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Will International Investment Rules Obstruct Climate Protection Policies?
An Examination of the Clean Development Mechanism

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Abstract. Rules governing the global environment and the international economy are currently decided in separate arenas. Yet, environmental agreements can have strong economic implications, particularly with the growing use of market mechanisms. Economic liberalization rules, meanwhile, may limit the effectiveness of environmental agreements. This paper assesses the potential interaction between one important market-based environmental mechanism – the Clean Development Mechanism of the Kyoto Protocol on climate change – and the framework of international investment law.

Key words: clean development mechanism, climate change, international investment agreements, international investment law, Kyoto Protocol, Multilateral Agreement on Investment

1. Introduction

The Kyoto Protocol's Clean Development Mechanism (CDM) will stimulate and govern the flow of investment finance from industrialized to developing countries for projects that reduce greenhouse gas emissions. For investments to generate internationally marketable emission credits, investors will have to comply with the rules of the CDM. At the same time, the wider body of international law relating to investment flows across national boundaries will also govern CDM investments.

In this paper, the authors argue that there is potential for CDM rules to conflict with international investment law. Yet, investment law, appropriately constructed, can also support the effective functioning of the CDM. In either case, close attention must be paid to these areas of overlap. Specifically, we aim to encourage the design of CDM rules that fit the Kyoto Protocol Parties' shared objectives, in a manner that takes into account existing international legal frameworks. In addition, current and future investment agreements must allow for legitimate circumstances in which countries might depart from the tenets of investment

agreements by deciding to take actions pursuant to multilateral environmental agreements, such as the Kyoto Protocol.

The price of incoherence in law applicable to CDM investments may be high. An effective CDM could result in billions of dollars of new investment flows to sustainable development objectives in the developing countries while promoting climate protection (Zhang 1999). Moreover, market mechanisms may become increasingly popular instruments of international environmental policymaking. As the first such mechanism to be operationalized, the CDM is precedent-setting, with implications for the future of market-based international environmental protection.

For several reasons, now is a particularly opportune moment to explore the intersection between multilateral environmental agreements and investment law. First, although many rules have already been concluded, the CDM is still in its formative stages with few precedents already established. Second, Governments are engaging in ambitious investment liberalization efforts, despite the notable collapse of the Multilateral Agreement on Investment (MAI) in 1998. (*See Box 1.*) These efforts include those under the Free Trade Agreement of the Americas[1] negotiations as well as those under the WTO. In November 2001, the WTO Ministerial Declaration from Doha recognized "the case for a multilateral framework to secure transparent, stable and predictable conditions for long-term cross-border investment, particularly foreign direct investment" and agreed to consider undertaking negotiations on this topic at the next Ministerial Conference, scheduled for October 2003.[2] To gain credibility and public acceptance, new agreements will need to accommodate measures taken to promote public welfare, including environmental protection. Finally, while the United States – the world's largest exporter of foreign direct investment – is part of many investment agreements, it will be a non-Party to the Kyoto Protocol. This raises particular concerns over CDM conflicts between Protocol Parties and non-Parties.

The first section of this paper identifies the main provisions of the Clean Development Mechanism, focusing particularly on those aspects of the CDM that are likely to entail government intervention in investment activities. The second section outlines the key provisions of the existing patchwork of international investment agreements that cut across different sectors and countries. The third section examines the potential for measures taken in accordance with the CDM to conflict with existing or planned international investment laws. The extent to which conflicts arise between the two systems will depend on the future operation of the CDM, the countries involved, the agreements applicable, and other circumstances of the investment. We conclude with a summary of findings and recommendations.

2. The CDM and the Potential Foreign Investor

The CDM has the potential to channel capital toward more environmentally sustainable outcomes by rewarding climate-friendly investments. Industrialized

Box 1. The Rise and Fall of the Multilateral Agreement on Investment

Among the many recent efforts to liberalize international investment flows, none has received more attention than the Multilateral Agreement on Investment (MAI). The primary objective of the MAI was to liberalize flows of foreign direct investment and provide a stable, predictable regulatory environment for investors. It was believed that this could best be achieved through a common international framework covering "high standard" investment rules. Such an agreement eventually proved unworkable and talks were officially aborted in December 1998, three years after their initiation within the Organisation for Economic Cooperation and Development (OECD).

Although it is difficult to know exactly why the MAI failed, we can cite two main reasons. First, negotiators found it impossible to agree on key *substantive* issues. In important areas – such as dispute settlement, privatization measures, expropriation, investment incentives, and performance requirements – the MAI represented a significant "leap" in favor of investor rights beyond those provisions commonly found in other international investment agreements. Provisions for environmental and social standards in the agreement formed a further substantive topic of disagreement, as did the many exemptions countries sought. These substantive issues suggest that, despite the aim of the talks, governments placed a high premium on maintaining the discretion to regulate investment.

The second explanation for the collapse of the talks is the surge of public opposition to the MAI led by nongovernmental organizations (NGOs). NGOs throughout the world, often well connected through digital technologies, were able to transform the MAI from what its proponents viewed as a largely technical exercise into a highly controversial political affair. NGOs and public interest groups were deeply concerned with the increase in rights granted to corporations, and the absence of appropriate countervailing obligations in such areas as environmental protection, cultural safeguards, and labor rights. Groups also objected vehemently to some procedural aspects of the negotiations, as talks were largely behind closed doors with little input from, and output to, the public interest community. For some environmental and human rights groups, and others with diverse interests, opposing the MAI became the *cause célèbre* within a broader backlash against globalization.

The fact that the treaty, intended to be a global instrument, was formulated largely by the industrialized countries, was grounds for further procedural objections from some governments and NGOs. From the outset of the talks, it was clearly envisioned that the MAI would be a free-standing international treaty, open to accession by any country. However, only a handful of developing countries that obtained "observer" status to the OECD talks were able to raise their concerns. The substantive difficulties of the talks combined with a broad and unexpected public opposition, made political support for the MAI ultimately untenable for many governments.

Sources: See generally, UNCTAD 1999a; Henderson 1999.

(Annex I) countries that invest in climate-friendly projects in developing (non-Annex I) countries would receive emission credits to offset their commitments to reduce greenhouse gas emissions. If designed properly, the CDM could become an important element of the broader effort to prevent dangerous human-induced climate change.

Under Article 12 of the 1997 Kyoto Protocol and the subsequent 2001 Marrakesh Accords, CDM projects are intended to promote two main objectives: assist non-Annex I Parties in achieving sustainable development; and assist Annex I Parties in meeting their commitments by generating emission credits. Creating a market mechanism that promotes these dual goals will require active regulatory intervention and approval by governments and Kyoto Protocol bodies. Several of the most important interventions are elaborated in this section. Because the CDM is only one element within a broader policy framework elaborated in the Kyoto Protocol, the regulatory intervention and oversight, described below, are necessary to promote the environmental credibility not just of the CDM but of the Protocol as a whole.

2.1. Eligibility for Participation

Prior to the initiation of a CDM project, rules will govern the eligibility of countries, private entities within countries, and specific project types. One category of eligibility requirements will address the right of a country to invest in, or to host, a CDM project. Eligibility to host a project as established in the Kyoto Protocol is open only to developing, non-Annex I Parties to the U.N. Framework Convention on Climate Change (UNFCCC). Host or investor country eligibility could be contingent upon ratification of the Kyoto Protocol. In addition, participation (i.e., use of CDM credits) by Annex I Parties is also conditional upon successfully implementing other international obligations called for under the Kyoto Protocol and the UNFCCC, such as national reporting obligations (UNFCCC 2002). Future eligibility requirements may address the right of private entities to participate in CDM projects. National governments can also establish their own participation requirements and approval procedures for nonstate actors.

A final category of eligibility requirements relates to project types. Nuclear power projects, for example, have been essentially rendered ineligible by the Parties through a provision that calls on industrialized countries to "refrain from using [CDM credits] generated from nuclear facilities."[3] Similarly, certain kinds of land-use projects – such as those involving forest conservation – have been deemed ineligible by the Parties (UNFCCC 2002). In addition, individual Parties acting unilaterally as government investors or behalf of their private entities may explicitly include or exclude projects within their territory.

While not an eligibility requirement per se, Parties have also collectively agreed to establish "simplified modalities and procedures" for certain types of small-scale projects (UNFCCC 2002). This would advance the cause of renewable energy

and energy efficiency projects that are deemed especially beneficial to climate protection and sustainable development.

2.2. National Sustainable Development Criteria

The Kyoto Protocol requires that non-Annex I Parties "benefit from [CDM] project activities" and that the mechanism contribute to "achieving sustainable development" in developing countries (UNFCCC 1997, Article 12). In response to similar guidelines under the Activities Implemented Jointly (AIJ) pilot phase, some host and investor country governments have developed national criteria for sustainable development for use in the project approval process. Such criteria are also envisioned for the CDM and include protection of biological diversity, enhancement of local employment, purchase of local goods and services, building of local capacities, and explicit limitation on project types, such as exclusion of fossil fuel projects (UNFCCC 2001). Project acceptance by the host or investor government is usually conditional upon satisfying some or all of the criteria that a country elaborates. (*See discussion below.*)

2.3. Government Approval

The Kyoto Protocol establishes that CDM participation is voluntary. Thus, projects must receive the formal consent of participating governments. This consent requirement, combined with the sustainable development provision discussed above, allows host governments to screen prospective CDM investments according to many different criteria, including technology, project type, or sector.

2.4. Additionality and Baselines

CDM credits will, in effect, allow Annex I Parties to increase their emissions above their stated Protocol obligations.[4] Thus, credits granted from activities that do not verifiably create emission reductions will result in a net increase in global greenhouse gas emissions. To address this, the Kyoto Protocol requires that CDM projects generate emission reductions "*additional* to any that would occur in the absence of the project activity" (UNFCCC 1997, Article 12).

To guard against the crediting of non-additional activities, project developers – possibly in conjunction with the host country government – will develop a reference case, or baseline, for a project activity, which quantitatively expresses "what would have occurred in the absence of the project activity." The difference between the project's actual emissions and the baseline will largely determine how many emission credits the project generates.

Decisions regarding the acceptability of a project's baseline will involve the oversight of independent bodies. (*See discussion below.*)[5] Host country approval of the project may also be conditional upon the acceptability of the baseline, as

judged by the host government. Baselines may be subject to periodic revision during the lifetime of a CDM project (UNFCCC 2002).

2.5. The CDM Project Cycle and Institutions

CDM projects must pass through a set of common stages, beginning with the initial project idea, then flowing through implementation, and ending with periodic issuance of credits (Baumert and Kete 2000). The first step of the project cycle entails *project design and development*. The project developer will need to conduct feasibility and baseline studies, and obtain government approval for the project.

Subsequent steps form the core regulatory requirements that are envisioned for CDM (UNFCCC 2002). Before a project is implemented, an independent third party must *validate* it to ensure that the project meets all requirements for CDM projects decided by the Parties, such as a valid baseline. This step is followed by *registration* with the CDM Executive Board – an institution created by the Kyoto Protocol that is charged with supervising the mechanism. Next, during implementation, project participants must *monitor* the performance of the project in a transparent and verifiable fashion. Finally, all projects must have their claimed emission reductions independently *verified* before credits are issued.

2.6. Individual CDM Project Agreements

In addition to any international investment agreements, discussed below, individual project agreements are likely to govern the legal relationship between the host and a foreign investor. These contracts, which may involve a range of actors, will set out the parties' obligations to ensure the project's performance. In the case of CDM projects, these contracts will spell out the terms upon which the credits resulting from the project will be transferred or shared between the host government and the investor. This specific agreement could complement or, in some circumstances, override the requirements of any international investment agreements that may be in force between home and host governments. On a case-by-case basis, investor and host can agree on specific conditions for the investment, the laws applicable to the contractual relationship, and the forum for resolving any disputes that might arise.

The terms of these individual project agreements will be essential for predictability and stability in the relationship between investors and hosts. Well-negotiated agreements, expressed in clear terms, can set out each participant's legitimate expectations and prevent disputes from arising. Negotiators within the Kyoto Protocol process have not stipulated that such contracts are required under CDM rules or whether the terms of such contracts might be harmonized in whole or in part at the international level. In any case, given the importance of project agreements, Parties will need to address the differing negotiating capacity between industrialized and developing countries. The legal expertise and experience of

foreign investors, relative to their hosts, could lead to inequitable sharing of benefits between participants (Stewart et al. 2000, pp. 41–43).

3. A Primer on International Investment Law

International investment law has its source both in customary international law (as reflected in state practice) and treaty law. International investment rules are extremely diverse in their specificity and legal character. They range from bilateral "high standard" investor protection treaties that extend broad substantive and procedural rights to foreign investors, to the common denominator of an "international minimum standard" reflected in customary international law that, at least in theory, binds all states. Because debate over the content of a customary "international minimum standard" has been extremely politicized and has never formally been resolved, this analysis will focus on the treaty law standards, as embodied in international investment agreements (IIAs).

The bulk of investment treaty law is contained in the over 1,700 bilateral investment treaties (BITs) now in force.[6] Regional economic integration organizations (such as the European Union), free trade agreements (such as the North American Free Trade Agreement, [NAFTA]), and other regional agreements also have provisions that protect foreign investors from discriminatory treatment. Finally, several agreements under the World Trade Organization (WTO) – such as the Agreement on Trade-Related Investment Measures (TRIMs) and the General Agreement on Trade in Services (GATS) – discipline the treatment of foreign products, services, and service providers. As noted earlier, efforts to conclude a comprehensive Multilateral Agreement on Investment (MAI) were undertaken unsuccessfully under the auspices of the OECD from 1995 to 1998. Box 2 contains a summary of major IIAs.

Many key elements of IIAs – such as their expanding scope of coverage, nondiscriminatory treatment of investors, and prohibitions on performance requirements – are aimed at the liberalization of foreign investment. Such measures are expected to promote investment flows by removing market barriers and distortions, and allowing investors and investments to operate more efficiently. Other features – namely those that address expropriation, compensation, and settlement of disputes – are aimed at protecting investors from host governments' actions that harm investor interests. These measures are intended to increase investor certainty, promote confidence, and reduce risks, thereby promoting foreign direct investment. Together, these provisions, examined in this section, comprise the main elements found in existing IIAs and the draft MAI.

3.1. Coverage and Scope

A threshold issue for the analysis of any IIA is the *scope of investment-related activities* it covers. A "high standard" IIA, such as the draft MAI, might take a

Box 2. The Landscape of International Investment Agreements

Although no single global investment framework yet exists, there is an extensive and growing set of bilateral, regional, multilateral, and other legal instruments governing foreign direct investment. These instruments consist of many different kinds of rules and vary with respect to geographic scope, structure, coverage, and strength. Several categories of investment agreements are summarized below.

Bilateral Investment Treaties (BITs). More than three-fourths of the over 1,700 BITs now in force were negotiated since 1990. Investment liberalization commitments in BITs often proceed along schedules and timetables and are restricted in coverage to a positive or negative list of sectors. While many BITs contain common elements, their provisions are tailored to the needs and circumstances of the two countries. Nearly half of the BITs in force exist between industrialized or transitional economies and developing countries.

Regional Agreements. Although very different in purpose and scope, many regional agreements – such as the European Union, NAFTA (in North America), MERCOSUR (South America), the Framework Agreement on the ASEAN Investment Area (Southeast Asia), and others – routinely contain provisions for investment liberalization. The Free Trade Agreement of the Americas, under negotiation among 34 countries since 1994, also contains extensive draft investment liberalization provisions.

Multilateral Agreements. Several existing multilateral agreements, which focus on issues broader than investment, contain provisions for foreign direct investment. The most prominent are several World Trade Organization agreements, including the Agreement on Trade-Related Investment Measures (TRIMs), the Agreement on Trade-Related Aspects of Intellectual Property (TRIPs), and the General Agreement on Trade in Services (GATS).

Non-Binding Investment Standards. In addition to legally binding instruments, "soft" law promulgated by international organizations is important to the international investment framework. The most important in this category include the OECD Guidelines for Multinational Enterprises, revised in June 2000, and the World Bank's Guidelines for the Treatment of Foreign Direct Investment. Although not legally binding, standards of this sort may influence the practices of international organizations and the policies of their member states, while also laying the groundwork for future binding rules.

Sources: UNCTAD 1999b,c.

Acronyms: ASEAN: Association of Southeast Asian Nations. MERCOSUR: Mercado Com˙n del Sur (Common Market of the South). NAFTA: North American Free Trade Agreement. OECD: Organisation for Economic Cooperation and Development.

top-down approach to liberalizing investment rules. In such an agreement, the negotiations begin with the assumption that the IIA's rules cover all economic sectors and all investment-related measures. In the course of the negotiations, countries that wish to preserve their sovereign discretion to make distinctions between foreign and domestic investors must specify measures or sectors of their economy that they want to shield from IIA disciplines. These exceptions would then be formally lodged with other Parties as country-specific exceptions. The exceptions might then be subject to "stand still" requirements that discourage Parties from adding to their exceptions or "roll back" requirements that place pressure on Parties to gradually reduce these exceptions over time.

In addition to such *specific exceptions*, IIAs typically provide for *general exceptions* that allow a host country to take measures that might otherwise violate the IIA on the basis of overriding policy objectives, including the protection of human health or the environment. Most BITs do not provide for general exceptions or do so only to permit measures necessary for the maintenance of public order or for reasons of national or international security.[7] General exceptions relating to health and the environment were, however, proposed for the draft MAI and exist in international trade agreements, such as the General Agreement on Tariffs and Trade (GATT),[8] the General Agreement on Trade in Services (GATS),[9] and NAFTA.[10]

The scope of an IIA will also vary on whether it covers both the *pre-* and the *post-establishment* phases of investment. The majority of existing bilateral and regional investment regimes impose disciplines on host countries only after they have made the initial decision to allow a foreign investor to establish its commercial presence (i.e., post-establishment) (UNCTAD 1998, p. 46). High standard IIAs, such as the draft MAI, would limit the extent to which host governments could screen foreign investors prior to their establishing an investment presence (i.e., pre-establishment).

Finally, the definition of the term *investment* that appears in an IIA is not a neutral concept – it forms part of an agreement's substantive content by determining the scope of activity it will regulate. The term "investment" in the draft MAI, for example, covered every kind of asset owned or controlled directly or indirectly by an investor, including the following: intangible assets; state authorizations or licenses; claims to money; and all kinds of contractual rights. Agreements can also define an investment to include the commercial expectations derived from that investment.

3.2. Nondiscriminatory Treatment

Nondiscriminatory treatment of investors on the basis of their nationality is a bedrock principle of IIAs. Two standards of treatment, which are also reflected in trade liberalization agreements such as the GATT, form the basis of this principle. First, the *national treatment* standard requires the host government to extend

the same or better treatment to foreign investors and investments as they extend to domestic investors and investments. Second, the *most favored nation* standard requires the host to treat all foreign investors equally, regardless of country of origin.

An IIA may, however, go beyond direct discrimination and prohibit domestic measures that are neutral as to the citizenship of the investor, but that have the *effect* of discriminating against foreign investors. High standard IIAs are likely to prohibit such *indirect* discrimination.

National treatment and most favored nation are *relative* standards of treatment, in that they prohibit discrimination against foreign investors in relation to either domestic or other foreign investors. Generally, IIAs also protect foreign investment through *absolute* standards of treatment, which typically demand that foreign investors are not treated below a minimum standard, usually requiring "fair" or "equitable" treatment and prohibiting "arbitrary" or "unjustifiable" treatment.

3.3. Prohibitions on Performance Requirements

An IIA may restrict the extent to which governments can screen foreign investors by requiring investors to meet certain standards or conditions known as performance requirements. Perhaps the most significant IIA in force restricting performance requirements is the TRIMs Agreement under the WTO, which prohibits host countries from maintaining investment-related measures that restrict the trade in goods or discriminate against imported goods. Under the TRIMs Agreement, foreign investors could challenge measures that require them to hire locally, export a percentage of the goods they produce, or use a specified amount of domestically produced components.

3.4. Expropriation and Compensation

Investment agreements provide rules on other kinds of treatment of foreign investors by host governments, such as expropriation (i.e., the government "taking" of private property). IIAs can protect an investor from nationalization, nullification of state contracts, or other actions by a host government that result in loss of property. The manner in which an IIA defines expropriation (and "investment") will determine the extent of a foreign investor's grounds for challenging an environmental measure. As with national treatment and most favored nation standards, high standard IIAs may define expropriation broadly to include not just the direct taking of an investment, but also indirect takings, including "measures having equivalent effect" of expropriation. Such a broad definition is intended to cover so-called "creeping expropriation" or "regulatory takings," whereby government taxation or regulations, short of a direct taking, may diminish the value of an investment.

In circumstances where investments were expropriated, foreign investors would,

under most IIAs, be entitled to compensation from the host government. IIAs vary in terms of the formula by which this entitlement to compensation is calculated. High standard IIAs typically require expropriating governments to pay "prompt, adequate and effective" compensation.[11]

3.5. Dispute Resolution

Finally, IIAs are only as effective as the rules and procedures that are available to enforce them. Most agreements anticipate the possibility of disputes between Parties, and between investors and host governments. As with all international legal agreements, IIAs rely first and foremost on the good faith and diplomacy of state Parties to resolve disputes between states, including those involving the "diplomatic protection" of a foreign investor by its home government. "High standard" IIAs will also provide for compulsory third-party arbitration, should diplomacy fail.

The draft MAI, NAFTA, and an increasing number of BITs allow foreign investors to take the host government directly to binding arbitration. Under NAFTA's investment provisions, for example, 13 known cases have been initiated, 8 of which have an environmental component (Moltke 2000b, pp. 19–20). IIAs that do provide for this controversial investor-to-state arbitration procedure will vary as to whether the investor must first exhaust the local remedies of the host country's court system and whether the host country must explicitly consent to the arbitration before any particular claim can move forward. Most IIAs do not establish their own institutions for the settlement of disputes, but instead rely upon the services of the International Center for the Settlement of Investment Disputes (ICSID) or for ad hoc arbitration in accordance with the U.N. Commission on International Trade Law (UNCITRAL) rules.[12]

4. Potential Interaction betwen the CDM and International Investment Law

Focusing on the high standard IIA provisions outlined above, this section examines the potential for investment rules to interact or conflict with measures taken pursuant to the CDM. It is important to not overstate the likelihood that disputes will actually occur on the basis of conflicts identified. Few CDM projects have been initiated, some rules have not been finalized, and most international investment rules that are contemplated or in existence have not been thoroughly tested through dispute resolution processes.

Generally, disputes that raise conflicts among two or more applicable international treaties are resolved through the customary rules of treaty interpretation. These rules, reflected in the Vienna Convention on the Law of Treaties, assess the parties' intent as to which of the conflicting rules should prevail in a given circumstance. This intent can be reflected explicitly through a provision in a treaty that indicates which treaty shall prevail, or the preference can be

inferred implicitly by favoring the more recent treaty or the treaty that is more specific.

Further interpretative challenges may arise from a conflict between an IIA and the CDM. For example, was the conflicting CDM-based measure *required* by the Protocol's rules (and thus agreed to by all the Protocol Parties, and thus the parties to the IIA)? Or is the measure one that a country has unilaterally determined to be necessary for its effective implementation of the CDM? Again, the more precise the Parties are in collectively endorsing a measure, the more likely it will be that the measure survives an IIA-based challenge.

To promote the security and the predictability necessary for the success of the CDM, and for international investment more generally, this paper recommends that the Protocol Parties are explicit in their preference that CDM rules prevail and are as specific as possible in their articulation and collective approval of those rules.

4.1. Coverage and Scope

The coverage and scope of the CDM and IIAs are certain to overlap. The project cycle outlined in Section I suggests at least three categories of foreign investor whose interests could be affected by the CDM:

- Investors in CDM-related *projects*;
- Investors in emission *credits* from CDM projects; and
- Investors in project cycle-related *services*.

These categories – CDM projects, credits, and project services – could fall under various definitions of "investment." BITs increasingly use the phrase "every kind of asset" to describe the intended breadth of their coverage. Some provide a broad and illustrative list of the types of assets they intend to include.

Without doubt, CDM projects themselves, to the extent they are owned in whole or in part by a foreign investor, would be considered "investments" within the meaning of IIAs. Broader IIAs will expressly include "contractual rights" and "returns on investment."[13] Some IIAs also make explicit reference to licenses or permits in their definition of investment.[14] The credits resulting from project activities are likely to fall under these types of definitions. A license to provide CDM services as an independent third party would, once issued, become an asset protected by such an IIA (UNCTAD 1998, p. 35).

As has been indicated, most IIAs do not create an unconditional right of establishment or entry for foreign investors.[15] However, where high standard IIAs are in force between host and home countries, the host country may be required to offer nondiscriminatory access to foreign investors from states that are party to the IIA. If interpreted to provide a foreign investor with an unqualified "right to establishment," this obligation could short-circuit the CDM's expectation that host governments "voluntarily" approve each project.

4.2. Direct Discrimination

Prohibiting discrimination between countries, in the form of the national treatment and most favored nation standards, is common and central to all IIAs. This approach to investors and investments on the basis of their country of origin is potentially problematic in the context of the Kyoto Protocol. A fundamental principle of the Protocol is the differential treatment of countries, based on such factors as level of economic development and historical greenhouse gas emissions. This principle is most clearly elaborated in the 1992 Climate Convention:

> "The Parties should protect the climate system for the benefit of present and future generations of humankind, on the basis of equity and in accordance with their common but *differentiated responsibilities and respective capabilities*." (UNFCCC 1992, Article 3.1. Emphasis added).

Thus, in the Kyoto Protocol context, goals of equity are actually pursued by treating countries differently on the basis of their varying national circumstances. The CDM exemplifies this most clearly by restricting the location of projects to within non-Annex I Parties (CDM projects cannot be hosted in industrialized countries). A potential for conflict with an IIA may arise if a Party hosting a CDM project is encouraged or required by the Protocol to expressly discriminate between investors on the basis of their nationality and the status of their home country. Direct discrimination between investors, on the basis of their nationality, could conceivably take place in at least the following five ways.[16]

i. Party versus Non-Party. Rules that bar non-Parties from participating in (or otherwise benefiting from) the CDM might provide an incentive for countries to ratify or accede to the Protocol. At the same time, such rules could run counter to nondiscriminatory standards of treatment found in IIAs. Discrimination against non-Parties might be challenged under a relevant IIA that also covers the participating countries. Currently, the Kyoto Protocol rules are unclear regarding the status of non-Parties. Can a non-Party entity invest in or implement a CDM project (i.e., "participate", in the colloquial sense)? Can a non-Party entity have title to (i.e., possess, acquire, transfer) CDM credits?

Non-Parties, such as the United States, are likely to interpret the provisions of the CDM in a manner most favorable to their interests. Thus, a non-Party could argue that it has the right to participate in CDM projects and have title to credits since there is no rule in the 2001 Marrakesh Accords explicitly barring non-Parties (or their investors and service providers).[17] The rules explicitly bar non-Parties only from "using" CDM credits toward emission control obligations. Yet, non-Parties have no such emission control obligations, making this language insufficient to deter non-Party participation. CDM credits will, after all, have an inherent value as an investment as long as there is a demand generated by those bound by the Kyoto regime. Furthermore, the text implicitly allows non-Parties to participate (at least in some sense), given that the CDM can operate under "prompt start" provisions before the Protocol even comes into force.[18] This inter-

pretation – allowing participation of non-Parties – would eliminate one potential source of conflict with IIAs, which prohibit direct discrimination on the basis of the investor's country of origin.

However, a contrary argument could also be made, on the basis of fairness and treaty interpretation. The Kyoto Protocol is, first and foremost, an agreement among governments, spelling out government rights and duties. The involvement of private entities in no way vitiates government responsibility for compliance. To ensure this, the Marrakesh Accords refer to private entities that are "authorized" by Parties. But it is not clear whether authorization is mandatory and, if it is, whether any Party can authorize a private entity *from a non-Party* (e.g., Monaco authorizes a U.S. private entity).

In terms of fairness, some Parties and stakeholders believe that countries, such as the United States, with no intention of joining the Protocol should not benefit, directly or through its companies from the Protocol's market mechanisms. This sentiment raises the possibility of unilateral restrictions imposed by some Parties against non-Parties. Such restrictions could run counter to IIA nondiscrimination provisions.[19]

ii. Complying versus Noncomplying Parties. The Protocol Parties may wish to condition an investor's eligibility to participate in CDM activities on the basis of whether its home country is currently in compliance with Protocol commitments. Such rules could be applied either at the pre-establishment phase (to ban the participation of companies from noncomplying Parties in CDM project activities) or it could be applied at any time during the project cycle to invalidate a project activity or an emission credit.

The Marrakesh Accords prohibit the *use* of a CDM credit by any Annex I Party that is not in compliance with their broader treaty obligations (UNFCCC 2002). However, the suspension of the right to use CDM credits applies to the noncomplying state directly, and not to the project or the investors. Generation, transfer and acquisition of CDM credits (which do not constitute *use*, under the Marrakesh Accords) can continue during the period of noncompliance. Thus, under the Protocol (and an IIA) a host developing country would probably *not* be justified in refusing investment, or halting an existing investment, from a noncomplying Party since it does not appear that the emission credits would be in jeopardy. In this instance, the Marrakesh Accord provisions are structured rather compatibly with the principles found in IIAs, reducing the likelihood of conflict. But again, as discussed above, this could engender resentment (and subsequent unilateral action) among some Parties or stakeholders if it becomes apparent that noncomplying countries are benefiting from the CDM.

iii. Foreign Investors from Annex I versus Foreign Investors from Non-Annex I Parties. It is unclear from Article 12 of the Kyoto Protocol whether foreign investors from non-Annex I Parties would be entitled to participate in any or all

CDM activities. In other words, would a company from a non-Annex I Party be able to invest in a credit generating CDM project in another non-Annex I Party? Or is such investment only open to Annex I companies?

Since it is not expressly prohibited, decisions by the Protocol Parties appear to allow such investment (UNFCCC 2002). In the future, however, participation in the CDM could be considered an opportunity that is granted exclusively to countries (and their companies) that have committed to other obligations under the Protocol, such as the emission caps agreed to by Annex I Parties. Such a rule would discriminate directly against non-Annex I Parties and investors within those countries, who may demand access to project types that are eligible for the CDM, raising the potential of a conflict with an IIA. Box 3 illustrates such a potential scenario.

Box 3. Direct Discrimination: Foreign Investors from Annex I versus Non-Annex I Parties

The government issues a public tender for an electric power project in Malaysia, a non-Annex I Party. Two companies bid on the project, one from South Korea (non-Annex I) and another from Japan (Annex I). Under a scenario whereby CDM investment is limited to Annex I Parties and entities, only the Japanese company would be able to generate credits from the project. This could affect the relative commercial attractiveness of the two bids, giving the Japanese company an advantage and discriminating against the South Korean company. Under a high standard IIA that covers the relevant countries and sectors, the South Korean company may have a valid claim against host country CDM regulations (which are consistent with international CDM rules), as the Japanese company was accorded more favorable treatment by the host, violating the most favored nation standard of treatment.

Some argue that a non-Annex I investor without emissions reduction commitments of its own, would have no incentive to invest in CDM projects. However, if CDM credits are fully tradable, an investor without commitments of its own may see the potential rewards in generating and holding credits to sell to the highest bidder.

Such bars on CDM participation, in either CDM projects or in the ownership of credits, would be largely unenforceable, because companies could establish superficial joint ventures with Annex I-based entities. Although barring such participation might be justified on the grounds set out above, the same rationale would not justify prohibiting the participation of non-Annex I investors in the provision of other CDM-related services, such as project certification performed by independent third parties.

iv. Foreign versus Domestic Investor. As noted above, limiting CDM participation to Annex I Parties and their companies would prevent developing countries from implementing CDM projects "unilaterally," i.e., within their domestic realm without the involvement of a foreign investor (Baumert, Kete and Figueres 2000). Prohibiting unilateral CDM, however, would discriminate *in favor* of foreign investors, and thus would not conflict with IIAs.

If unilateral CDM investment were allowed, it might create additional incentives for host governments to limit or bar foreign investors from CDM projects. To promote an endogenous, climate-friendly technology in a particular sector, a host country might decide to keep these sectors domestic, at least until the domestic investment sector was prepared to compete with foreign rivals. Similarly, non-Annex I Parties wishing to promote land-use projects, but anxious to prevent foreign investors from owning large tracts of real estate, might use unilateral investment as a means of profiting from the sale of credits, while barring direct foreign investment. Because these measures would afford better treatment to domestic investors, they would be contrary to the national treatment standard and could run counter to the provisions of an IIA.

v. Discrimination and the Trade in CDM Credits. The four examples of potential direct discrimination described above apply chiefly to CDM *project* investments, such as land, physical plant, and capital associated with a project. Direct discrimination could also extend to international trade in CDM *credits*. Domestic laws within Annex I Parties, for example, might discriminate in their recognition of CDM credits on the basis of the country of origin or project type. As noted in section 2, Annex I Parties might even be required to discriminate against credits generated from a nuclear power project.

Such discrimination, however, would not violate even high standard investment agreements. IIAs cover investments only in the domestic context of the host country and do not extend to the international trade aspect of CDM credits. Thus, even if Protocol rules result in controversial credits, an industrialized country could unilaterally ban their use domestically. Similarly, as an international treaty that runs between states, the Kyoto Protocol and whatever rules adopted under the CDM cannot grant rights directly or indirectly to private companies to buy, sell, hold, or redeem credits. Such rights are created only under domestic legislation of Annex I countries. Thus, one country should be able to choose whether or not to accept certain types of CDM credits on the basis of any number of criteria, such as those mentioned above.

4.3. Indirect Discrimination

The indirect discrimination provisions of some IIAs may provide a basis for a claim that a CDM regulation in a host country – prohibiting coal – fired power projects for example-indirectly discriminates against investors from those countries that

exported such technologies. IIA rules may provide a basis for challenging such a rule, if a foreign investor can establish that the host country was treating its investment less favorably than a "like" domestic investment or investor or a "like" foreign investment or investor from another country. The dispute would turn on arguments as to whether the activity of providing energy services via coal power was "like" providing the same energy through other sources. There is currently little in state practice that can help predict how an arbitrator might determine the scope of the term "like" in this context. The experiences of the GATT/WTO regime, however, do not bode well for an interpretation of "like" that allows for discrimination on the basis of environmental criteria (Moltke 2000a).

4.4. Prohibitions on Performance Requirements

The Kyoto Protocol provides that CDM project activities should assist developing countries in achieving sustainable development and should promote real, measurable, and long-term benefits. As noted in Section I, such criteria applied by a host country could require a CDM project activity to use locally produced goods or services, build domestic capacity by employing local citizens, or require the transfer of technology to a local firm. Such requirements, to the extent that they affect the import or export of products, could run afoul of IIAs, including the WTO's TRIMs Agreement. Similarly, under a high standard IIA, such as that contemplated in the MAI, these employment and performance requirements, even if imposed equally on domestic and foreign investors, would be prohibited. A blanket prohibition on "performance requirements" could potentially undermine a core objective of the CDM – sustainable development benefits for the host country.

4.5. Expropriation and Compensation

i. Direct Expropriation. The risk of expropriation for a CDM project is no greater than other foreign investments. In the past, however, investments in the natural resources sectors have tended to be more prone to expropriation than other types of investments.[20] This arose, in part, because many developing countries in the post-independence period were persuaded to sign over their natural resources on long-term concessions to foreign investors at prices well below their market value. When true prices were revealed, or when domestic demand for these resources grew, governments broke extortionate deals by exercising their "permanent sovereignty" over their natural resources. This history holds a salutary lesson for CDM. If similar extortionate deals are done in the CDM, including those that restrict land-use over indefinite time periods, similar pressures could motivate a host government to directly expropriate either CDM projects or the contractual right to the credits they may produce. (*See Box 4.*)

Box 4. The "Permanence" of Sinks and Permanent Sovereignty Over Natural Resources

Negotiators have yet to agree if, how, or when projects involving land-use, land-use change, and forestry (LULUCF, or "sinks") might be eligible for the CDM. It is widely recognized that the storage of carbon in organic material, such as soils and forests, is inherently temporary in nature. If such activity is used to offset industrial emissions into the atmosphere, the value of the offset must reflect the fact that the carbon stored will eventually be re-released.

Efforts may be made to monitor, regulate, and promote the continuing existence and absorptive capacity of carbon stocks that have been credited under the CDM. These additional regulations may seek to require host countries to provide assurances that land being credited under the CDM continues to produce offsets. The investor and its home country, which are relying upon the project to allow them to increase their emissions, and the international community, which will be seeking to prevent fraud and leakage, will want to restrict any changes in the use of that land for the project's productive life.

A strong IIA regime could protect the investment interest of the home and the investor country in extending the "permanence" of these sinks. Sovereign states do, however, frequently assert the permanent right to return natural resources, such as land, to public ownership. Efforts to ensure or to extend the productive capacity of LULUCF activities, backed by investor protection rules, could conflict with a host state's expectations based on the principle of permanent sovereignty and could lead to conflicts over any resulting expropriation. CDM rules that ensure that LULUCF projects, if they are to be credited, are "time bound" to reasonable periods could help to avoid such conflicts.

Sources: Hossain and Chowdhury 1984; Yamin 1999.

ii. Indirect Expropriation. An investor's assets can lose value as a result of host country activity without the host government actually seizing ownership of the property. Traditionally, this "indirect expropriation" only gave rise to a claim for compensation when state measures, such as taxation and licensing, were discriminatory or had the precise intent and effect of confiscation (Browlie 1990, pp. 531–538). More recent IIAs, such as NAFTA, however, expand the international standard for expropriation to cover "regulatory" takings that are tantamount to expropriation. This is interpreted to include "creeping expropriation" where a series of regulatory acts over a period of time significantly impairs the asset's value (UNCTAD 1998, pp. 65–66). Recently, a panel of arbitrators found that environ-

mentally-based restrictions that prevented an investor from operating a landfill amount to an indirect expropriation under NAFTA rules.[21]

One example of potential indirect credit expropriation relates to revising a CDM project's baseline, which will affect the amount of credits the project generates. The CDM rules in some cases require baselines to be revised after seven years (UNFCCC 2002). Such a requirement adds integrity to the assumptions underlying the scenario upon which the project was first deemed to be additional by allowing for unanticipated improvements in regulatory standards or the penetration of technologies. If host countries have taken domestic measures to upgrade technologies and reduce emissions, baseline revisions might result in fewer or zero credits. This could lead investors to feel that their commercial expectations had been expropriated. Investors and hosts reduce the likelihood of such a dispute by clearly defining, either under international agreed rules or through the project agreements, the baseline methodologies and circumstances for revision.

A host country could take countless other measures that could effect the future quantity of credits generated, prevent credits from being generated at all (e.g., refusing entry to a third-party verifier), or reduce project profitability. Such actions might be construed as indirect expropriation. Furthermore, regulatory actions taken by the host government to provide a CDM-conducive investment environment might also have a disproportionate impact on *non-CDM* foreign investors, leading to claims of indirect expropriation. This could include, for example, regulations that limit greenhouse gas emissions from certain sectors where CDM investment is sought.

Generally speaking, the expansion of expropriations to regulatory takings could have sweeping and untold implications for the CDM, foreign direct investment, sustainable development, and beyond. Surprisingly, NAFTA provisions have been interpreted to grant this right of recovery for indirect expropriation to Mexican, Canadian, and U.S. foreign investors. However, domestic legal processes in these countries have been reluctant to compensate domestic companies for property value losses resulting from otherwise neutral regulation.[22] In the worst case, IIAs that cover strict indirect expropriations could have the effect of a "regulatory freeze," whereby the host government would adopt no new environmental or other regulations over the lifetime of an investment for fear that such measures would reduce the commercial value of an investment and, therefore, be considered expropriatory (Moltke 2000b). Under such a scenario, the threat of (foreign) litigation would make it difficult for a government to respond to the shifting welfare and policy priorities of its populace.

4.6. Dispute Resolution

Each CDM project, as with any substantial commercial venture, will carry expectations and risks. Although individual project agreements will seek to allocate these

among project participants, disputes may still arise. CDM negotiators have not yet clearly identified procedures for resolving CDM investment disputes. One option is for disputes to be settled in accordance with the arbitration provisions referenced in Article 14 of the Climate Convention or by using the Protocol's Compliance Committee.[23] Parties have also suggested an appeals panel be created under the direction of the Executive Board to oversee and resolve disputes.

Some investment disputes may include claims by a foreign investor that the host government acted in a discriminatory manner or in a manner that expropriated the investor's assets. This raises the following two important issues related to IIAs: (1) which procedure or forum should resolve such disputes; and (2) what law will be applicable to the dispute at hand? If both the Protocol and the individual project agreements are silent on the choice of forum and choice of law, whatever IIA is in force between the home and host states would likely govern the dispute. This could have the unwelcome effect of trumping emission reduction and sustainable development policies taken pursuant to the CDM.

5. Conclusions and Recommendations

CDM investment is embedded in an international regulatory system, constructed by sovereign states through the Kyoto Protocol, that aims to reduce the threats of human-caused global climate change. The guiding principles of the CDM are greenhouse gas emission reductions and sustainable development. Furthermore, the effectiveness and fairness of the Kyoto Protocol rests on the bedrock principle of differential treatment of countries, according to their varied levels of historical "responsibility" for the problem of climate change and "capabilities" to curtail their domestic emissions. The 2001 Marrakesh Accords further call for the differential treatment of potential CDM project types, particularly for renewable, energy efficiency, and nuclear projects.

On the other hand, rules governing international investment operate under some principles, such as nondiscrimination and market access, not found in the Kyoto Protocol. In fact, some IIAs aim to prohibit the kind of conditioning of investment that the CDM aims to promote. Given these potentially divergent approaches, conflicts might arise between the CDM and international investment rules. This section identifies the key findings and recommendations regarding the interaction between the two fluid bodies of law. In some cases, the design of the CDM can be shaped in a way that minimizes the likelihood of disputes. Another opportunity for minimizing conflict is through the negotiation of future international investment agreements. (*See Box 5.*) Such agreements must be shaped in a way that accommodates, and indeed promotes, the kind of investment needed to protect the global environment and foster sustainable development at the local level.

Box 5. A Future for a Multilateral Framework on Investment?

Despite the failure of the MAI (Box 1), it would be a mistake to conclude that the trend toward investment liberalization is reversing and a future multilateral framework is unlikely. First, bilateral and regional investment agreements continue to be on the rise, even since the collapse of the MAI negotiations. The most ambitious of these initiatives is the Free Trade Agreement of the Americas (FTAA), under negotiation among all countries in the Western Hemisphere (except Cuba) since 1994.

On the multilateral front, talks on an international investment framework could emerge under a variety of fora outside the OECD. The 4th WTO Ministerial Declaration from Doha, for example, calls for such a negotiation to be considered in 2003. Negotiations are ongoing to expand the scope and coverage of the WTO's GATS, which promotes foreign investment by opening market access to overseas service suppliers. Likewise, the Convention establishing the Multilateral Investment Guarantee Agency (MIGA) authorizes World Bank's MIGA to "promote and facilitate the conclusion of agreements, among its members, on the promotion and protection of investors." The U.N. Convention on Trade and Development (UNCTAD) is examining the "implications of a possible multilateral framework on investment." Negotiations could also emerge independently outside of any existing multilateral fora.

Moving forward on investment liberalization in future international agreements will require approaches that are open, participatory, and transparent. This will better ensure that such agreements do not encroach upon the social, environmental, and human rights goals that countries are already committed to both internationally and domestically. Moreover, it will allow governments to retain certain economic sectors within public or local ownership. A future multilateral investment framework may also need to integrate environmental and sustainable development considerations into its rule-making and dispute resolution institutions.

Sources: Henderson 1999; UNCTAD 1999 a; Websites of WTO (www.wto.org), UNCTAD (www.unctad.org), OECD (www.oecd.org) and FTAA (www.alca-ftaa.org).

5.1. Key Findings

Effective functioning of the CDM could involve discrimination among investors in a manner proscribed by "most favored nation" standards of IIAs. Discriminating on the basis of whether an investor's country of origin is a *Party* to the Protocol, a *complying Party* to the Protocol, or an *Annex I Party* to the Protocol could promote the environmental soundness of the Protocol and

other policy objectives, such as compliance and global participation. Thus far, however, the Protocol negotiators have avoided this potential conflict by defining eligibility in terms of *using CDM credits rather than participating in CDM projects*.

Provisions that allow host countries to selectively approve CDM projects could run counter to prohibitions against "pre-establishment screening" and "performance requirements" stipulated in IIAs. Many high-standard IIAs prohibit pre-establishment screening of investments that may be necessary to ensure sustainable development benefits from the CDM. Moreover, sustainable development provisions could be interpreted as "performance requirements" which are prohibited by many IIAs, and, in some circumstances by the WTO TRIMs Agreement.

The application of domestic regulations based on CDM rules could be challenged as "indirect expropriation" under some IIAs. The effect of a regulation might be construed as expropriatory if it decreases the amount of credits expected from a project activity (indirect expropriation). Such measures taken by a developing country might be justified on environmental or developmental grounds but open to dispute under an IIA that defines an investment to include the commercial expectations derived from that investment. These potential conflicts apply to CDM investments and non-CDM investments alike.

There is no clear mechanism or procedure in place to resolve disputes related to CDM investments. In the absence of clear identification of dispute resolution forum and choice of law in CDM project agreements, in the Protocol or in rules agreed by the Parties, the provisions of the relevant IIA would prevail, potentially giving short shrift to environmental and sustainable development goals of the CDM.

Annex I Parties could ban the domestic use of certain types of CDM credits without running afoul of an IIA. Nothing in IIAs prevents Annex I Parties from choosing not to approve or from deeming invalid the credits generated from certain project types or countries. This would allow industrialized countries that do not wish to promote certain project types (e.g., large dams) at home or abroad to discriminate against credits on such a basis. Although this could reduce the market value of such credits, a market would continue to exist in those countries that chose to accept them as valid.

5.2. Recommendations

Standardize CDM rules and procedures in a way that reduces the chance of conflict. Confidence in the CDM can be earned by standardizing the processes and procedures necessary to generate credits. This will avoid discretionary application of generalized CDM provisions, thereby aligning the expectations of investors

and hosts. For example, the determination of whether a project contributes to a host's sustainable development should be made at the time of project approval. This provision should not be re-invoked several years later, in order to invalidate the project. Similarly, any ongoing sustainable development requirements of a project should be built into the project agreement as contractual obligations.

The Executive Board should help formulate and disseminate standardized CDM rules through a continuously updated CDM Reference Manual for use by project developers, government agencies, local communities, and CDM service providers.

Establish the Kyoto Protocol as applicable law for CDM conflicts. The Parties may agree, through the decisionmaking structure of the Protocol, that the Protocol's procedures shall resolve all investment-related disputes arising under the CDM in accordance with the unique set of rules agreed by the Parties or the Executive Board.[24] As noted, if both the Protocol and the individual project agreements do not stipulate the forum and choice of law, whatever agreement is in force between the home and host states would likely govern the dispute. Depending on the Parties involved, this could include compulsory and binding dispute settlement procedures that could be triggered by foreign investors against host governments. Of course, establishing the Kyoto Protocol as the applicable law for conflict resolution will not pertain to any non-CDM investors that may be adversely affected by a CDM-related measure taken by the host country.

Vest authority in the CDM Executive Board or other Protocol body to resolve project disputes. If dispute settlement has not been agreed upon or is not covered by the project agreement, projects in dispute by investors or Parties could be taken up by an *ad hoc* or standing dispute resolution body that operates under the Executive Board. Such a body would oversee those disputes and recommend action to the Executive Board, including the de-registration of a project or the refusal to issue credits. Alternatively, additional arrangements could be made to have such disputes fall under the jurisdiction of another Protocol body, such as the Compliance Committee.

Create provisions for legal assistance in structuring project agreements. Well constructed and understood project agreements will be essential to equitable cost- and benefit-sharing in the CDM and avoiding conflicts. The Executive Board, or other appropriate body, should help build developing countries' capacity in this area through training, guidance, or other provisions for legal assistance on project agreements. This could help balance the bargaining power of host countries and foreign investors.

Confirm that credits generated through the CDM have no risk of being invalidated. By definition, credits are only generated *after* emission reductions have taken place. CDM credits, generated from projects that have been indepen-

dently validated and whose emission reductions have been independently verified and certified *ex post*, should not be invalidated under any circumstances. Ongoing liability for holding CDM credits will create uncertainty, reduce confidence, and increase the likelihood of conflicts within the CDM. Fortunately, the 2001 Marrakesh Accords provide reasonable certainty that the regulatory stages of the CDM project cycle, such as validation and verification, will prevent emission reductions that are of questionable integrity from being certified in the first place. However, credits from certain forestry or other land-use projects represent emission reductions that are impermanent or reversible. Thus, an exception or special measures specific to such project types may be required.

Eliminate or scale down the investor-to-state dispute resolution provisions in international investment agreements. Because public interests are often at stake, investor-initiated dispute resolution provisions are rare in international economic law (even under the WTO, only governments can initiate a dispute). The dispute resolution processes in IIAs (e.g., ICSID and UNCITRAL) were originally created to arbitrate between competing *private* interests and are ill-equipped to deal with *public* interests (Moltke and Mann 2001). Eliminating or reshaping investor-to-state dispute resolution would help governments balance the competing policy interests at stake, such as environmental goals, economic development, or attracting foreign investment.

Prohibit indirect expropriation claims in IIAs that are the result of broadly applicable, facially nondiscriminatory laws and regulations. The expansion of expropriations to cover so-called "regulatory takings" from facially neutral measures would have sweeping and untold implications for the CDM, foreign direct investment, sustainable development, and beyond. Even the perception that foreign investors can challenge such actions will negatively affect governments' ability to improve public welfare through measures that protect the environment, improve public health, and promote local economic development, among others.

Exempt CDM-related investment activities from the provisions of international investment agreements when these activities are identified as vital to achieving the goals of CDM. As noted, the CDM creates legitimate reasons to discriminate against investors on the basis of country of origin and perhaps breach other IIA provisions. Unless investment agreements recognize such measures as valid, the potential for conflict exists. Rather than basing future investment agreements on trade liberalization principles (such as nondiscriminatory treatment), negotiators will need to factor in other principles, such as sustainable development and environmental protection (Moltke 2000b).

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Notes

1. For more information, see the Free Trade Agreement of the Americas website on the investment negotiating group. Available online at http://www.ftaa-alca.org/ngroups/nginve_e.asp.
2. Doha WTO Ministerial 2001: Ministerial Declaration, Adopted 14 November 2001. Available online at: http://www.wto.org/english/thewto_e/minist_e/min01_e/mindecl_e.htm. The declaration also authorizes the WTO Working Group on the Relationship Between Trade and Investment to undertake further work "on the clarification of: scope and definition; transparency; non-discrimination" among other issues. The declaration also states that "any framework should reflect in a balanced manner the interests of home and host countries, and take due account of the development policies and objectives of host governments as well as their right to regulate in the public interest."
3. Nuclear projects are not categorically ineligible. However, this provision, coupled with the additionality and public participation provisions of the CDM, would make it difficult or impossible for a nuclear project to be independently validated and subsequently registered with the CDM Executive Board. Since industrialized countries have declared their intentions not to buy credits from nuclear projects, any such credits would likely have a market value of zero. The project would not pass any reasonable additionality test if its credits had no value.
4. Article 3 of the Kyoto Protocol explains the treaty's accounting system. According to Article 3.12, any certified emission reduction acquired in accordance with the CDM will be "added to the assigned amount for the acquiring party."
5. According to the Marrakesh Accords (UNFCCC 2002, decision 17/CP.7), the Executive Board will need to approve new baseline methodologies, and will play a role in recommending to the Parties what methodologies are acceptable.
6. UNCTAD 1998, Chapter 1; N. Schrijver 1997, pp. 190–195; UNCTAD 1999d.
7. UNCTAD 1998: 86, citing U.S. model BIT and the BIT between Bolivia and Peru.
8. Article XX, which provides an exception for measures "necessary to protect human, animal or plant life or health" or "relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption" but that are "not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade." Article XX exceptions also apply to trade-related investment measures (TRIMs) through Article 3 of the Uruguay Round TRIMs agreement.
9. Article XIV, which provides an exception for measures "necessary to protect human, animal or plant life or health;" but that are "not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services."
10. Article 2101, which provides that "GATT Article XX and its interpretative notes, or any equivalent provision of a successor agreement to which all Parties are Party, are incorporated into and made part of this Agreement. The Parties understand that the measures referred to in GATT Article XX(b) include environmental measures necessary to protect human, animal or plant life or health, and that GATT Article XX(g) applies to measures relating to the conservation of living and non-living exhaustible natural resources." Article 2101 does not, however, apply to NAFTA's Chapter 11 on investment.

11. An IIA may also provide criteria to assist the Parties in determining the monetary value of the expropriated asset. Many BITs require compensation "equivalent to the fair market value" of the expropriated asset, but vary widely in terms of the currency in which it should be paid and the extent to which other factors should be taken into account.
12. United Nations Commission on International Trade Law (UNCITRAL) is the core legal body of the United Nations system in the field of international trade law. More information available online at http://www.uncitral.org/en-index.htm.
13. UNCTAD 1998, pp. 32–37.
14. For example, the U.S. model BIT definition of investment includes "rights conferred pursuant to law, such as licenses and permits." UNCTAD 1996, p. 196.
15. UNCTAD 1998, p. 47.
16. This section draws upon J.Werksman and C. Santoro 1998.
17. UNFCCC 2002. See decision 17/CP.7, section F paragraphs 30 and 31.
18. Until the Kyoto Protocol enters into force, the CDM will, in fact, operate under the authority of the Climate Convention, whose membership may not be identical in the future to the Kyoto Protocol. The first meeting of the Parties of the Kyoto Protocol (likely in 2003) will most likely assume authority over the CDM.
19. Indeed, the OECD Secretariat's own analysis of potential conflicts between the draft MAI and MEAs that used quotas and permits noted that: "If quotas or permits are earned by enterprises as a return on participation (investment) in a pollution reducing project in a developing country, the question would arise as to whether the ineligibility for such a quota or permit (return) of enterprises of countries not Party to the system constituted a discriminatory measure of the project host. If the eligibility requirement were established by an international regime, that might be interpreted for MAI purposes to be a measure of each Party to it." OECD 1998.

    The OECD Secretariat qualified the risk by suggesting that barring investors from non-Parties to the Protocol from eligibility may not be necessary, as a certified emission reduction would have no value in the legal system of the investor's home country. This analysis is, however, based on the assumption that CDM credits would not have an inherent value as an investment that could be sold to investors in home countries where they did have value. Note, however, that the Montreal Protocol, to avoid potential conflicts with WTO rules and encourage compliant behavior of non-Parties, extends certain Protocol privileges to non-Parties that can demonstrate they are acting in accordance with the Protocol's provisions.
20. For example, since 1990, four of the fourteen investment disputes concluded by the International Center for the Settlement of Investment Disputes involved either petroleum extraction or electricity distribution. See Scimitar Exploration Limited v. Bangladesh and Bangladesh Oil, Gas and Mineral Corporation (Case No. ARB/92/2) (Oil exploration and development); Société Kufpec (Congo) Limited v. Republic of Congo (Case No. ARB/97/2) (Petroleum exploration and exploitation agreement); WRB Enterprises and Grenada Private Power Limited v. Grenada (Case No. ARB/97/5) (Electricity enterprise); Mobil Argentina S.A. v. Argentine Republic (Case No. ARB/99/1) (Petroleum exploration and production venture). Available online at: http://www.worldbank.org/icsid/cases/conclude.htm. In addition, one recent dispute involved disagreements between a host and an investor over the valuation of a tract of rainforest that was expropriated for the purpose of creating a national park. See Compañia del Desarrollo de Santa Elena S.A. v. Republic of Costa Rica (Case No. ARB/96/1) (Valuation of land holding).
21. Metalclad Corporation v. United Mexican States (Case No. ARB(AF)/97/1), Award of the Tribunal, para 107. See http://www.naftaclaims.com (December 2000).
22. NAFTA, Chapter 11: Investment. Full text available online at http://www.sice.oas.org/trade/nafta/naftatce.asp. The fifth amendment of the U.S. Constitution states that private property shall not "be taken for public use, without just compensation." For a description of the U.S.

case law history on the interpretation of the fifth amendment, with respect to regulatory takings, see FindLaw: Internet Legal Resources, U.S. Constitution: Fifth Amendment – Rights of Persons, available online at http://caselaw.findlaw.com/data/constitution/amendment05/16.html#1 (October 2000).

23. UNFCCC 2002, decision 24/CP.7. Article 19 of the Protocol enables Parties to the Protocol to make use of arbitration procedures provided for under Article 14 of the Convention. These procedures have yet to be developed, but if they are similar to those in other MEAs, they would apply only to those Parties that had expressly consented to their application, would involve the establishment of ad hoc arbitral panels, and would be empowered to render decisions binding upon the disputants.
24. Commentators differ on the extent to which international agreements, such as the Kyoto Protocol, can establish, by agreement, discrete areas of international law. Many argue that all treaties must be interpreted in the context of existing customary and treaty law. In other words, any Protocol institution resolving an investment dispute would need to take into account international investment law existing between the disputants.

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