What You Don't Know Can Hurt You: Investor-State Disputes and the Protection of the Environment in Developing Countries

*Kyla Tienhaara**

Introduction

Foreign direct investment (FDI) is the most important source of external finance in developing countries because it is more stable than portfolio investments and bank lending, and far more available than Official Development Assistance.[1] In order to attract FDI, countries have increasingly offered certain forms of legal protection to foreign investors, including recourse to international arbitration mechanisms in the event of a dispute. These protections can be found in national laws and bilateral investment treaties (BITs) (now numbered at over 2300), as well as in numerous regional treaties[2] and many state contracts.[3] Although it is debated whether the presence of an international investment agreement will lead to increased flows of investment,[4] investors tend to regard certain protections, such as access to investor-state dispute mechanisms, as an "essential item on the menu".[5] These provisions are regarded as particularly important when investing in a developing country, where political risk may be high. Foreign investors argue that local courts are ill-equipped to deal with investment disputes. If asked to adjudicate claims brought against their own State, as

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1. Morgera 2004, 215.
2. The United Nations Conference on Trade and Development (UNCTAD) maintains a compendium of international investment agreements, available at www.unctad.org.
3. UNCTAD 2004, 3, defines a state contract as "a contract made between the State, or an entity of the State . . . and a foreign national or legal person of foreign nationality." State contracts feature prominently in the natural resource sectors of developing countries.
4. Hallward-Driemeier 2003; and Neumayer and Spess 2005.
5. Author's confidential interview with a mining investor (#3), Jakarta, July 2005.

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Bernardini argues, local courts "may hardly be able to resist the political pressure inherent in this situation".[6] International arbitration, on the contrary, is commonly framed by investors and in the academic literature as neutral and depoliticized.

Investor-state dispute settlement can be either institutional or *ad hoc*. Institutional dispute settlement involves a supervising institution that administers the arbitration. The supervising institution may assist in appointing arbitrators, determining the place of arbitration, determining costs and arbitrator fees, and so forth. The institution charges a fee for the performance of these functions. The most common institutions referred to in international investment agreements are the International Center for the Settlement of Investment Disputes (ICSID) and the International Chamber of Commerce's (ICC) International Court of Arbitration. ICSID is a part of the World Bank Group and was established in 1966 when the Convention on the Settlement of Investment Disputes between States and Nationals of Other States came into force. Its most recent set of Rules and Regulations took affect in 2006.[7] ICSID was designed expressly for the purpose of handling investor-state arbitrations and does not handle disputes between firms. The ICC, in contrast, is a private institution, which refers to itself as "the world's business organization."[8] The current Rules of Arbitration of the ICC came into force in 1998.[9]

Ad hoc arbitrations also follow sets of established rules; however, in these cases there is no supervising institution. The most common *ad hoc* rules referred to in international investment agreements are those of the United Nations Commission on International Trade Law (UNCITRAL). UNCITRAL was established by the UN General Assembly in 1966 and was given the general mandate to further the progressive harmonization and unification of the law of international trade.[10] An integral part of the Commission's work is the promotion of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958 "New York Convention"). The UNCITRAL Arbitration Rules were adopted in 1976.[11]

Recent years have witnessed an explosion of investor-state arbitrations. The cumulative number of all known[12] cases brought under investment agreements was 219 as of November 2005, excluding instances where a notice of intent had been filed but the request for arbitration had not.[13] This can be com-

6. Bernardini 2001, 246.
7. The Rules and Regulations are available at www.worldbank.org/icsid/.
8. See the ICC website www.iccwbo.org/home/menu_what_is_icc.asp, last accessed 05–06–06.
9. The full text of the Rules is available at www.iccwbo.org/court/english/arbitration/rules.asp #foreword.
10. See the UNCITRAL website at http://www.uncitral.org/, last accessed 05–06–06.
11. The full text of the Rules is available at www.uncitral.org/uncitral/en/uncitral_texts/arbitration/1976Arbitration_rules.html.
12. As discussed below cases are not necessarily made public, and thus it is not possible to assess how many exist in total.
13. UNCTAD 2005b, 2.

pared to the end of 1994 when there were only five known cases. While a large number of cases have been filed against Argentina[14] (thus inflating the total count), at least 61 governments (37 in the developing world) have faced investment arbitration.[15]

Concerns have been raised, particularly in the wake of several controversial investor-state disputes,[16] that in some instances the protection offered to investors may limit the ability of governments to regulate investment for the protection of the environment, natural resources and other social goods, and to ensure that foreign investment contributes to overall national development goals.[17] Some authors have also suggested that the threat of an investor-state dispute could have a chilling effect on government policy, though they note that there is little evidence to substantiate such a claim.[18]

This article is structured in the following manner: first, the particular difficulties that developing countries face as respondents in investor-state disputes will be discussed; second, the relationship between investment protection and environmental protection will be explained, with a focus on the issues of expropriation, stabilization, and compensation; third, the potential chilling effect of investor-state disputes will be assessed; and finally a case study from Indonesia[19] will be presented. The main argument is that the lack of transparency in arbitration, and the lack of consistency of tribunal decisions, creates uncertainty for regulators. This uncertainty, when combined with the financial risk involved in proceeding to arbitration, may create situations in which the threat of an investment dispute is sufficient to convince a developing country government to reverse, amend or fail to enforce an environmental regulation. The article concludes that in the absence of a complete overhaul of the investment arbitration system, efforts should be focused on procedural reform as well as targeted capacity building and financial assistance for developing countries.

1. Investor-State Disputes and Developing Countries

A recent report of the United Nations Conference on Trade and Development (UNCTAD) suggests that "since developing countries continue to be mainly

14. The financial crisis and subsequent implementation of an Emergency Law in Argentina gave rise to a significant number of investor-state disputes.
15. UNCTAD 2005b, 3.
16. See for example Ethyl Corp. v. Government of Canada. 1999. *ILM* 38(3), 700–737 (award also available at www.dfait-maeci.gc.ca/tna-nac/disp/ethyl_archive-en.asp); Glamis Gold Ltd. v. United States of America (case pending, preliminary documents available at www.state.gov/s/l/c10986.htm); Metalclad Corp. v. United Mexican States. 2001. *ICSID Review* 16 (1): 165–202 (award also available at www.worldbank.org/icsid/cases/awards.htm); and S.D. Myers, Inc. v. Government of Canada. 2001. *ILM* 40 (6): 1408–1492 (award also available at www.dfait-maeci.gc.ca/tna-nac/disp/SDM_archive-en.asp).
17. See for example Baughen 2001; Gantz 2001; Guzman 1998; Mann 2001; and Peterson 2003.
18. Neumayer 2001a, 87; and Gray 2002, 311.
19. This case study is based on a variety of sources, including interviews conducted by the author in July and August 2005.

capital-importing countries, they are likely to bear the brunt of the potential increase in investor-State dispute settlement cases."[20] It also noted that these countries might have difficulty responding to an increased number of disputes. This section first explores some of the procedural aspects of investment arbitration that may disadvantage developing countries involved in disputes and create uncertainty for regulators. It then addresses the capacity of developing countries to defend their interests in investment arbitration.

Procedural Issues

Investor-state arbitration has its origin in private firm-to-firm dispute resolution, which is cloaked in confidentiality to protect commercial interests. Consequently, there are no requirements in international investment agreements or in any of the *ad hoc* or institutional dispute settlement mechanisms for investors to publicly signal their intention to launch a dispute. The ICSID secretariat does keep a registry of all cases filed under its rules which is published on the Internet and includes the names of the disputants, the date the case was registered and a short description of the dispute. The registry does not, however, indicate whether the case was brought in relation to a contract, consent to arbitration under a national law, or under the provisions of a BIT or regional treaty. The other institutional mechanisms, such as the ICC, do not have a public register and the *ad hoc* mechanisms such as UNCITRAL do not even keep track of arbitrations that make use of their rules.[21]

Proceedings of investment disputes are held *in camera* and non-disputant parties will not have access unless there is the consent of the disputant parties to open the proceedings. Once a ruling is made by a tribunal there is no requirement to publish the award. ICSID requires the consent of both parties to a dispute before a ruling will be published by the Secretariat (although either party may unilaterally publish it elsewhere), while under UNCITRAL the award may only be published with the consent of both the investor and the state.[22] As Blackaby succinctly summarises: "the current opacity occurs at various levels: first, the knowledge of the dispute's existence; secondly, the access to the process itself and finally the access to the resulting decision."[23]

The lack of transparency in investor-state arbitrations makes it impossible for there to be an accurate assessment of how many cases even exist, let alone to know their substantive content. Peterson suggests that there is a "legal iceberg" where an unknown proportion of cases remain hidden from view.[24] It may also create an information imbalance, which puts developing countries at a disadvantage. As Cosbey et al. note:

20. UNCTAD 2005a, 9.
21. Peterson 2005, 129–130.
22. Article 32(5) of the UNCITRAL Arbitration Rules.
23. Blackaby 2004.
24. Peterson 2005, 129.

> States or investors with the financial resources to hire major international law firms specializing in this area will enjoy greater entrée to this disparate body of arbitral decisions through the formal and informal links those firms maintain, than will many developing country counsel relying on scattered and incomplete sources.[25]

Blackaby refers to this network of international law firms as the "magic circle" and suggests that it is "not right that (they) should have a wider array of jurisprudence with which to fight their case."[26]

Closed proceedings may also upset the balance between the national and lower levels of government within a country. Often it is local authorities that make decisions concerning permits and licenses for commercial operations, and in many countries provincial or state level governments have a strong role in regulating public health and the environment. However, as a consequence of the limited access to dispute proceedings, state/provincial and local authorities are not able to fight their own battles and they may have concerns that the federal government is not accurately representing their interests.[27] Given that decentralization is occurring in one form or another in the majority of developing countries,[28] this issue could become increasingly important in future disputes.

Compounding the problems relating to the lack of transparency in investor-state disputes is the lack of consistency in arbitral decisions. The rulings of tribunals have no *stare decisis.* In other words, there is no system of precedent. As arbitrators do not have to base their decisions on those of previous tribunals, very different conclusions about the nature and meaning of (often vaguely worded) treaty provisions can emerge and tribunals may come to different conclusions about cases that are substantively similar. Although the majority of investment agreements promote closely related concepts, there are legal and textual variations, as Houde and Yannaca-Small note, which "could result in divergent interpretations of the same general obligation under different agreements."[29] Franck argues that this inconsistency creates uncertainty for both investors and states, contributing to a "looming legitimacy crisis" in investment arbitration.[30]

While a permanent appellate body could ensure consistency in tribunal decisions and provide some predictability for regulators, at present no such mechanism is available. The only remedies that can be sought under ICSID, for example, are the interpretation of the meaning or scope of an award, revision of an award based on the discovery of new information, or annulment of an award. An annulment is only possible in rather extreme circumstances, where there is evidence of any of the following with respect to the tribunal: it was not

25. Cosbey et al. 2004, 7.
26. Blackaby 2004.
27. Gaines 2002, 108.
28. See Larson and Ribot 2005.
29. Houde and Yannaca-Small 2004, 3.
30. Franck 2005, 1583.

properly constituted, it manifestly exceeded its powers, it was corrupt, it seriously departed from rules of procedure, or it failed to state the reasons on which the award was based. Furthermore, as Garcia points out, annulment committee members "are composed from essentially the same group of private lawyers and law professors (as tribunals), and are not required (nor even expected) to have any additional expertise or erudition in matters of international law or arbitration."[31]

While the confidentiality and inconsistency of investment arbitrations have been subject to increased scrutiny and critique in recent years, Garcia also highlights other procedural aspects which may be particularly relevant to developing countries. For example, he notes that there is a prevalence of the use of the English language in disputes:

> Where only one or even neither of the disputing parties, for example, has English as their native tongue, the parties will nevertheless default to English (and arbitrators who speak or at least understand English) as the most practical language in which to conduct proceedings. This predilection spreads even to the interpretation of the language of the BITs themselves as in some instances of treaties between Latin American and non-English speaking countries, English is added as a third official text and deemed to prevail in the event of a difference in interpretations between the versions of the languages of the contracting parties.[32]

He goes on to remark that the disproportionate numbers of investor-state arbitrators and lawyers hail from the United States, the United Kingdom, Australia, New Zealand, and Canada and,

> Even where the English language and Anglo-Saxon methods do not predominate, the president of the arbitral panel will likely hail from an OECD-member state in continental Europe, and may not be sensitive to or cognizant of the legal, economic, cultural, political, and commercial mores at work in the host state that are the necessary context to any evaluation of investor treatment.[33]

There are some signs of progress on certain procedural issues, particularly transparency. However, these are mainly confined to practice within Chapter 11 of the North American Free Trade Agreement (NAFTA). Since 2001, the NAFTA Free Trade Commission has issued several Statements and Notes of Interpretation which have provided for the publication of awards and have indicated the support of the NAFTA parties for open hearings.[34] Garcia notes, however, that this practice will not be easily extended (at least in any formal sense) outside of

31. Garcia 2004, 345.
32. Ibid, 362.
33. Ibid, 363.
34. NAFTA Free Trade Commission, Notes of Interpretation of Certain Chapter 11 Provisions, 31 July 2001; Statement of the Free Trade Commission on non-disputing party participation, 7 Oc-

NAFTA. This is because BITs have no provisions for making interpretations of the treaties and any amendment to this effect is "a remote, improbable scenario."[35] Newly negotiated BITs may take these issues into account, however; both the 2004 US Model BIT[36] and the Canadian Model Foreign Investment Protection Agreement[37] provide for the publication of awards and stipulate that hearings should be conducted in a manner that is open to the public. There have also been amendments to ICSID's Rules and Procedures which include changes to Rule 32 (The Oral Procedure), allowing tribunals to open hearings to non-parties to the dispute, subject to certain conditions (the most important being that neither party to the dispute objects).

There has been less progress, though some discussion, on the possibility of an appellate body. The 2004 US Model BIT contemplates the development or use of an existing appellate mechanism, and a 2004 discussion paper from the ICSID Secretariat[38] also considered the creation of an appeals facility. However, for the moment such a development is considered premature by the ICSID Secretariat, which will nevertheless continue to study this option.[39] With regard to the prevalence of Western-based arbitrators, an UNCTAD report has noted that "[p]erhaps more of an effort should be made to train arbitrators from developing countries."[40]

As a final note, it should be remarked that there are other procedural issues that have been given extensive attention in developed countries which may not be well received in developing countries. In particular, the notion of permitting *amicus curiae* ("friend of the court") submissions has been viewed with skepticism. In part, this is because such submissions may result in an increased burden on the parties to the dispute in terms of length and cost of the proceedings.[41] However, the South Centre, an intergovernmental body of developing countries, argues further that

> Permitting amicus submissions effectively disadvantages developing countries because the civil society and industrial organisations in the developed countries are more experienced, better organised and equipped as well as better funded.[42]

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tober 2003; NAFTA Free Trade Commission Joint Statement on the Decade of Achievement, 16 July 2004. Available at www.dfait-maeci.gc.ca/nafta-alena/celeb2-en.asp.

35. Garcia 2004, 349.
36. Many countries have taken up the practice of producing what is called a "model" or "prototype" BIT—a template used in negotiations. The current American model is available at www.state.gov/documents/organization/29030.doc.
37. Available at www.dfait-maeci.gc.ca/tna-nac/documents/2004-FIPA-model-en.pdf.
38. ICSID 2004, 14.
39. ICSID 2005, 4.
40. UNCTAD 2005a, 8.
41. Bennaim-Selvi 2005, 806.
42. South Centre 2005, 10.

1.2 Capacity Issues

There are two main factors to consider in terms of capacity: the cost of arbitration, and the technical capacity of developing countries to deal with an increasing number of disputes. In terms of cost, Garcia notes that while in any regime the parties would have to pay their own legal fees, in an investment arbitration they also must pay for the decision-makers (the arbitrators). Arbitrators in investment disputes are paid by the hour at rates proportionate to their reputations and experience as private lawyers or law professors. ICSID sets the "low-floor" rate (currently US$ 3000 per day[43]) but these can be topped-off, and in UNCITRAL arbitrations where fees are not prescribed they can also be higher. Garcia notes that:

> Arbitrators' allegiances are to their law firms. Their billing requirements make it impossible for them to approach a case in the same way a judge or other decision-makers do when they have no financial stake either in the existence of the claim itself nor in its prolonged duration . . . it cannot be denied that the BIT arbitral system, in paying its adjudicators by the hour and without any overall time limits, financially rewards the continuation and prolonging of proceedings. No enlightened domestic judicial system would tolerate such incentives which unavoidably (and perhaps unconsciously) favor the party advancing the claim.[44]

According to an UNCTAD report, companies have been known to spend up to US$ 4 million on lawyers' and arbitrators' fees for an investor-state dispute, and countries can expect an average tribunal to cost US$ 400,000 or more in addition to the US$ 1–2 million in legal fees.[45] It should be noted that it is possible for a tribunal to award all costs to one party in a dispute, though it is not required to do so. In the *Methanex* case, the tribunal placed the burden of the cost of arbitration, including the United States' legal costs, on the unsuccessful claimant.[46]

In terms of the technical capacity, Garcia comments that a "close observer from within the ICSID confirmed to me his own concerns that some of these respondents are not adequately arguing and preparing their defenses."[47] One possible reason for this is that the mode of litigation (which draws heavily from the common law tradition which is adversarial and gives an important role to oral hearing and cross examination) may be unfamiliar to lawyers from countries with different legal traditions. Furthermore, many lawyers may be handling an investor-state arbitration for the first time and may not even have litigation ex-

43. The schedule of fees is available at www.worldbank.org/icsid/schedule/fees.pdf.
44. Garcia 2004, 352.
45. UNCTAD 2005a, 7.
46. See the Final Award of the Tribunal on Jurisdiction and Merits in the Matter of an International Arbitration Under Chapter 11 of the North American Free Trade Agreement and the UNCITRAL Arbitration Rules Between Methanex Corporation and United States of America, Part V, available at www.state.gov/s/l/c5818.htm.
47. Garcia 2004, 364.

perience in their own countries. This lack of experience extends to witnesses, who are also unlikely to have had much previous involvement in legal cases.[48]

Peterson notes that "questions can be raised about the capacity of the poorest developing countries to defend against this type of specialized international arbitration, given the costs and uncertainty entailed by the process."[49] Efforts to remedy these capacity issues have thus far been limited. In 2005, UNCTAD launched a pilot course with "a view to equip especially developing country governments with the necessary capacity to manage investor-to-State disputes and to be able to mobilize the necessary expertise to assist in the proper conduct of such procedures."[50] The ICSID Secretariat has also cooperated with UNCTAD and organizations such as the International Development Law Organization in training programs for officials of developing countries.[51] The South Centre has recommended that the ICSID Secretariat should additionally consider the establishment of a fund for developing countries that could contribute to facility costs.[52] Wälde has suggested that there is a case to be made for legal aid (for poor governments as well as for "poor but legitimate" investors).[53]

2. Investor-State Disputes and the Environment

Investor-state disputes generally arise out of BITs, regional agreements such as NAFTA, or state contracts, which contain an arbitration clause (which invokes ICSID, UNCITRAL or other arbitration rules in the event of a dispute). The disputes themselves revolve around the claim of a breach of one or more of the other clauses found in these agreements. A distinction here is drawn between treaty and contract claims; however it should be noted that, depending on the scope of the treaty in question, a breach of contract may also constitute a breach of treaty in some instances.[54] With regard to the environment, the most important clauses found in investment treaties are standards of treatment (e.g. national treatment,[55] most favored nation treatment[56]) and prohibitions of expropriation. In state contracts there may be a stabilization clause to consider. This article will focus on the potential implications of expropriation and stabilization clauses for environmental regulation, as well as the question of compensation if a breach of contract or treaty is determined to have occurred.

48. Ibid.
49. Peterson 2004, 10.
50. Joubin-Bret 2005, 2.
51. ICSID 2004, 14.
52. South Centre 2005, 14.
53. Wälde 2004, 339.
54. See Reed et al. 2004; Schreuer 2004; Sornarajah 2004; and UNCTAD 2004.
55. Essentially, national treatment requires that countries not discriminate against foreign investors in favor of domestic ones. See UNCTAD 1999b.
56. This provision requires that a government not discriminate between foreign investors from different countries. See UNCTAD 1999a.

2.1 Expropriation

Historically, the direct taking of foreign property was one of the most significant risks to foreign investment, and usually came in the form of what is termed nationalization. Nationalization of foreign property involves the host government performing an outright taking of property in all economic sectors or on an industry-specific basis. In contrast to nationalization, expropriation involves takings targeted at specific properties and enterprises. According to most international investment agreements if three conditions are satisfied then an expropriation is lawful: the expropriation must be for a public purpose, must be nondiscriminatory, and must be compensated.

Outright takings are now considered rare in most parts of the world.[57] However, another form of taking, referred to as indirect expropriation, has become increasingly important. Indirect expropriations fall short of actual physical taking of property but result in the effective loss of management, use or control, or a significant depreciation of the value of the assets of a foreign investor.[58]

Indirect expropriation can be further divided into creeping expropriations and regulatory takings. Creeping expropriations involve the slow and incremental encroachment on the ownership rights of a foreign investor, leading to the devaluation of the investment. Regulatory takings are "those takings of property that fall within the police powers of a State, or otherwise arise from State measures like those pertaining to the regulation of the environment, health, morals, culture or economy of a host country."[59]

There is no comprehensive definition of what constitutes a regulatory taking and "[m]any commentators and arbitral tribunals have posited that a determination as to the occurrence of an expropriation can only truly be undertaken on a case-by-case basis, in light of all attending circumstances".[60] However, there are two main criteria that arbitrators are likely to consider in evaluating a measure: its effect, i.e. the degree of interference with the property right (including interference with the investor's reasonable investment-backed expectations); and its purpose. In evaluating the degree of interference of a measure, tribunals will likely examine both the economic impact and the duration of the regulation. There is broad support for the notion that the economic impact should be "severe" or "substantial" for the measure to qualify as an expropriation, though the threshold for such standards is open to interpretation.[61] Furthermore, a measure that is permanent, or of long duration, is more likely to be considered an expropriation than one that is temporary in nature.

There have been several controversial investor-state disputes that have dealt with environmental measures. However, in the majority of these cases ex-

57. Although the recent events in Bolivia show that they have not completely disappeared.
58. UNCTAD 2000, 4.
59. Ibid, 12.
60. Fortier and Drymer 2004, 314.
61. OECD 2004, 10.

propriation was not determined by the tribunals to have occurred. A recent NAFTA tribunal in the *Methanex* case has adopted what Mann describes as a "modern regulatory approach to the police powers concept"[62] in deciding that

> As a matter of general international law, a non-discriminatory regulation for a public purpose which is enacted in accordance with due process and, which affects, inter alias, a foreign investor or investment is not deemed expropriatory and compensatory unless specific commitments had been given by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulation.[63]

The "specific commitments" that the decision refers to may include stabilization clauses, which will be discussed in the next section.

2.2 Stabilization

Stabilization clauses are found in state contracts[64] and are aimed at freezing the law relevant to the investment at the point that the contract is concluded, thus ensuring that any future changes in law will not be applied to the investment.[65] According to Wälde and N'Di, "stability of key investment conditions responsible for the economic and financial performance of the investment venture is at the heart of investor concern".[66] While stability of the fiscal regime is likely to be the primary interest of investors, the above authors also note that there are other issues for which it may be desirous for investors to negotiate a stabilization clause:

> Perhaps most relevant at the moment is the imposition of new environmental obligations by subsequent regulation or by an administrative/judicial ruling re-interpreting existing law on which, arguably, the investment decision may to some extent have been based.[67]

As Verhoosel points out, even if a stabilization clause does not explicitly refer to environmental regulation it could effectively cover it. For example, a stabilization of the fiscal regime could cover market-based environmental measures.[68]

Some authors have questioned the binding character of stabilization clauses, suggesting that a state cannot waive or limit its own sovereignty in such a manner. Sornarajah, for example, contends that stabilization clauses "may not serve as anything more than a comforter to the foreign investor, who may derive

62. Mann 2005, 6.
63. Final Award, Part IV, Chapter D, para 7. See note 53.
64. While some investment treaties may prohibit the retroactivity of legislation, none contain full stabilization clauses. See UNCTAD 2004, 27.
65. UNCTAD 2004, 26.
66. Wälde and N'Di 1996.
67. Ibid.
68. Verhoosel 1998, 457.

some security from the belief that there is a promise secured from the state not to apply its future legislation to the agreement."[69] However, despite the academic debate, tribunals have consistently upheld stabilization clauses.[70] It can be concluded that while a stabilization clause may not forestall a state from changing legislation, the breach of such a clause is likely to lead to a requirement to compensate the affected investor.

2.3 Compensation

If it is determined by a tribunal that a breach of contract or treaty has occurred, then compensation is the most likely remedy that will be awarded to the claimant. There is a long-standing international debate over compensation that generally falls on a North-South divide. Industrialized countries have long advocated the so-called Hull standard as a means to calculate compensation. It states (in its various incarnations) that compensation should be "prompt, adequate and effective." In contrast to this, the appropriate compensation doctrine often favored by developing countries suggests a more complex calculation which factors in other considerations, such as the past practices of the investor, the depletion of natural resources or environmental damage that has occurred as a result of the investment, and the economic situation of the country.[71] Despite the fact that developing countries have historically objected to the Hull standard and have vehemently denied that it represents customary international law, they have signed numerous BITs that contain obligations that are equally or even more demanding.

More recently there has been discussion over whether the purpose of a government's interference with an investment should also be taken into consideration in the determination of the value of compensation to be awarded. In *Compania del Desarrollo de Santa Elena S.A. v. Costa Rica*, a dispute brought under a US-Costa Rica BIT and resolved under ICSID rules, there was no disagreement over the fact that a (direct) expropriation had taken place (in 1978 the government expropriated a property that was intended for development as a tourist resort in order to expand a national park) or that it was for valid public purpose (the protection of biodiversity). However, the parties disagreed on the amount of compensation that was owed. Costa Rica argued that setting the amount of compensation too high would discourage states (particularly those in the developing world) from adopting environmental objectives, and also noted that when it made the expropriation it had acted in accordance with its obligations under multilateral environmental agreements. The tribunal did not accept Costa Rica's arguments and concluded that the standard of compensation could not be affected by the reasons for making the expropriation:

69. Sornarajah 2004, 408.
70. Verhoosel 1998, 456.
71. UNCTAD 2000, 14.

> Expropriatory environmental measures—no matter how laudable and beneficial to society as a whole—are in this respect, similar to any other expropriatory measures that a state may take in order to implement its policies: where property is expropriated, even for environmental purposes, whether domestic or international, the state's obligation to pay compensation remains.[72]

3. Investor-State Disputes and Regulatory Chill

In academic circles, discussion of the relationship between foreign direct investment and environmental policy has long been dominated by the debate surrounding the pollution haven hypothesis and the related concept of the race to the bottom. According to Neumayer, "A country provides a pollution haven if it sets its environmental standards below the socially efficient level or fails to enforce its standards in order to attract foreign investment from countries with higher standards or countries that better enforce their standards."[73] As Porter indicates, the result is not as the term "race to the bottom" might imply (that standards literally fall to the bottom), but instead that standards are reduced to a suboptimal level and are therefore "inefficient for the entire system of jurisdictions in the sense of causing distortion in the allocation of resources."[74] These hypotheses have been generally difficult to prove, and research in this vein has been criticized on methodological grounds,[75] as well as the more general charge that it is an inadequate framing of the problem.[76]

In dismissing the value of continued research on pollution havens, several authors have directed attention to a potential new avenue for research on the relationship between investment and the environment. Neumayer argues that "what really matters is what policy makers believe, not what economic theory and evidence says, and there can be no doubt that they actually do believe that countries compete with each other".[77] The notion that regulators fear raising environmental standards beyond the status quo because they believe it may deter new investment or cause industrial flight has been termed regulatory chill.[78] Neumayer suggests that regulatory chill is particularly relevant to the protection of the global commons, including biodiversity, because the potential cost of industrial flight, to be born solely by the host country, has to be balanced against the "dispersed" benefits of raising environmental standards.[79]

72. Final Award In the Matter of the Arbitration between Compania del Desarrollo de Santa Elena S.A. and the Republic of Costa Rica, ICSID Case No. ARB/96/1, 2000 *ILM* 39 (6), paragraph 72 (also available at www.worldbank.org/icsid/cases/awards.htm).
73. Neumayer 2001c, 148. For an overview of the pollution haven debate see the special issue of this journal—volume 2, issue 2—devoted to the topic.
74. Porter 1999, 136.
75. See Brunnermeier and Levinson 2004.
76. See Clapp 2002; and Strohm 2002.
77. Neumayer 2001b, 20–21.
78. Clapp and Dauvergne 2005, 169.
79. Neumayer 2001b, 3.

Several authors have extended the notion of regulatory chill to also encompass state concerns over investment arbitration, suggesting that the knowledge of existing disputes, and/or the potential threat of a future dispute may deter the development or implementation of regulations. According to Peterson, "practicing lawyers do admit that they hear rumours of investors applying informal pressure upon host states—while brandishing an investment treaty as a potential legal stick."[80] Schneiderman claims that "[a] public auto insurance plan, proposals for the plain packaging of cigarettes, and the cancellation of contracts to transfer public property into private hands (Toronto's Pearson Airport) all triggered threats of litigation under NAFTA."[81] Wälde, a strong advocate of investment arbitration and sometime arbitrator, has also noted that due to the high risks of litigation (for investors) "[t]he impact of the arbitration clause is . . . less in its actual use, as in its implicit threat to both parties".[82]

However, many question the logic of the regulatory chill hypothesis. Coe and Rubins point out that

> it assumes that regulators are aware of international law, but are they? On the one hand, it is likely that legislators often attempt to acquaint themselves with the international ramifications of contemplated measures likely to affect foreign enterprises. Indeed, with the unprecedented public awareness of investor-state arbitration and the recent burgeoning of the associated docket, regulators may be more conscious of the prospect of liability than ever before. Nevertheless, there is still no shortage of State action clearly uninformed by the dictates of international law.[83]

While Coe and Rubins are correct in assuming that many environmental regulators (particularly outside of the NAFTA region) would be unaware of the commitments made in international investment agreements and contracts (as these agreements are generally negotiated by separate ministries), this statement ignores the fact that regulators can be *made* aware of the relevant points of international investment law when it is in the interests of investors to do so. The second critique that Coe and Rubins make is that

> the regulatory chill thesis assumes that the prospect of having to pay compensation will cause States to forbear from taking action, despite compelling regulatory objectives. While the apprehension of international liability may prompt reflection and careful tailoring of means to ends, it seems less likely to cause abandonment of legislation *at the heart of a government's mandate.* Indeed, to the extent a government *has the machinery to defend such claims,* it *might well expect victory,* since expropriation claims often fail (emphasis added).[84]

80. Peterson 2005, 139.
81. Schneiderman 2001, 524.
82. Wälde 1998.
83. Coe and Rubins 2004, 599.
84. Ibid.

This statement seems to have been written with countries such as the United States and Canada in mind; these countries would have little difficulty in making compensation payments, and certainly possess the "machinery" to defend claims. As the above discussion has shown, it is a different story for developing countries. Furthermore, in poorer countries desperate for foreign investment, it is unlikely that environmental legislation will be "at the heart of a government's mandate." And finally, the statement that a government "might well expect victory" assumes an awareness of the investor-state jurisprudence, which is in contradiction to the earlier statement that regulators will most likely be unaware of the nuances of international law. This statement also fails to acknowledge that the jurisprudence on regulatory takings is small and inconsistent, which creates uncertainty rather than the confidence implied by the authors.

The next section will explore these issues in greater detail by examining a case involving a threat of arbitration made by several multinational mining corporations to the Indonesian government. This case has been categorized by some as an example of regulatory chill.[85]

4. Case Study: Mining in Protection Forests in Indonesia

4.1 Background

Mineral investment in Indonesia is organized under a contract-of-work (CoW) system. According to the Foreign Investment Law of 1967, "[f]oreign capital investment in the field of mining shall be based on a cooperation with the government on the basis of a contract-of-work or other form of agreement, in accordance with the prevailing regulations."[86] Following the promulgation of the Foreign Investment Law, the first CoW was signed in April 1967 between the Government of Indonesia and Freeport Indonesia Incorporated. It was the first foreign investment project approved by the New Order government. Soon after, in December 1967, the government promulgated the Basic Mining Law, which remains the foundation of mining law in the country to this day. The Basic Mining Law, following the spirit of the 1945 Constitution, stipulates that mineral deposits are controlled exclusively by the state. State and national mining companies are to conduct mining on the basis of mining authorizations and permits, while foreigners participate in the sector through CoWs, as stipulated in the Foreign Investment Law. The Basic Mining Law requires that the government consult Parliament before approving and signing a CoW.

In the early years of the CoW system (1967–1970), the majority of the content in the contracts was negotiated, but later a standardized text on terms pertaining to technical, legal and general matters was adopted.[87] However, peri-

85. Gross 2003.
86. Article 8, quoted in Hoed 1997, 119.
87. Hoed 1997, 122.

odic changes to laws and regulations on taxation and financial matters required adjustment to the standardized terms, resulting in several "generations" of contracts. Between 1967 and 1998, 236 CoWs were signed, the majority in the 4th generation (1985–1990) and 6th generation (1997). At the time of writing, the Indonesian government was in the process of drafting a new mining law which may radically change, or eliminate entirely, the CoW system.

A CoW specifies land rents, royalties and other payments to be made by the company to the government. In addition it describes the environmental obligations of the company although these are for the most part general statements which, according to Hamilton, "lack the specificity required to allow effective inspection and enforcement of their terms."[88] With regard to the settlement of disputes, there are options for conciliation and arbitration under internationally accepted rules. In later generations the contracts specifically make reference to UNCITRAL Rules.

In addition to access to international dispute settlement, the CoW also has two critical elements for attracting investors: conjunctive title and *lex specialis.* Conjunctive title refers to the fact that if a commercial discovery is made, the CoW allows for the contractor to proceed from the initial stages of survey and exploration all the way through to exploitation and marketing. *Lex specialis* in this instance refers to the fact that the terms and conditions of a CoW are not subject to changes in the general laws and regulations of Indonesia: "the CoW, once approved by Parliament, has the status of law. Therefore in the case of conflict between the law and regulations of Indonesia and the CoW, the CoW supersedes."[89]

4.2 The Dispute

In 1999, the Government of Indonesia passed a number of reform laws, including an act on Forestry. Law no. 41 Year 1999 Stipulation to the Act on Forestry replaces Act no. 5 Year 1967 on Forestry Basic Law. Article 1 lays out the basic definitions of the Act, including the designation of various types of forest. These include: production forests, which are allocated mainly for the exploitation of forest products; protection forests, which have the chief function of protecting life-supporting systems for hydrology, preventing floods, controlling erosion etc.; and conservation forests, which are principally aimed at preserving plant and animal diversity.[90] Article 38(4) stipulates that that open-cast mining is prohibited in protection forests. The reason for this prohibition is that to expose and mine the ore in an open-cast design, it is generally necessary to excavate and relocate a large quantity of "waste rock." Two of the main environmental concerns of the construction of open-pit mines are the disruption of whatever eco-

88. Hamilton 2005, 38.
89. Barberis 1998, 47.
90. Articles 1.7–1.9. An unofficial translation of the law is available at www.fppm.org/KAJIAN%20KEBIJAKAN/Kaji%20PDF/law41_99.pdf.

system occurred where the mine was excavated, and the disposal of the waste rock. Other environmental impacts, applicable to any mine, are the building of roads, which require the clearance of land and result in changes to the hydrological functioning of the ecosystem, as well as the opening of access to the area to exploitation from other sectors. In Indonesia, increasing the accessibility of protection forests to illegal loggers is a major concern.

Prior to the entry into force of Forestry Law 1999/41, a number of CoWs had been signed covering areas of protection forests. In fact, over one hundred and fifty companies were supposedly affected by the ban on open-cast mining. At first the companies carried on with their activities as they presumed that the legislation would not be applied retroactively and that, in any case, the contracts were *lex specialis* and would, therefore, not be affected. The issue, however, was eventually brought to the attention of the public and was taken up by a number of nongovernmental organizations (NGOs). The Forestry department stopped issuing permits to mining companies in protection forests and all affected contracts were effectively suspended.

In 2002 reports began to emerge that several foreign mining companies were threatening to bring the Government of Indonesia before international arbitration on the matter of the Forestry Law. The NGOs involved in the debate declared that the threat of arbitration was without basis.[91] The following reasons were cited:

- All contracts state that companies must conform with the relevant environmental protection laws and regulations of Indonesia;
- The law only prohibits surface mining, whereas underground mining is still permitted;
- All the contracts in protected areas were signed during the period of authoritative government, and the Forestry Law was made under democratic rule;
- The preservation of protected areas is an issue of global concern with popular support;
- Indonesia is bound by international commitments including the provisions of the Convention on Biological Diversity,[92] and the Statement of Forest Principles and also participates in the United Nations Forum on Forests.

The issues raised by the NGOs are worth some further examination. The first point, that companies must comply with the relevant environmental laws of In-

91. WALHI (Friends of the Earth Indonesia) and JATAM (Mining Advocacy Network) released a press statement on 4 April 2002: "Mining Industry Threatens Indonesia with International Arbitration," available at www.jatam.org/english/case/conservation/uploaded/press_release_4_April_2002.pdf.

92. Togu Manrung, a professor at the Bogor Institute of Agriculture and director of Forest Watch Indonesia, has suggested that allowing mining in protected forests would specifically violate Articles 7 and 8 of the Convention. See "Open Pit Mines Endanger Lives, Nature," *The Jakarta Post*, 21 September 2002.

donesia, is accurate. For example, the CoW of Pt. Nusa Halmahera Minerals (Australia) states that the company shall:

> In accordance with the prevailing Environmental protection and natural preservation laws and regulations of Indonesia from time to time in effect, use its best efforts to conduct its operations under this Agreement so as to minimize and cope with harm to the Environment and utilize recognized modern Mining industry practices to protect natural resources against unnecessary damage, to minimize Pollution and harmful emissions into the Environment, to dispose of Waste in a manner consistent with good Waste disposal practices, and in general to provide for the health and safety of its employees and the local community.[93]

The use of the terminology "time to time in effect" suggests that investors should not expect regulations to remain frozen over the course of the contract. Sornarajah discusses a similar statement[94] found in Indonesian treaties:

> This is a complex provision as it gives rise to the impression that each state party to the treaty can regulate the extent of the protection of the treaty merely by changing its laws and regulation. If so, the question arises as to whether such an instrument can be described as creating a treaty obligation at all.[95]

Gross argues that the clear requirement of companies to comply with environmental regulations, combined with the absence of stabilization clauses in the CoWs, rules out the possibility that the companies could effectively argue that there was a breach of contract by Indonesia.[96] Additionally, according to a report in *The Jakarta Post*, a noted lawyer told legislators that they should not worry about being sued for breach of contract because the Forestry Law had been ratified by the House of Representatives (DPR) and any agreements signed between the government and investors could not violate Indonesian law.[97] However, the investors argued that this conclusion failed to take into account the fact that CoWs also have the status of law in Indonesia.

Whether the companies could have also claimed expropriation under BITs, such as the UK-Indonesia BIT or the Australia-Indonesia BIT, or regional agreements such as the 1987 Association of South-East Asian Nations (ASEAN) Agreement for the Promotion and Protection of Investments, is another question. Gross has analyzed the various options and has concluded that: "the Gov-

93. Article 26. It should be noted that CoWs are not, in general, public documents, although model CoWs have been published. A copy of this specific CoW was obtained from an NGO in Jakarta. Several other CoWs were also retrieved by the author from company filings to the Securities and Exchange Commission, which are available online at pro-edgar-online.com.
94. The provision is worded "made in accordance with the laws and regulations from time to time in existence, within their states."
95. Sornarajah 2003, 182.
96. Gross 2003, 896.
97. "House Urged to Challenge Mining Ruling," *The Jakarta Post*, 2 July 2004.

ernment of Indonesia could have likely beaten the mining companies' claims at a preliminary/jurisdictional phase, and certainly on the merits."[98]

If the companies were to argue that the Forestry law was a breach of treaty, then the second point in the NGO statement (that only one method of mining—surface mining—is banned) would likely be a key point for debate on whether the ban meets the requirement of an indirect expropriation. The mining companies reject the notion that alternatives to open-cast mining exist, arguing that underground mining operations are not feasible because more than ninety percent of Indonesia's mineral potential is found in the top soil layer (around 0–50 meters).[99] Thus, to companies a ban on open-cast mining is effectively a complete prohibition on all mining activities and thus a clear case of an expropriation of their investments. If the case had gone to arbitration the companies would have also likely argued against the public purpose of the ban. As the forests in question are classified as protection rather than conservation forests, the mining companies argue that the issue of biodiversity conservation is not relevant.[100] However, Dr. Hariadi Kartodiharjo, a lecturer at the Bogor Agricultural Institute, suggests that regardless of how the areas have been classified, mining in protection forests will result in permanent devastation of the environment, a raised threat of extinction of rare species, and a decrease in water supply to the Barito River and millions of people living along the riverbank.[101]

The third point in the NGO statement (that the contracts were signed under a period of authoritarian rule) is rather beyond the scope of this article. It is an issue, however, that has been considered by others. Sornarajah notes:

> It is an interesting point as to whether international lawyers who promote the norm of democracy would concede that concessions and other foreign investment agreements signed by dictators or unrepresentative governments should be considered invalid. It is possible to argue that the norm of self-determination, now having acquired a near *ius cogens* status would invalidate concession agreements signed by unrepresentative rulers.[102]

In this instance it seems unlikely that any arbitration panel would consider this issue, as government officials have consistently stated that contracts signed under the New Order regime would be honored.[103]

Finally, it is questionable whether the last two points in the NGO statement, relating to forest preservation as an issue of global concern and the obli-

98. Gross 2003, 901.
99. "Minister of Forestry Ready to Implement DPR Decision on Mining," *MiningIndo,* 1 September 2003.
100. "IMA Responds to NGOs and Mining in Forestry Critics," *MiningIndo,* 30 July 2003.
101. "Government Warned of Catastrophe from Mining in Protected Forests," *MiningIndo,* 8 March 2004.
102. Sornarajah 2004, 42.
103. Freeport McMoran Copper & Gold Inc. Form S-3 (Securities Registration Statement, simplified form). Filed 11/4/2001. Washington, D.C.: Securities and Exchange Commission. Available at pro-edgar-online.com.

gations of the government under multilateral environmental agreements, would have any influence on an arbitral tribunal, given the conclusions drawn in the *Santa Elena* case.

In any event, discussion of how a tribunal would deal with this case will remain hypothetical. In 2002 the Government of Indonesia produced a list of twenty-two companies with CoWs signed prior to the promulgation of Forestry Law 1999/41 that they recommended be given approval to operate in protected forests. How this list was devised from the original one hundred and fifty or so affected companies is not clear. Furthermore, the list did not remain constant over time; with half of the companies being removed (due to gloomy business prospects) and a further eleven being added, leading State Minister for the Environment Nabiel Makarim to ask "whether twenty-two was a sacred number."[104] In November of 2003, it was reported that thirteen "prioritized" companies from the list of twenty-two would be allowed to continue operations with the issuance of a Presidential Decree, but the actual issuance of the decree was put off until a later date.[105] These companies were prioritized because their operations were seen to be economically viable. The nine companies on the original list of twenty-two that were not included on the prioritized list of thirteen were reported to have made continued threats to sue the government. In March 2004, Paul Louis Coutrier, an executive of the Indonesian Mining Association, was quoted as stating that the nine companies had strong grounds to file a lawsuit, though he hoped that the dispute would be settled out of court.[106] The threat was particularly strong from PT Inco (Canada), but this company was later confirmed to in fact be on the prioritized list of thirteen.

On 11 March 2004, Perpu (government regulation substituting a law) no. 1/2004 was issued by the Government of Indonesia to add a new provision to the 1999 Forestry Law stating: "All permits or contracts in mining in forest areas which were issued before the promulgation of Law 41 of 1999 on Forestry are declared to remain valid until the expiration date of the respective permit or contract."[107] It also stated that further implementation of the Perpu would be determined by Presidential Decree.[108] The Constitution of 1945 provides that a Perpu should be utilized only in "a pressing matter of utmost urgency." This type of measure had only been used once before by the Megawati administration, following the 2002 Bali terrorist bombings.[109] Many environmental groups questioned the "utmost urgency" of the mining issue, but also pointed out that the Perpu did not actually change the position of the companies, whose contracts had never been declared invalid.

104. "Government Questioned Over Mining In Protected Forest," *The Jakarta Post,* 19 July 2003.
105. "13 Mining Sites get Forest Status Changed," *MiningIndo,* 6 November 2003.
106. "Mining Firms Threaten to Sue Indonesian Government," *Bisnis Indonesia,* 12 March 2004.
107. "Indonesian Forestry Issue Resolved," Weda Bay Minerals News Release, 17 March 2004.
108. "Mining in Protected Forests—Government Gives Way to Mining Industry Pressure," *Down to Earth* No. 61, May 2004.
109. "Nickel Miner to Sue Indonesian Government," *Asia Times,* 17 March 2004.

The Presidential Decree (no. 41/2004) issued in May was more specific and named the thirteen companies that would be allowed to continue operations in protection forests. The Decree also stated that the operations would be further regulated under a separate decree to be issued by the Ministry of Forestry. Immediately following the issuance of the Presidential Decree, a group of NGOs issued a statement that they would bring the Perpu, which had not yet been approved by Parliament, before the Constitutional Court for Judicial Review. Following the development of a special commission and much deliberation, the DPR finally voted on the Perpu in July. Initially it appeared that the emergency law would be rejected,[110] and the NGOs were confident that they "had the numbers" needed to defeat it.[111] However, the Perpu was passed into law (Law no. 19/2004) by a vote of 131 to 102[112] amidst allegations of corruption. NGOs reported that they had been informed that the government would provide Rp1 billion for every faction in the national parliament that voted to allow the mining operations to go ahead. These allegations were corroborated by several members of Parliament who came forward claiming to have been offered bribes. The money for the bribes was allegedly solicited from the mining companies by the Department of Mines.[113].

In late September 2004, the Ministry of Forestry issued its Ministerial Decree (no. 12/2004), outlining restrictions on the operations of companies permitted in protection forests. According to a spokesperson for the Ministry: "The decree is designed to limit the potential destruction caused by mining operations on natural forests and the environment."[114] Included in the decree was a requirement for companies to pay a bond to cover the costs of rehabilitating areas following mine closures, and also to provide alternate areas of land for reforestation.

In 2005, in what appeared to be the last hurdle for the government, the Constitutional Court conducted its review of Perpu no.1/2004 and Law 19/2004. The Minister of Forests was reported to have stated that he would be happy if the Court annulled the law,[115] however, it did not. Instead the judges concluded that:

> Although this Court shares the opinion of all the experts brought by the appellants regarding the dangerousness and negative impacts of open pit min-

110. Irwan Prayitno, Speaker of the Commission VIII of the DPR, was reported to state that if the Perpu was passed to the DPR it would be rejected ("DPR to Decline Approval of Mining in Protected Forest," *MiningIndo,* 20 April 2004).
111. Author's confidential interviews with nongovernmental representatives (#1 and #7), Jakarta, July 2005.
112. "Disputed Mining Bill Endorsed," *The Jakarta Post,* 16 July 2004.
113. "NGOs Allege Bribery in Indonesian Government Bid to Allow Mining Permits to Resume in Protected Forest," *MiningIndo,* 13 November 2002; "Lawmakers Smell Fishy Deal behind Mining Regulation," *The Jakarta Post,* 24 July 2004; and the author's confidential interview with a foreign embassy official (#4), Jakarta, July 2005.
114. "Forestry Ministry Soften Stance on Mining," *MiningIndo,* 1 October 2004.
115. "Constitution Court to Conduct Judicial Review over Mining in Protected Forest," *MiningIndo,* 17 February 2005.

> ing in protected forests, nevertheless this Court also understands the reasoning for the need for transitional regulation which continues the legal status or rights gained by mining companies before the advent of the Forestry Law.[116]

4.3 Analysis

Some might view the Indonesian case as nothing more than further proof, as Tan puts it, that "the institutional governance of natural resources and the environment in Indonesia continues to be fractured, with problems of corruption and lack of coordination becoming ever more pronounced than during the Suharto era."[117] But others suggest that it also provides evidence supporting the regulatory chill hypothesis.[118] The chilling effect is likely the result of a number of factors.

First of all, the desire to maintain existing mineral investments and attract further ones was clearly a factor in the government's decision to issue the Perpu. Indonesia's mining sector ranked twenty-seventh out of thirty-five countries assessed for "attractiveness" in a 2001/2002 industry survey.[119] The low attractiveness ranking is not based on resources, which are in abundance, but rather due to problems in the "investment climate."[120] An ASEAN report concluded that:

> The conflict between provisions of the Forestry Law of 1999 and the mining industry has probably created more uncertainty for investors in Indonesia's mining sector than any other legal or regulatory provision and is one of the key reasons for the decline in investment activity in recent years.[121]

Another likely factor in the government's decision was the informal pressure applied by the home governments of the investors through their embassies.[122] Finally, there is significant evidence to suggest that the threat of international arbitration played an important role in the government's decision. According to several observers, the government had been "burned" in previous arbitrations and was not eager to try their luck again.[123] *The Jakarta Post* noted:

> Government officials have often cited a case in which the Geneva Arbitration Court ordered state oil and gas company Pertamina to pay US$261 million

116. Conclusions of the Judgement of the Constitutional Court pp. 413–414 quoted in a Press Release of the NGO Forum for Protected Forests "Constitutional Court Rules no to BHP et al. in Indon Protected Forests," 8 July 2005.
117. Tan 2004, 178.
118. Gross 2003.
119. "Indonesian Government can't Bury Mining Conflicts," *Asia Times,* 10 January 2004.
120. See the report "Mine Indonesia 2004: Review of trends in the Indonesian Mining Industry," PricewaterhouseCoopers, Jakarta.
121. Mélanie et al. 2005, 13.
122. See for example: "Indonesia: Mining and Forestry (Question No.1662)," Australian Senate Official Hansard, No. 11, 2003, 15356–57, available at parlinfoweb.aph.gov.au.
123. Author's confidential interviews with foreign embassy officials (#4, #10), a nongovernmental representative (#7), and a mining investor (#9), Jakarta, July 2005.

> in compensation to Karaha Bodas Co., which was owned by several U.S. investors for canceling its geothermal power project in Garut, West Java.[124]

Gross suggests several elements that connect the threat of arbitration to the government's decision:

> The unprecedented speed at which the government took action on the issue after two years of inaction in the face of mining company complaints regarding the law; the exact coincidence between the companies listed in the article reporting the threat and those which had been granted relief or which will be soon; and the timing of the reversal all weigh heavily toward the conclusion that the threat plays a significant role in the process.[125]

The need to avoid arbitration was also mentioned by the Parliament in their discussions on the issue and by the judges in the Constitutional Court decision.[126] Furthermore, the fact that the government is now trying to move away from the CoW system, and is specifically trying to remove the recourse to international arbitration in future arrangements with mining companies,[127] suggests that the threat of a dispute was a serious concern of the administration (although this shift is also likely connected to efforts to decentralize the governance of mineral resources).

The lack of available funds to pay compensation contributed to the desire to avoid arbitration. The government reportedly received legal advice that it could be sued for up to US$ 31 billion.[128] The Minister for Environment at the time, Nabiel Makarim, stated that the decision to issue the licenses for thirteen companies was "hard luck"[129] and only taken to avoid paying compensation for which funds were not available.[130] The desire to avoid arbitration can also be linked to the desire to improve the general investment climate, as mentioned above, as involvement in a dispute may not bode well for the investor-friendly image a government is trying to attain.[131]

The Ministries of Environment and Forestry remain disappointed with the decision of the government to issue the Perpu.[132] Furthermore, while the Minister of Environment has been quoted as stating that no more licenses (beyond the thirteen) should be issued, there is certainly potential for further threats of arbitration. In fact, by singling out thirteen companies the government has actually made the case of other companies far stronger as they could now also claim

124. "House Urged to Challenge Mining Ruling," *Jakarta Post,* 2 July 2004.
125. Gross 2003, 895.
126. Author's confidential interview with a nongovernmental representative (#7), Jakarta, July 2005.
127. Author's confidential interviews with foreign embassy officials (#4, #10), a nongovernmental representative (#7), and a mining investor (#9), Jakarta, July 2005.
128. "Indonesian Government can't bury Mining Conflicts," *Asia Times,* 10 January 2004. Other analysts have estimated the potential costs and compensation payments closer to $22.8 billion.
129. "No More Mining Permits in Protected Forests," *MiningIndo,* 16 March 2004.
130. "State Minister for Environment: Issuing Mining Licenses for 13 Companies was a Mistake," *Tempo Interactive,* 15 March 2004.
131. Reed et al. 2004, 9.
132. Author's confidential interviews with government officials (#18 and #19), Jakarta, August 2005.

discriminatory treatment.[133] Furthermore, the additional requirements imposed on companies operating in protection forests included in the Ministerial Decree issued in late 2004 may also be subject to challenge. The current chair of the Indonesian Mining Association, Jeffrey Mulyono, was recently reported to be particularly upset with the requirement that mining firms operating in protection forests would have to provide a "compensatory site" twice as large as the mining concession. According to Mulyono, the requirements will cause unnecessary problems for mining firms and could deter future investment in the sector.[134] An Inco report to the US Securities and Exchange Commission also alludes to this issue:

> While PT Inco continues to believe that the terms of its Contract of Work provide it with all authorizations needed to conduct mining activities in the areas covered by its Contract of Work and any disputes relating to its Contract of Work are subject to arbitration under international conventions, if the Forestry Regulation restricts PT Inco's ability to mine in certain areas, it could reduce PT Inco's estimated ore reserves and adversely affect PT Inco's long-term mining plans.[135]

Conclusions

The uncertainty created by the current framework for investor-state dispute settlement, coupled with the high cost associated with arbitration proceedings, can leave governments in developing countries in a precarious position. When faced with a decision on whether to risk millions of dollars for an unknown outcome, many countries may opt instead to retract, amend or fail to enforce an environmental regulation. This is illustrated in the Indonesian case, where the threat of arbitration clearly influenced the government decision to allow open-cast mining to proceed in protection forests.

The Indonesian case also demonstrates the importance of state contracts and mechanisms that stabilize regulations. While the regulation-expropriation debate has been extensively covered in the literature, particularly in relation to NAFTA cases, comparatively less attention has been given to the issue of stabilization.[136] If developing countries continue to provide stability of environmental

133. Author's confidential interviews with a nongovernmental representative (#7) and a mining investor (#9), Jakarta, July 2005.
134. "Mining Group Objects to New Forest Guidelines," *The Jakarta Post*, 31 May 2006.
135. Inco Limited. 2005. Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended June 30, 2005. Commission file number 1–1143. Washington, D.C.: Securities and Exchange Commission. Available at pro-edgar-online.com.
136. It is notable, however, that recently several NGOs have begun to investigate the issue, see the IIED briefing paper "Lifting the Lid on Foreign Investment Contracts: The Real Deal for Sustainable Development," available at www.iied.org/SM/CR/documents/Liftingthelid_000.pdf, and Amnesty International's 2005 Report "Contracting Out of Human Rights: The Chad-Cameroon Pipeline Project," available at web.amnesty.org/library/Index/engpol340122005.

regulations to attract investors, then we may see the persistence of the status quo, and as Clapp rightly points out:

> If the status quo is as stringent as environmental regulations are going to get, then the effect will be an entrenchment of poor quality regulations, and the entrenchment of differences in the stringency of those regulations between rich and poor countries.[137]

Reforming the procedures in investment arbitration mechanisms would not necessarily eliminate the concerns raised in this article about stabilization and expropriation clauses. However if, as many commentators suggest, it is only possible to define these substantive requirements on a case-by-case basis, then at the very least regulators should have complete access to tribunal decisions. Furthermore, if procedural reform, for example through the creation of appeals procedures, can lead to a more consistent and clear interpretation of these substantive provisions, then this will not only increase the predictability for regulators, but may also in turn lessen the potential for companies to effectively wield the threat of arbitration when they lack the grounds for a case.

The capacity issues that may position developing countries at a disadvantage in disputes, compared both with investor claimants and with developed countries involved in similar disputes, are less often discussed and are also not as easy to address through procedural reforms. In the absence of any complete overhaul of the investor-state dispute settlement system, it seems reasonable to turn to consideration of what can be achieved externally to this system in terms of assisting developing countries with targeted capacity building and financial aid.

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137. Clapp 2002, 17.

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