prove that the state made a specific representation of this kind to induce the investment, that the investor relied on such a representation in making the investment decision, and that the state frustrated that expectation."

Also, the provision not only limits legitimate expectations based on regulatory stability but also restricts the scope of legitimate expectations and undermines their relevance since a tribunal is not mandated to consider such expectations in a FET analysis. The European Parliament confirmed that the provision adopts the restrictive approach to interpreting the FET standard by tribunals (including NAFTA tribunals). Accordingly, investments are vulnerable to disruption or expropriation since a tribunal may not consider the existence of legitimate expectations or assurances given to investors in deciding a FET claim.

Similarly, Krieubaum, in her article, explained that Article 8.10(4) limits the scope and relevance under the FET standard since the provision "grants panels of CETA's investment tribunal a significant margin of appreciation with regard to the relevance of legitimate expectations since they may, but do not have to, take them into account." She further noted that the provision did not specify the form in which such representations must take (oral, written, administrative act, or law) to be valid. However, she argued that "because of the use of the word 'specific,' a promise made in a concrete context to a distinct investor will have the best chance of passing the test." Similarly, Ursula argues that legislation creating a special regime for a specific type of investment and promising a particular treatment to investors (for example, tax reductions or other incentives) also meets the requirement of Article 8.10(4).

However, Article 8.10(4) should not be read in isolation and should be read together with Article 8.9 to fully understand the extent of the limitation of legitimate expectation by CETA. Article 8.9(2) of CETA provides:

"For greater certainty, the mere fact that a Party regulates, including through a modification to its laws, in a manner that negatively affects an investment or interferes with an investor's expectations, including its expectations of profits, does not amount to a breach of an obligation under this Section."

This provision further limits the scope of legitimate expectation and undermines its relevance in determining a breach of the FET standard. Under this provision, the mere fact that a host state negatively affects (whether through a change in law or other means) an investor's expectation is not sufficient to constitute a breach of the FET. The European Parliament has also clarified that a "legitimate expectation claim is further limited by the article on the regulatory right of the state (CETA Article 8.9), where it is clarified that the mere fact of a change to a law that adversely affects the investors' expectation does not amount to the breach of an obligation".

Equally, the USMCA treaty, which replaced the defunct NAFTA treaty, contains a provision similar to CETA's Article 8.9. Unlike CETA, the USMCA did not specify whether the legitimate expectation is restricted to specific representation or regulatory stability. However, based on NAFTA arbitral jurisprudence, the presumption is that legitimate expectations under USMCA are restricted to specific representations alone. Article 14.6 (4), in content and purpose, is similar to CETA's Article 8.9. The provision provides:

For greater certainty, the mere fact that a Party takes or fails to take an action that may be inconsistent with an investor's expectations does not constitute a breach of this Article, even if there is loss or damage to the covered investment.

USMCA's Article 14.6(4) indicates that the breach of legitimate expectations by the host state does not constitute a breach of the FET, even if an investor suffers loss or damages his investment because of the breach of legitimate expectations. This provision creates uncertainty for the investor since it is unclear whether it covers situations where a breach of legitimate expectations leads to a complete loss of investment.

Accordingly, USMCA's Article 14.6(4) and CETA's Article 8.9 could have serious implications for investors in a decarbonization dispute since they could cover modification of a law creating a special regime for specific investors. For example, the US EPA's proposed standards promise to offer existing coal power plant operators a 70% tax credit to offset a significant part of decarbonization costs. This regulation creates a special regime for existing coal power plant operators. Hence, should a future law completely take away or significantly reduce the tax credit previously enjoyed by investors to defray their decarbonization cost, Article 8.9 and Article 14.6(4) render the effect of such measures insufficient to constitute a violation of the FET.

This provision confirms the importance of showing the existence of specific representation to establish legitimate expectations. The exclusion of legitimate expectations based on the stability of the legal framework in the above provision is indeed a restriction on the FET standard. The implication of such a provision is that tribunals only recognize legitimate expectations created by specific representations as constituting a valid expectation, but the tribunal is not bound to include or consider the existence of legitimate expectations in determining a violation of the FET standard

3. Conclusion

In conclusion, the FET standard, particularly its principle of legitimate expectation, has been a central pillar in international investment law. However, in this current era of decarbonization and energy transition, the role of this standard in protecting investments is becoming increasingly complex. The interplay between states' right to regulate and investment protection, especially in relation to environmental measures, presents a significant challenge for tribunals.

This author asserts that the limitations on legitimate expectations in modern treaties, such as CETA and USMCA, raise doubts about the effectiveness of the FET standard in safeguarding investments. Furthermore, these treaties prioritize the right to regulate over investment protection, shifting the focus of international investment law towards a new paradigm. As a result, tribunals are faced with the difficult task of balancing these conflicting interests in energy disputes.

It is concluded that the landscape of international investment law has evolved to prioritize the right to regulate over investment protection. This shift poses significant challenges for tribunals and raises questions about the future effectiveness of the FET standard in protecting investments in the context of decarbonization and energy transition. Ultimately, the issue of balancing is determined at the treaty-making stage, and not primarily by arbitral tribunals. The issue of balancing should be given more attention in treaty drafting especially in this era of decarbonization and energy transition.

Compliance with ethical standards

Disclosure of conflict of interest

No conflict of interest to be disclosed.

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