

TO THE DEPARTMENT FOR BUSINESS INNOVATION AND SKILLS:

COSTS AND BENEFITS OF AN EU-USA INVESTMENT PROTECTION TREATY

Version: April 2013

On behalf of LSE Enterprise:

LAUGE N. SKOVGAARD POULSEN
UNIVERSITY OF OXFORD

JONATHAN BONNITCHA
LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

JASON WEBB YACKEE
UNIVERSITY OF WISCONSIN

INTRODUCTION

This report assesses the likely costs and benefits for the United Kingdom (UK) of an investment protection chapter in a proposed free trade agreement between the European Union (EU) and the United States (US). Our assessment throughout is based on the approach articulated in our Analytical Framework report, which provides the basic structure for this report as well as identifying more specific questions that inform our analysis. We assume that readers will have read the Analytical Framework report before turning to this document. We follow the same organizational scheme as in our EU-China report, and where appropriate we refer in this report to discussions or points in the EU-China report. Unless the context indicates otherwise we also refer to investment chapters in a larger free trade agreement, when we use the terms “investment treaties” or “BITs”.

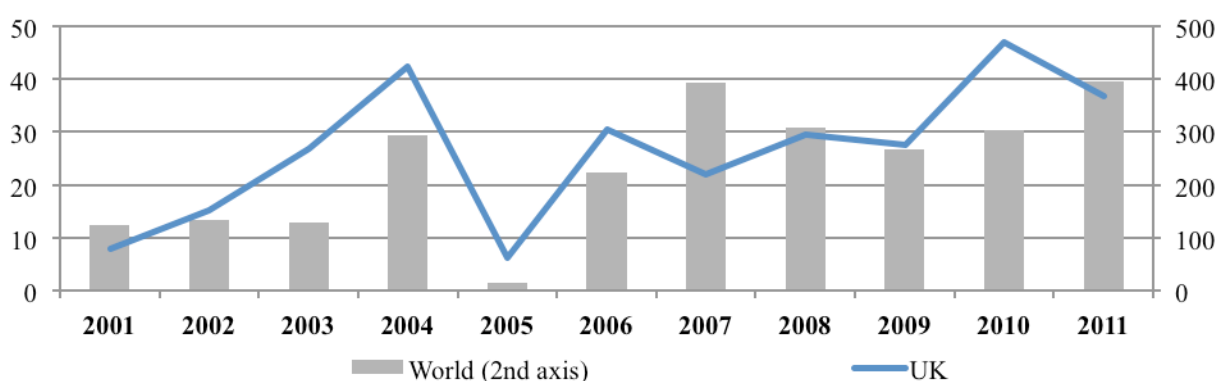
1. UK-US INVESTMENT RELATIONS

In this section we provide a brief overview of the UK-US investment relationship, focusing on the amount and composition of investment between the two countries. As in the EU-China report, two caveats should be mentioned before proceeding. First of all, much of the available data focuses specifically on foreign direct investment (FDI). This is important, as investment treaties typically cover both direct *and* portfolio investment, and the costs and benefits of an investment treaty will flow from its coverage of both kinds of investment. Secondly, FDI statistics typically do not offer information on the original source of inward FDI or the ultimate destination of outward FDI. If a foreign investor routes its investment from the ‘home’ state to the ‘host’ state via a subsidiary incorporated in a third state (perhaps for tax purposes) this investment would show up twice in FDI data, both as an investment of the home state in the third state and as an investment of the third state in the host state. It would not, however, show up in FDI data as an investment from the home state in the host state, making it difficult to determine how much FDI in a host state is indirectly owned by investors of the home state. This is an important point, since it would seem that a significant amount of both UK and US investment is routed through third states, such as the Cayman Islands.

US INVESTMENT IN THE UK

The US is the largest outward investor in the world, accounting for more than 23% of the world total in 2011. Figure 1, below, shows US FDI outflows from 2001 to 2011. After stagnating at about 130 billion USD in the aftermath of the bursting of the dot-com bubble, US investment abroad reached a new high in 2007 of almost 400 billion.¹ American appetite for outward investment decreased again as a result of the financial crisis after 2007; US outflows did not bounce back to pre-crisis levels until 2011. Not shown here is outward US FDI stock, which reached 4.2 trillion USD in 2011.

The vast majority of US overseas investment goes to developed countries, and among these the UK is the most important destination. In 2011, more than 9% of all US FDI flows – almost 40 billion - went to the UK and the year before the figure was more than 15%.

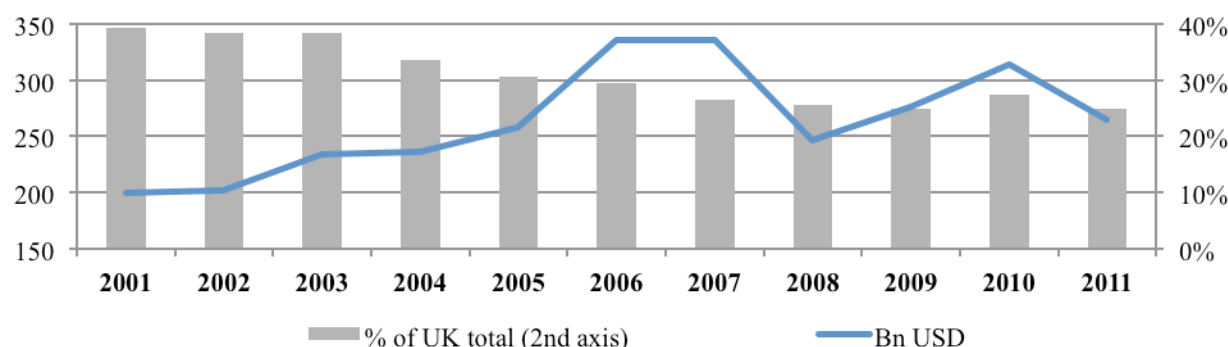


Source: OECD

FIGURE 1. US OUTWARD FDI FLOWS, 2001-2011, BN. USD

For the UK, American investment is also by far the most important source of FDI. Figure 2, below, shows that US FDI stock in the UK account for more than a quarter of a trillion dollars in 2011, down from 335 billion USD before the crisis. And while the US has gradually decreased in importance for the UK as a source of FDI over the last decade, one quarter of all FDI in the UK still comes from the US.

¹ The dip in 2005 was due to the Homeland Investment Act, which created a one-year tax incentive for repatriation and led to considerable withdrawal of retained earnings from US foreign affiliates that year.



Source: OECD

FIGURE 2. INWARD FDI POSITION WITH US, 2001-2011

The exact distribution of the investment stock is uncertain, as almost one third of all US investment in the UK has gone through holding companies – most likely for tax reasons – and the industry in which the holding company’s subsidiary operates is not registered.² US investors in some industries may well make greater use of offshore holding companies than others – for example, much of outward US manufacturing FDI is channelled through holding companies.³ Yet, it seems safe to say that the bulk of US investments in the UK go to the financial industry. According to ONS data it is one third (Table 1). Information and communication investments are also considerable (15%) and so is investment across the manufacturing sector. The key point for our purposes, however, is to highlight the sheer depth and breadth of US investments in the UK. All top 100 of Fortune 500 firms have operations in the UK,⁴ and American investors own or control assets in practically all industries in the UK ranging from billion pound investments in mining and quarrying to high-tech financial and other services.

² US Department of Commerce’s Bureau of Economic Analysis, Balance of Payments and Direct Investment Statistics. Available at: www.bea.gov/international.

³ Whichard 2008, 27-28.

⁴ US Department of State, *Investment Climate Statement 2013 – United Kingdom*. Available at: www.state.gov. (The “Fortune 500” is a list of the largest US corporations, published by Fortune Magazine.)

	Billions GBP	% of total
Agriculture, forest & fishing	..	..
Mining & quarrying	5.5	3%
Food products, beverages & tobacco products	19.5	10%
Textiles & wood activities	1.0	0%
Petroleum, chemicals, pharmaceuticals, rubber, plastic products	5.3	3%
Metal and machinery products	5.8	3%
Computer, electronic & optical products	0.1	0%
Transport equipment	8.5	4%
Other manufacturing	3.3	2%
Electricity, gas, water & waste	..	..
Construction	0.1	0%
Retails & wholesale trade, repair of motor vehicles & motor cycles	10.6	5%
Transportation & storage	1.8	1%
Information and communication	30.0	15%
Financial services	68.1	33%
Professional, scientific & technical services	3.8	2%
Administrative and support service activities	3.8	2%
Other services	7.2	4%

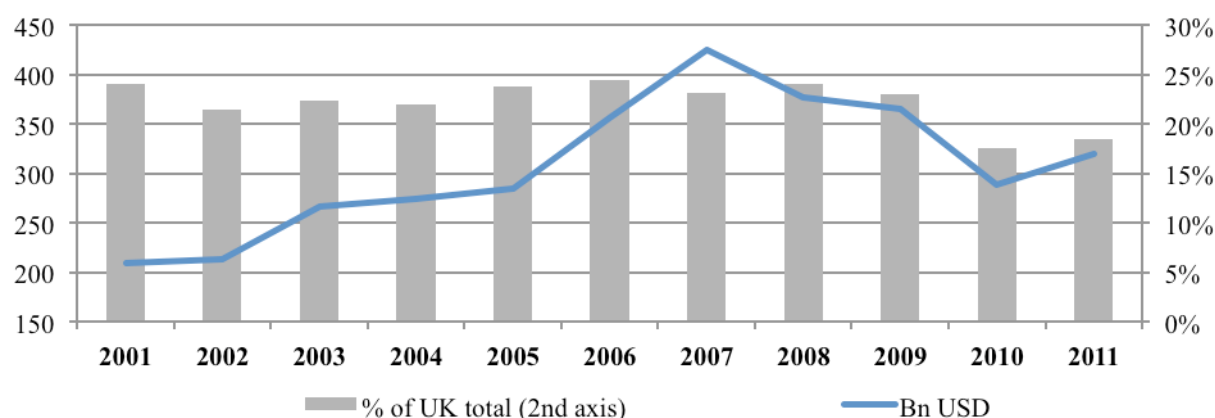
Notes: Percentages do not sum to 100 due to missing data.

Source: ONS

TABLE 1. US FDI POSITION IN UK BY INDUSTRY, ONS DATA, 2011

UK INVESTMENTS IN THE US

With over 300 billion USD invested, UK investors are the largest foreign direct investors in the US. The US is also the most important destination of UK overseas investment, accounting for 18% of all UK outward FDI stock (Figure 3). Before the crisis, almost 1 in 4 pounds leaving the UK as direct investment went to the US, and after bottoming out in 2010 investments to the US have been growing in importance once again - both in absolute values as well as shares of total outward FDI stock from the UK.



Source: OECD

FIGURE 3. OUTWARD FDI POSITION WITH US, 2001-2011

As with US investments in the UK, the bulk of British investment in the US is in financial services – 30% according to ONS data (table 2). Manufacturing is important as well. With more than 25 billion GBP investments in chemicals manufacturing, this industry sector takes up 12% of the UK investment stock in the US. Mining and quarrying accounts for 8%. The key point again is that UK investors are active in practically all areas of the US economy. British investors dominate foreign investment in several sectors ranging from petroleum, where BP together with Royal Dutch Shell account for the bulk of foreign investments in the US, to more than 60 billion GBP British investments in financial services and more than 40 billion GBP in manufacturing.

	Billion GBP	% of total
Agriculture, forest & fishing	..	..
Mining & quarrying	17,5	8%
Food products, beverages & tobacco products	5,9	3%
Textiles & wood activities	0,2	0%
Petroleum, chemicals, pharmaceuticals, rubber, plastic products	25,2	12%
Metal and machinery products	3,5	2%
Computer, electronic & optical products	..	..
Transport equipment	..	..
Other manufacturing	15,3	7%
Electricity, gas, water & waste	..	..
Construction	0,4	0%
Retails & wholesale trade, repair of motor vehicles & motor cycles	2,7	1%
Transportation & storage	3,8	2%
Information and communication	9,5	5%
Financial services	63,7	30%
Professional, scientific & technical services	3,3	2%
Administrative and support service activities	2,7	1%
Other services	9,5	5%

Notes: Percentages do not sum to 100 due to missing data.

Source: ONS

TABLE 2. UK FDI POSITION IN US BY INDUSTRY, ONS DATA, 2011

2. TREATY PROVISIONS: THE LIKELY CONTENT OF AN EU-US INVESTMENT TREATY

Since the beginning of its BIT program in the early 1980s, the US has negotiated its investment treaties on the basis of a detailed model text. Investment chapters in US FTAs generally follow the same model. Historically, the US has not been willing to deviate considerably from its model treaty.⁵ This means that successful investment treaty negotiations with the US have typically resulted in agreements almost exactly mirroring the US template. One notable exception is the investment chapter of the US-Australia FTA, which generally follows the US model BIT save that it does not provide consent to investor-state dispute settlement.

The US released its most recent model BIT in 2012, which is the intended basis for all current and future US BIT negotiations, including the ongoing US-China BIT negotiations.⁶ Given the US negotiating position in the past, it is very likely that Washington will insist that its 2012 model text provide the starting point for negotiations over an EU-US investment treaty. We also think it likely that the EU would accept the 2012 US model, or something close to it, as a starting point for negotiations. This assessment is based on our understanding that the proposed investment chapter in the EU-Canada Comprehensive Economic and Trade Agreement (CETA) reflects a US-style (or “NAFTA”) approach to investment protection. We therefore assume for the purposes of this Report that the text of an EU-US investment treaty would follow the CETA/2012 US Model BIT approach.

The US model BIT is considerably more detailed and more comprehensive than the existing BITs typical of EU Member States. Unlike EU Member State BITs, US BITs mandate national treatment (NT) and MFN treatment at both the pre-establishment and post-establishment phases. With the exception of Canadian BITs, the BITs of most other countries,

⁵ Vandevelde 2009, 108.

⁶ The 2012 US Model BIT can be found at www.state.gov/documents/organization/188371.pdf.

including the UK, do not address pre-establishment rights. The US model can thus be seen as requiring the liberalization of inward FDI policy in addition to investment protection. The US model BIT also includes typical post-establishment provisions, such as guarantees of the international “minimum standard of treatment” (art. 5), full compensation for expropriation (art. 6), and the right to free transfer of capital (art. 7). Finally, the US model contains comprehensive investor-state dispute settlement (ISDS) (Sec. B), which unlike the simple ISDS provisions in many European BITs specifies required ISDS procedures in significant detail, including mandatory “transparency” of arbitral proceedings (art. 29).

The comprehensive nature of the US model is evident in other provisions that go beyond the traditional core of favourable standards of treatment backed up by access to ISDS. For example, the US model bans many types of “performance requirements”, beyond what is already prohibited under the WTO TRIMs agreement (art. 8). It also encourages the implementation a US-style “notice and comment” system for the development and promulgation of investment-related administrative regulations (art. 11). And it contains provisions concerning the host state’s right to implement treaty-consistent measures to protect the environment (art. 12) and the desirability of not weakening domestic labour laws in order to attract investment (art. 13). These latter two articles are largely hortatory, however. The US model is also notable for its inclusion of various explanatory footnotes and annexes that attempt to clarify the meaning of otherwise vague or ambiguous treaty text. For example, the “minimum standard of treatment” is defined as equivalent to the “customary international law minimum standard of treatment of aliens” (Annex A).

Finally, the US model contains a number of exceptions designed to enhance the host state’s policy space. For example, Article 18 provides a self-judging “essential security” exception that allows the host state to apply otherwise treaty-inconsistent measures “that it considers necessary for the fulfilment of its obligations with respect to the maintenance or restoration of international peace and security, or the protection of its own essential security interests.” The self-judging nature of the essential security exception (“that it considers necessary”) means that the host state’s invocation and application of the exception will be difficult or perhaps

impossible for an investor to challenge in arbitration.⁷ Article 20 of the US model provides another exception, for prudential measures designed to ensure the “integrity and stability of the financial system.” Crucially, the investor’s right to challenge state decisions taken under this exception is subject to numerous important limitations drafted into the article’s text. Moreover, the US model limits the ability of investors to challenge “taxation measures” as treaty-inconsistent (art. 21).

As mentioned, we assume that an EU-US investment protection chapter will contain many of the provisions discussed above. From the perspective of the UK’s existing BITs, an EU-US investment chapter is thus likely to contain the familiar core of UK treaties (NT, MFN, minimum standard of treatment, expropriation, free-transfer of capital). It should also be clear that an EU-US investment chapter is likely to contain provisions that are relatively foreign to UK BIT practice. Those new provisions may be relevant to a cost-benefit analysis. For example, the various exceptions noted above (essential security, prudential financial regulation, taxation) may provide the host state with additional policy space beyond what would be available under a traditional UK BIT. Another example is that the transparency provisions relating to ISDS may provide the host state with additional policy costs in terms of increasing the chances for political controversy resulting from sensitive claims.

A key question for the cost-benefit assessment, of course, is whether the chapter will be backed up by comprehensive ISDS. While the US did agree to remove ISDS from the investment chapter of its 2004 FTA with Australia—at Australia’s request—we understand that several stakeholders in the EU and the US desire comprehensive ISDS.⁸ For our purposes, we assume that if negotiations are concluded, the investment protection chapter will indeed include comprehensive ISDS. Our cost-benefit assessment is conducted on this basis.

A cost-benefit assessment of an EU-US investment treaty that did not contain ISDS would look very different. Most of the potential benefits of an EU-US investment treaty that we

⁷ For an overview of these so-called “non-precluded measures” provisions, see Burke-White and von Staden 2008.

⁸ The US-Australia FTA, in addition to *not* including ISDS, also *does* include the various exceptions discussed above: essential security (art. 22.2); taxation (art. 22.3); prudential regulation of financial services (art. 13.10).

identify in this report – for example, its ability to promote investment in the UK by offering reliable legal protection against certain political risks to US investors, and its ability to depoliticise investment disputes between the US and the UK – stem from investors’ ability to enforce their rights under the treaty through ISDS. Similarly, most of the potential costs of an EU-US investment treaty that we identify in this report – notably, the economic and political costs associated with the risk of claims under the treaty – stem from investors’ ability to enforce their rights under the treaty through ISDS. Ultimately, we conclude that an EU-US investment treaty that *does* contain ISDS is likely to have few or no benefits to the UK, while having meaningful economic and political costs. Removing ISDS from the treaty would be unlikely to have an appreciable impact on the (already negligible) benefits of a treaty with ISDS, while largely removing the costs of the treaty to the UK. While we have not conducted a full cost-benefit assessment of an EU-US investment treaty *does not* contain ISDS, such a treaty would likely be a less costly policy option from the perspective of the UK.

A note on pre-establishment national treatment

Pre-establishment national treatment would obviously be relevant to any cost-benefit analysis of an investment chapter because of its liberalizing effects on investment flows. However, as instructed by BIS, we do not attempt to integrate an analysis of pre-establishment national treatment into our report. It should be noted, also, that the US and UK already provide pre-establishment national treatment in most economic sectors and for most activities as a matter of domestic law. The extent to which an EU-US investment treaty would provide liberalization over and above what the US and UK would anyway offer is uncertain at this point. Our analysis in this report thus examines only whether the inclusion of post-establishment investment protection provisions in an EU-US trade and investment agreement would result in net benefits for the UK. This analysis is relevant to determining whether the UK should support the inclusion of investment protection provisions in an EU-US agreement, regardless of whether the treaty includes investment liberalisation commitments.

Possibility to rely on an MFN clause

As we discussed in our China report, most BITs contain MFN clauses, and those clauses can be used to import more favourable standards of treatment into the investment treaty at issue.

US BITs routinely include MFN clauses, and it is likely that an EU-US investment chapter will include one as well. In our China report, we considered whether the MFN clause in the 1986 UK-China BIT would allow UK investors in China to access the more generous protections of China's more recent BITs. In the case of an EU-US investment chapter, two issues arise. The first is whether an MFN clause in the treaty would apply to ISDS; the second is whether an MFN clause would allow investors to invoke more favourable substantive provisions from other US or EU Member State treaties that do not contain the various exceptions and clarifications discussed above.

With respect to the first issue, we note the uncertainty about whether MFN clauses in other investment treaties apply to “procedural” provisions, like ISDS.⁹ We discussed this issue at some length in our China report. The issue is less relevant here, as we are assessing the costs and benefits of an EU-US investment treaty on the assumption that it would contain ISDS. (If the EU-US investment treaty did not contain ISDS, our overall assessment of costs and benefits would be very different. In these circumstances it would be important to make sure that the MFN clause was drafted carefully, so as not to override a conscious policy choice to exclude ISDS from the treaty.) In any case, unlike the MFN clauses of other investment treaties, the MFN clause of the 2012 Model BIT, which we assume would be incorporated in an EU-US investment treaty, does not apply to dispute settlement.¹⁰

With respect to the second issue, US BIT practice contains some examples of treaty-based limitations on the applicability of MFN clauses. For example, some US BITs include sectoral or subject matter exceptions to MFN treatment in an annex.¹¹ The US has also sometimes excluded from its MFN clause treaty provisions in *earlier* BITs ensuring that the MFN clause only applies to more favourable treatment provided in *later* BITs.¹² As Vandevelde points

⁹ For a detailed treatment, see Vandevelde 2010, 339-373.

¹⁰ Article 4, the MFN clause of the 2012 US Model BIT, applies only to the ‘establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments’. This list does not include dispute settlement. This clause differs from the MFN clauses of other treaties that apply to ‘all matters’, or to the ‘treatment’ of the investment in general.

¹¹ Vandevelde 2010, 348 (citing the US-Egypt BIT).

¹² Vandevelde 2010, 351.

out, this kind of exclusion allows the drafters of a later treaty to conclude a “weaker” treaty that is not then undermined by the free application of MFN principles as to earlier, “stronger” treaties.¹³ Our analysis in this report is based on the assumption that the MFN provision of an EU-US investment treaty would be drafted to exclude the application of MFN to early treaties. (The UK government should still be mindful of the fact that future EU investment treaties would expand the protection available to US investors in the UK, if they grant more generous rights to foreign investors than the EU-US treaty.)

The situation would be different if an MFN clause in the EU-US investment treaty were not drafted to exclude more favourable rights conferred on the investors of third states by earlier BITs. In these circumstances, UK investors in the US could invoke the more generous substantive rights contained in older US BITs. US investors in the UK could also invoke the more generous rights contained in any other EU investment treaties. Moreover, as we understand that the EU Member States would be parties to an EU-US investment treaty, an MFN clause would allow US investors in the UK to invoke rights granted to investors of third states in earlier UK BITs. These factors would significantly alter the costs and benefits of an EU-US treaty, as assessed in this report. In particular, a broadly drafted MFN clause would significantly increase the political and economic costs to the UK of an EU-US investment treaty, by allowing US investors in the UK to invoke the more generous and unqualified substantive rights found in older UK BITs.

Possibilities to rely on other investment treaties via corporate structuring

As discussed in our UK-China report, if investors of a home state seeking to invest in a host state route their investment via an intermediary incorporated in a third state the investment may be entitled to the protection of an investment treaty between the host state and the third state. From the outset, we emphasise that we are not aware of any evidence of US investors in the UK or UK investors in the US in structuring their investments via third states for the purpose of accessing the protection of existing investment treaties. This is not surprising, because, as we explain below, neither US investors in the UK nor UK investors in the US have expressed significant concerns about the sort of risks against which an investment treaty

¹³ Vandevelde 2010, 351.

might protect. Nevertheless, in cases where investors have specific concerns about future government measures it is conceivable that they could structure the investment with investment treaty implications in mind. For example, in the dispute between *Philip Morris Asia v Australia*, the Australian government has argued that the Philip Morris group structured its investment in Australia so as to bring its trademarks within the coverage of the Hong Kong-Australia BIT.¹⁴ Insofar as there is a possibility to structure investment between the US and the UK so as to bring it under the protection of existing investment treaties, this would have implications for our estimation of both the costs and the benefits of a US-EU investment protection chapter.

UK investors seeking to structure investments in the US so as to ensure the protection of an existing US investment treaty face two challenges. The first is that the US has included “denial of benefits” provisions in a number of its investment treaties and FTA investment chapters. According to a commentary on the 2012 US Model BIT, the main purpose of denial of benefits provisions is to provide “safeguards against the problem of treaty shopping through the creation of ‘sham’ enterprises.”¹⁵ For example, NAFTA Article 1113(2) allows the United States (and the other Parties to NAFTA) to:

deny the benefits [of NAFTA’s investment chapter] to an investor of another Party that is an enterprise of such Party and to investments of such investors if investors of a non-Party own or control the enterprise and the enterprise has no substantial business activities in the territory of the Party under whose law it is constituted or organized.

The term “substantial business activities” is not further defined. Equivalent denial of benefits provisions are included in the 2012 and 2004 US Model BITs (art. 17 in both cases), and in other non-NAFTA free trade agreements, including the United States-Central America-Dominican Republic FTA (CAFTA art. 10.12).¹⁶

¹⁴ *Philip Morris Asia v Australia*, Australia’s Response to the Notice of Arbitration, 21 December 2011 [4]-[6].

¹⁵ Caplan and Sharpe 2013, 812.

¹⁶ CAFTA’s denial of benefits provision was, in fact, recently successfully invoked by El Salvador to defeat jurisdiction in a claim filed by a US-based holding company that, in the Tribunal’s view, was only a “passive actor” in the US. *Pac Rim Cayman LLC v Republic of El Salvador* (ICSID Case No. ARB/09/12) (Decision on Jurisdiction).

A second difficulty for UK investors seeking to structure investments in the US so as to access the protection of an existing US investment treaty is that the US lacks investment treaties with states such as the Netherlands, Cayman Island and the Virgin Islands that are likely to be attractive for tax reasons. This is an important consideration as tax planning plays a far greater role in corporate structuring than concerns related to investment treaties. Similarly, while a US investor could invest in the UK via an intermediary incorporated in a country with which the US has an investment treaty, the UK lacks investment treaties with the states that are likely to be attractive to US investors for tax purposes.

In summary, we assume that an EU-US investment treaty will provide enforceable treaty protections to British and American investors, which they currently are unlikely to benefit from via corporate restructuring. Unlike an EU-China treaty, where existing BITs occasionally provide opportunities for obtaining similar protections, an agreement between the EU and the US would significantly change the international legal protections granted to British investors operating in the US and American investors operating in Britain. This will likely entail both costs and benefits to which we now turn.

3. ECONOMIC BENEFITS OF AN EU-US INVESTMENT TREATY

As described in our Analytic Framework report, an EU-US investment treaty may provide economic benefits to the UK in two main ways. First, the treaty might encourage US investors to make investments in the UK. Second, the treaty might benefit the UK economically by protecting UK investments in the US.

PROMOTION OF US INVESTMENT IN THE UK

As suggested in Box 1 of Analytic Framework report, the principal question here is whether American investors looking to invest in the UK are likely to factor in the existence of an EU-US investment protection treaty when deciding whether to invest in the UK. We find this unlikely.

First of all, the US government assesses the UK as a very safe place to invest, and advertises it as such to potential American investors. The following sections of the 2013 Investment Climate Statement by the US Department of State are worth quoting at length:¹⁷

Market entry: Market entry for U.S. firms is greatly facilitated by a common language, legal heritage, and similar business institutions and practices. Long-term political, economic, and regulatory stability, coupled with relatively low rates of taxation and inflation make the UK particularly attractive to foreign investors. ... U.S. companies have found that establishing a base in the UK is an effective means of accessing the European Single Market, and the abolition of most intra-European trade barriers enables UK-based firms to operate with relative freedom throughout the EU.

On discrimination: With a few exceptions, the UK does not discriminate between nationals and foreign individuals in the formation and operation of private companies. ... Once established in the UK, foreign-owned companies are treated no differently from UK firms. ... Local and foreign-owned companies are taxed alike. Inward investors may have access to certain EU and UK regional grants and incentives that are designed to attract industry to areas of high unemployment, but no tax concessions are granted. ... In all observable circumstances, foreign investors, employers, and market participants have been treated equally and benefit from government initiatives equally. There are no signs of increased protectionism against foreign investment, and none are expected. Recently, a Parliamentary committee opened an investigation into tax avoidance by multinational companies, including several major U.S. firms. However, foreign and UK firms remain subject to the same tax laws, and several UK firm have also been criticized for tax avoidance.

On repatriation: The British pound sterling is a free-floating currency with no restrictions on its transfer or conversion. There are no exchange controls restricting the transfer of funds associated with an investment into or out of the UK.

On expropriation: In the event of nationalization, the British government follows customary international law, providing prompt, adequate, and effective compensation.

On UK courts: International disputes are resolved through litigation in the UK Courts or by arbitration, mediation, or some other alternative dispute resolution (ADR) method. Over 10,000 disputes a year take place in London, many with an international dimension, reflecting its strong position as an international center for legal services.

¹⁷ US Department of State, *Investment Climate Statement 2013 – United Kingdom*. Available at: www.state.gov.

Further, apart from the increase in tax levies on North Sea oil and gas production in April 2011, which is criticized for not being pre-announced or consulted, the statement generally highlights the transparency and predictability of the UK regulatory system. All in all, the types of risks an investment protection chapter would cover are not considered present in the UK economy.

Secondly, there is no convincing evidence that *past* US treaties with investment protection clauses have had a tangible impact on US outward investment – even in far more risky jurisdictions than the UK. When American negotiators have met with developing countries in the past, they have always reminded them that despite the wide range of the US BIT model, concluding a BIT with the US would not necessarily result in an increase in US investment flows.¹⁸ And indeed, there is evidence supporting the view that US BITs do not reliably promote US outbound FDI. The most comprehensive study came out in 2012, showing that few American BITs or FTAs with investment protection chapters have had an impact on American investment patterns (Table 3). For those treaties that have had a measurable impact, it has been only marginal. Crucially, not a single investment treaty with a developed country – including Canada, Australia, Israel, and Singapore – has had an impact on US investment outflows.

This is important, as investment protection treaties have arguably been more likely to be considered by US firms compared to European firms.¹⁹ Apart from their legally binding liberalization provisions, the inclusive and open debates in Washington on investment protection treaties following the very public investment claims under NAFTA (see below) has led to a greater awareness of the treaties among US multinationals. This contrasts with Europe, where BITs have hardly ever been politicized until recently. Yet, irrespective of the greater awareness of investment treaties in the US, they do not appear to have played a considerable role in promoting American investment abroad.

¹⁸ Vandevelde 2009.

¹⁹ Poulsen 2010.

	Sustained positive effect on US FDI (annual increase in net US inflows)	No sustained effect on US FDI	Insufficient data
BITs	Bangladesh (USD 28 million) Honduras (USD 83 million) Trinidad & Tobago (USD 254 million) Turkey (USD 155 million)	Albania, Argentina, Azerbaijan, Bahrain, Bolivia, Bulgaria, Cameroon, Rep. of Congo, DR Congo, Croatia, Ecuador, Egypt, Estonia, Georgia, Grenada, Jamaica, Latvia, Mongolia, Morocco, Mozambique, Panama, Poland, Romania, Senegal, Sri Lanka, Tunisia, and Uruguay	Armenia, Czech Republic, Jordan, Kazakhstan, Kyrgyz Republic, Lithuania, Moldova, Serbia, Slovakia, and Ukraine
PTIAs	Morocco (USD 72 million)	Australia, Bahrain, Canada, Chile, El Salvador, Guatemala, Honduras, Israel, Mexico, Morocco, Nicaragua, Singapore	Jordan

Notes: Analyses regressed each country's net FDI inflows from the US on a one-year lag of net FDI inflows, a one-period pulse for the first full year after the agreement entered into effect and a dummy variable taking the value of one in each year the agreement has been in effect. Further details explained in source.

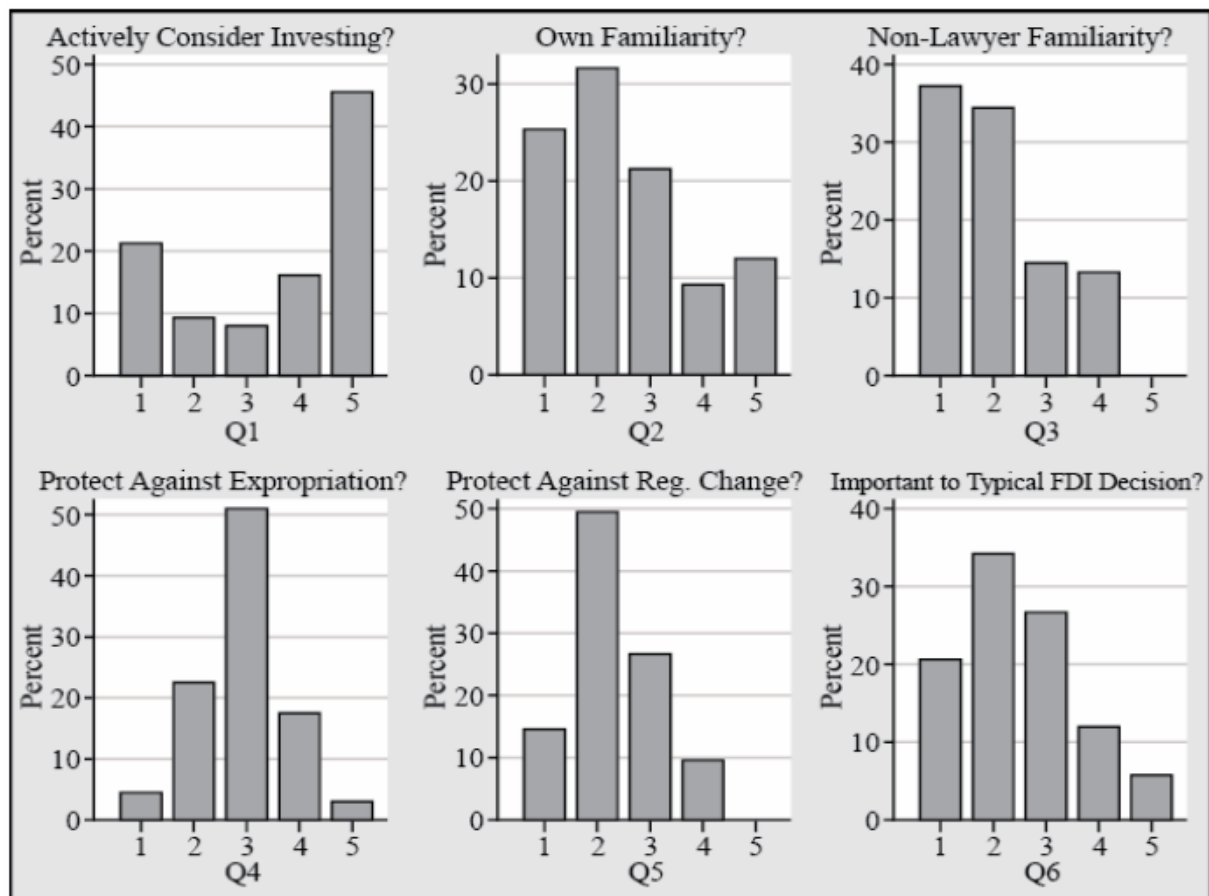
Source: Adapted from Peinhardt and Allee 2012.

TABLE 3. ESTIMATION OF INVESTMENT EFFECTS OF US BITs AND FTAs,
PEINHARDT AND ALLEE 2012.

It is important to note, as indeed we have done in earlier reports, that econometric impact studies of BITs have serious limitations. Investigating American agreements only, however, allows the authors to use more complete investment data than panel-type studies, as American FDI flows are more readily available. Also, to account for the endogeneity of the relationship between FDI and investment treaties, the authors analyse the impact of each investment treaty in isolation with one or more lagged dependent variables. This further prevents questionable assumptions of homogeneity of effects across different countries, as is otherwise standard in panel data studies.

Even more significant is the fact that these 'negative' findings are supported by feedback from American investors themselves. In 2010, a survey of in-house legal counsel in the 100 largest American multinationals showed that not only did many find BITs less effective to protect against expropriation and adverse regulatory change than commonly assumed, hardly any saw the treaties to be critical to their companies' investment decisions (Figure 4). This survey concerned the US BIT program, which consists almost exclusively treaties with

developing and transition economies. In our view, investment treaties with developed countries would be regarded as even less relevant by in house legal counsel of the same firms.



Notes: Histogram reports responses from in-house legal counsel in major American multinationals to: (i) To your knowledge, how regularly does your company actively consider investing in foreign (non-U.S.) operations, businesses, joint ventures, or other projects; (ii) How familiar are lawyers in your office with the basic provisions of BITs; (ii) how family are non-lawyer senior executives in your corporation with the basic provisions of BITs?; (iv) In your view, how effective are international treaties like BITs at protecting foreign investments from expropriation by a foreign government?; (v) In your view, how effective are international treaties like BITs at protecting foreign investments from adverse regulatory change in the foreign country?; (vi) How important is the presence or absence of a BIT to your company's typical decision to invest in a foreign country?

For the first question, 1 indicates 'Never or Rarely' and 5 indicates 'Frequently'. For the next two questions, 1 indicates 'Not at all familiar' and 5 indicates 'Very familiar.' For questions four and five, 1 indicates 'Not at all Effective' and 5 indicates 'Very Effective'. For the last question, 1 indicates 'Not at all important' and 5 indicates 'Very Important'.

Source: Yackee 2010.

FIGURE 4. RESPONSE FROM GENERAL COUNSEL WITHIN AMERICAN MULTINATIONAL CORPORATIONS ABOUT AWARENESS AND IMPORTANCE OF BITs

Overall, we find it unlikely that an EU-US investment protection agreement would have a tangible impact on the amount of US investment flowing to the UK. The UK is already considered a safe investment destination by American investors and there is no convincing evidence to indicate that an EU-US investment protection agreement would have any bearing on whether American multinationals decide to invest in the UK or elsewhere. While liberalisation provisions could perhaps have such an effect, this would not be contingent on an EU-US treaty also providing post-establishment protection to US investors in the UK.

PROTECTING UK INVESTMENTS IN THE US

An EU-US investment treaty might provide economic benefits to the UK if it more adequately protects UK investors in the US from treaty-relevant mistreatment compared to the level of protection that UK investors currently enjoy (Box 2 in our Analytic Framework report). The question for the UK analyst, then, is whether an EU-US investment protection treaty could mitigate problems experienced by investors in the US. We find this unlikely as well.

To our knowledge, there are very few aspects of the US investment climate that concern British investors. UK investors in the US have no restrictions on repatriation of profits, dividends, interest, or royalties. And with respect to discrimination, “buy American” provisions in the 2009 American Recovery and Reinvestment Act raised concerns about discrimination against foreign investors, for instance, but foreign firms commonly receive national treatment in the US with respect to local, state, and federal government fiscal or financial incentives.²⁰ More generally, there are hardly any discriminatory measures against foreign investors after establishment. Exceptions from national treatment are clearly set out in the OECD’s ‘National Treatment Instrument’ and both local, state, and federal level deviations from treatment proscribed by investment treaties are set out in the non-conforming measures annexes of recent US BITs and FTAs.²¹

²⁰ See, e.g., the self-reported United States Report on its investment regime to APEC, in APEC 2011.

²¹ Available at: www.ustr.gov.

With respect to discrimination when it comes to M&As or takeovers, the administration by the Committee on Foreign Investment in the United States (CFIUS) has become increasingly politicized in recent years when reviewing security implications of such transactions. CFIUS decisions are unlikely to be challengeable in investment arbitration, however, given the likely national security exception in an EU-US investment chapter. This means that even if UK investors are concerned about the politicization of CFIUS – which we do not have evidence to sustain – an EU-US investment treaty is unlikely to provide them with any other recourse than is currently available. It is also important to note that while acquisitions by UK investors account for the largest share of notices to CFIUS (26% in 2011), few of these results in legally binding mitigation measures.²² Rather, actual restrictions have primarily been targeted at sovereign owned or controlled investments, particularly from China.²³

With respect to expropriation, property rights are protected under the US Constitution, constitutions of individual states, as well as federal, state, and local laws. As in BITs, US takings jurisprudence addresses both direct and indirect forms of expropriation and provides for compensation at fair market value at the time of the taking. Enforcement of contracts is not a problem either. Due to the efficiency of the US judicial system in enforcing contracts, the US ranked 6th on the World Bank's *Doing Business 2013* report on this indicator.

Finally, US courts are characterised by both high quality as well as a high level of independence compared to “typical” BIT-partners of the UK. While examples of anti-foreign bias do exist in US courts - such as the infamous *Loewen* dispute in a Mississippi state court²⁴ - we are aware of no evidence that US courts have a tendency to discriminate against foreign investors. One concern about litigating disputes in US courts is costs, and UKTI informs British investors that commercial lawsuits in US courts are time-consuming and expensive.²⁵

²² 32 notices by British firms were made in manufacturing; 28 in finance, information, and services; 5 in mining, utilities and construction; and 3 in wholesale, retail, and transportation. CFIUS 2012.

²³ See, e.g., Fagan 2010.

²⁴ *Loewen v US*, ICSID Case No Arb (AF)/98/3, Award of 26 June 2003.

²⁵ UKTI 2013.

But this is true also for American investors, and investment treaty arbitration tends to be equally, if not more, expensive than domestic court proceedings.

All in all, it is doubtful that UK investors will find additional protections from an EU-US investment protection treaty beyond those currently provided, and enforced, under US law. That said; while the chances of a successful investment treaty claim against the US may be small, UK firms could still use the option of investor state arbitration against the US as a bargaining tool for resolving disputes in their favour. There are several instances of American investors using NAFTA's Chapter 11 to reach favourable settlements with Canada, for instance, and UK firms could similarly benefit from this option. The same is the case for US investors in the UK. *Crucially, however, whereas all the costs of an investment treaty arbitration against the UK would be borne by the UK government, part of the benefits accruing to UK investors from being able to resort to international arbitration against the US would remain off-shore rather than flowing back to the UK economy (via dividends paid to UK nationals and/or higher taxes).*

4. ECONOMIC COSTS OF AN EU-US INVESTMENT TREATY

THE RISK OF CLAIMS AGAINST THE UK BY US INVESTORS

In our Analytical Framework report, we identify the risk of successful investment treaty claims against the UK as the primary economic cost associated with an investment treaty. In estimating the scale of this cost, the first step is to assess the size of investment stocks in the UK, as the likelihood of claims against the UK can be expected to increase roughly in proportion with the size of the investment stock in the UK covered by the treaty. As discussed in our section on the US-UK investment relationship, the UK possesses a very large stock of US-origin investment.

Two further issues relate to the type of US investments in the UK: their size and sectoral composition. These issues are relevant because, as discussed in our Analytical Framework report, investment treaty claims involving investors in certain sectors and of certain sizes have been more common. Given the tremendous quantity of US investment in the UK, there are undoubtedly a great number of investment projects that are of sufficient size to make the

economics of an investment treaty claim (i.e. ratio of legal costs to potential award) viable in theory. With respect to sector, and as noted in our section on the UK-US investment relationship, US companies have made significant investments across virtually all sectors of the UK economy.

A different consideration concerns the culture and practice of dispute resolution among US investors in the UK. Generally, American investors tend to be the most litigious in the world. UKTI warn British investors operating in the US that,

Americans are, in general, inclined to start litigation or to threaten it – probably more so than the British. It is not just American lawyers that exhibit this tendency, but also American business people. Americans often sue or threaten suit as a strategic device to obtain some sort of amicable settlement (e.g., a money payment, a new contract, an agreement by the other side to abandon its claim). The great majority of commercial litigation started is never decided by the court or an arbitration panel. It is settled by the parties after the legal proceeding has begun; sometimes, the threat of legal action is sufficient to bring about a settlement.²⁶

This seems relevant also in the context of investment treaty arbitration. A 2008 empirical analysis of the 83 investment treaty disputes that were known at the time to have resulted in awards found that 32 of those cases—over 38%—involved an investor from the United States.²⁷ The second-most-frequent nationalities were Canada and Italy, with just six cases each. Absent a theoretical model for predicting baseline expectations for investor participation in investment treaty arbitration, it is difficult to make any definitive conclusions from these figures. For example, the US is a major source of outward FDI, and for that reason it may not be entirely unexpected that many investment treaty claims would involve US investors. On the other hand, the high proportion of claims by US investors may be seen as striking given the relatively low number of US investment treaties in force (approximately 40, plus investment chapters in US FTAs, such as NAFTA). Unfortunately, Franck's data do not control for such things as the amount of FDI from the home country, so it is impossible to say whether the level of US investor claims is objectively “high”. Franck's data also shows that investors won damages in 38.5% of claims that were finally resolved in an award.²⁸ Franck's

²⁶ UKTI 2013, 32.

²⁷ Franck 2008, 28.

²⁸ Franck 2008, 49 & 58.

data do not break out these statistics by the home state of the investor, so we are not able to say whether US investors win more often, or win more, than other investors.

US investors have brought a significant number of claims against Canada under NAFTA's investment chapter, Chapter 11. Canada's experience is relevant as Canada is a developed country with a strong rule-of-law tradition like the UK. If anything, we expect that the UK would be more prone to US claims than Canada, as Canada accounts for less than 8% of US outward FDI stock, whereas the UK accounts for more than 13%.²⁹ As of the date of writing Canada has been the target of 34 NAFTA investment-chapter claims, all but one brought by US investors.³⁰ Table 3 shows all known Chapter 11 notices of intent filed by US investors against Canada. The Table lists the claimant's name, the minimum amount of damages sought (as indicated in the notice of intent), the year the notice of intent was filed, a short description of the dispute, and the dispute's outcome.

Claimant(s)	Minimum Damages Sought	Year Notice Intent	Dispute Description	Outcome
<i>Ethyl Corp.</i>	USD 201 million	1997	Import ban on gasoline additive	Settled; investor paid approx. CDN 20 million
<i>Pope & Talbot Inc.</i>	USD 30 million	1998	Softwood lumber	Partial award for investor, USD 408 thousand
<i>S.D. Meyers Inc.</i>	USD 10 million	1998	Export ban for PCB waste	Award for investor, CDN 6 million
<i>Sun Belt Water, Inc.</i>	NA	1998	Denial of license for water export	Inactive
<i>Ketcham Investments, Inc. and Tysa Investments</i>	CDN 30 million	2000	Softwood lumber	Withdrawn
<i>United Postal Service of America, Inc.</i>	USD 100 million	2000	Anti-competitive practices of Canadian postal service	Claim rejected on merits
<i>Chemtura Corp.</i>	100 million	2001	Regulation of crop pesticide	Claim rejected on merits
<i>Trammel Crow Co.</i>	USD 32 million	2001	Abuse of postal service procurement process	Withdrawn

²⁹ Source: OECD FDI statistics for 2011 with US as reporting country (unlike figures 2 and 3 where UK was reporting country).

³⁰ www.naftaclaims.com/disputes_canada.htm. By "claims" we mean that a notice of intent to file a Chapter 11 claim was filed by the investor.

Claimant(s)	Minimum Damages Sought	Year Notice Intent	Dispute Description	Outcome
<i>Albert Connolly</i>	NA	2004	Forfeiture of mining claim site	Inactive
<i>Contractual Obligation Productions, LLC et al.</i>	USD 20 million	2005	Denial of television programming subsidy	Inactive
<i>Peter Nikola Pesic</i>	NA	2005	NA	Withdrawn
<i>GL Farms LLC and Carl Adams</i>	78 million	2006	Milk export program	Inactive
<i>Merrill & Ring Forestry LP</i>	25 million	2006	Export controls on logs	Claim rejected on merits
<i>V.G. Gallo</i>	355 million	2006	Expropriation of landfill	Claim dismissed for lack of jurisdiction
<i>Gottlieb Investors Group</i>	USD 6.5 million	2007	Change in tax laws	Inactive
<i>Mobil Investments Inc. & Murphy Oil Corp.</i>	50 million	2007	Imposition of performance requirements	Award in investor's favour; compensation TBD
<i>Centurion Health Corp.</i>	USD 155 million	2008	Restrictions on private health care	Claim dismissed by tribunal
<i>Clayton Bilcon</i>	USD 188 million	2008	Environmental assessment of quarry project	Pending
<i>David Bishop</i>	USD 1 million	2008	Revocation of license for wilderness outfitter	Inactive
<i>Dow AgroSciences LLC</i>	2 million	2008	Ban on lawn pesticides	Settled with no compensation paid
<i>Georgia Basin L.P.</i>	USD 5 million	2008	Export controls on logs	Inactive
<i>Janet Marie Broussard Shiell et al.</i>	USD 21 million	2008	Fraudulent bankruptcy proceedings	Inactive
<i>William Jay Greiner and Malbaie River Outfitters Inc.</i>	USD 5 million	2008	Revocation of license for wilderness outfitter	Withdrawn
<i>AbitibiBowater Inc.</i>	CDN 300 million	2009	Termination of water and timber rights	Settled; investor paid CDN 130 million
<i>Christopher and Nancy Lacich</i>	USD 1.2 thousand	2009	Change in tax laws	Withdrawn
<i>Detroit International Bridge Co.</i>	USD 1.5 billion	2010	Regulation of toll bridge	Pending
<i>John R. Andre</i>	CDN 4 million	2010	Emergency caribou hunting restrictions	Inactive
<i>Mesa Power Group LLC</i>	CDN 775 million	2011	Renewable energy regulation	Pending
<i>St. Mary's VCNA, LLC</i>	USD 275 million	2011	Denial of license for quarry	Pending
<i>Eli Lilly & Co.</i>	CDN 100 million	2012	Invalidation of pharmaceutical patent	Pending
<i>Windstream Energy LLC</i>	CDN 475 million	2012	Renewable energy regulation	Pending
<i>Lone Pine Resources Inc.</i>	CDN 250 million	2012	Revocation of mine permit	Pending

Claimant(s)	Minimum Damages Sought	Year Notice Intent	Dispute Description	Outcome
<i>Mercer International Inc.</i>	CDN 250 million	2012	Electricity generation	Pending

NOTES: “Minimum damages sought” are taken from Notices of Intent and do not include pro forma requests for costs, interest and the like; actual amounts claimed in arbitration may be higher. Where “US” or “CDN” is not listed, the Notice of Intent is ambiguous as to whether the investor is requesting monetary relief expressed in United States or Canadian dollars.

SOURCES: Department of Foreign Affairs and International Trade Canada web site, www.international.gc.ca/trade-agreements-accords-commerciaux/topics-domaines/disp-diff/NAFTA.aspx; NAFTAClaims.com.

TABLE 3. CLAIMS AGAINST CANADA BY US INVESTORS PURSUANT TO NAFTA CHAPTER 11

Table 3 illustrates the breadth of Canadian government actions that US investors have challenged: electricity regulation; changes in tax laws; the revocation or denial of various licenses; export bans on hazardous materials; health care regulations; patent decisions; and more. The table also shows that a significant proportion of notices of intent are eventually withdrawn or become inactive (14/33). Unfortunately, the Canadian government does not indicate the reason for withdrawal or inactivity. We think it likely that many withdrawn or inactive notices of intent are withdrawn or become inactive because the investor realizes that the claim has little chance of success, or that proceeding with arbitration will be too costly. However, we have no hard evidence relating to this hypothesis. Eleven notices of intent have proceeded to arbitration and led to an award or a formal settlement. Of those eleven, only five have resulted in payments to the investor. In total, it appears that Canada has paid investors approximately CDN 156 million, with the bulk of that total consisting of a CDN 130 million settlement in *AbitibiBowater*. (Damages are still pending in the recent award in *Mobil Investments*). Eight disputes are on-going. US investors appear to have become more active in filing Chapter 11 notices of intent in recent years, with eight notices filed since 2010. Those eight notices together claim a minimum of over USD 3 billion in damages, including a claim for USD 1.5 billion in the *Detroit International Bridge Co.* case. However, it is probably safe to say that those damage claims are exaggerated and intended by the investors to increase pressure on Canada to settle in the investors’ favour.

We think that it is fair to say that Canada has managed to compile a relatively impressive record of success in defending itself against investor-state claims, at least in the sense of

avoiding frequent and/or large adverse awards.³¹ This contrasts with the experiences of certain developing countries, such as Argentina and Ecuador, which have seen very large adverse awards as a result of investor-state arbitration initiated by US investors.³²

Legal costs

We expect that the UK would be able to develop a defence capacity of a quality roughly comparable to that of the US and Canada, especially given that the UK government is unlikely to engage in the kinds of mistreatment of US investors that are likely to be viewed as clear or egregious violations of international law. However, it must be recalled that the UK will necessarily incur costs (lawyer's fees; tribunal fees) in defending itself against investor lawsuits *even if the UK "wins"*. A recent OECD scoping paper on ISDS reported the results of a survey showing that total "legal and arbitration costs for the parties in recent ISDS cases have averaged over USD 8 million [or, USD 4 million per party] with costs exceeding USD 30 million in some cases."³³ These figures are consistent with a briefing by the law firm Allen & Overy obtained by BIS, which puts average costs at slightly over USD 4 million per party, with minor variations of tribunal costs as between cases under differing sets of procedural rules.³⁴ Additional costs (such as the costs to the government of maintaining an office dedicated to investment-treaty defence) would add some amount of "overhead" to the per-dispute averages reported in the OECD report. It should also be noted that ISDS costs can be significantly higher than the average figure mentioned above. For example, in the recent *Abaclat* decision on jurisdiction, the claimants had spent some USD 27 million on their case to date, and Argentina had spent about USD 12 million.³⁵ These costs were solely for a decision addressing jurisdiction but not the merits. In our own experience, costs for the respondent states and claimants are roughly equivalent on average, albeit with significant

³¹ While Canada, as indicated, has lost a small number of investor-state arbitrations, the US has never lost an investment treaty arbitration. Gallagher and Shrestha 2011, 8.

³² Gallagher and Shrestha 2011, 4 Table 1.

³³ OECD 2012, 18.

³⁴ Hodgson 2012.

³⁵ OECD 2012.

variation between cases. This impression is broadly consistent with a briefing by the law firm Allen & Overy obtained by BIS, which suggests that average costs for claimants are fractionally higher than those for respondent states.³⁶

We lack sufficient data to compare the magnitude of likely ISDS costs to the costs that the UK would be likely to incur in defending itself in domestic court against domestic law claims by foreign investors. However, we assume that, all else equal, it would be significantly more costly for the UK to defend itself against an ISDS claim than an equivalent domestic court/domestic law claim. BIS should also be aware that international investment law is *not* characterized by reliable a “loser pays” rule as to costs. Even when investors are required to pay the costs of the tribunal, considerable legal fees can still be borne by the “winning” party. In *Plama v Bulgaria*, for instance, Bulgaria had to spend more than USD 6 million in legal fees in a case the Bulgarian government “won”.³⁷ Thus, the UK should not necessarily expect to see its costs “shifted” to the losing investor. In many cases, and perhaps most cases, the UK will be responsible for its own costs even if it wins the case. As the OECD report on costs notes, “It is widely recognised that outcomes on cost shifting in ISDS cases are highly uncertain.”³⁸ On the other hand, some observers suggest that investor-state tribunals have in recent years become more likely to shift costs to the losing party.³⁹ Cost shifting to the investor may be particularly likely where the investor’s claim is found to be patently frivolous. BIS should carefully consider the specific language on cost shifting, if any, contained in an EU-US draft investment chapter when conducting its cost-benefit analysis, as it is possible for the investment chapter to expressly address the cost-shifting issue.

We also understand that BIS is already aware of the draft EU regulation on financial responsibility for investor-state disputes.⁴⁰ The draft regulation would establish the

³⁶ Between USD 100,000 and USD 350,000 higher on average, depending on whether outlying cases are excluded from average figures.

³⁷ *Plama Consortium Limited v. Bulgaria*, ICSID Case No. ARB/03/24, Award, 27 August 2008.

³⁸ OECD 2012, 21.

³⁹ See generally Franck 2011 on cost-shifting in investment-treaty arbitration; OECD 2012, 21; Hodgson 2012.

⁴⁰ European Commission, *Draft Financial Responsibility Regulation* COM(2012) 335 final, 2012/0163 (COD), 21 June 2012

responsibility of the UK to pay any costs incurred by the EU in defending the member state against an investor challenge. We point this out to emphasize that even though the EU may be the respondent party in an investor-state arbitration under an EU-US investment chapter, the UK is likely to remain liable for any costs incurred by the EU on the UK's behalf in the arbitration.

Risk of adverse awards

If an EU-US investment chapter provided US investors with more generous rights than they would otherwise have under UK law, the risk of investor lawsuits and adverse arbitral awards would rise considerably. In general, our view is that an EU-US investment chapter is unlikely to grant US investors in the UK *significantly* greater rights than they would otherwise have under UK law. However, as we explain below, an EU-US investment treaty may provide opportunities or incentives for investors to bring claims that they would not bring under UK domestic law. The content of international investment law remains contested and uncertain, and it is possible that an ISDS tribunal formed under an EU-US investment chapter would grant a US investor significant damages for conduct that would not normally be actionable under UK domestic law.

We say that an EU-US investment chapter would not grant US investors in the UK *significantly* greater rights than they currently enjoy because most successful investment treaty claims concern circumstances that would clearly be inconsistent with UK law, such as the unilateral abrogation of contracts by government authorities, or serious procedural failures in administrative or judicial processes. While in some cases investment tribunals have interpreted investment treaty text in ways that go beyond the protections contained in UK law (for example, on the question of “legitimate expectations” or the granting of regulatory permits and licenses—see our China report), we believe that an EU-US investment chapter is likely to contain relatively restrictive formulations of the minimum standard of treatment, regulatory expropriation, and other standards that have, when drafted without qualification, been interpreted more expansively. Since the well-known *Methanex* NAFTA Chapter 11 arbitration, in which a Canadian investor unsuccessfully challenged a California environmental regulation, the US has appeared to be particularly concerned with protecting its

right to change the legal or regulatory regime in non-discriminatory ways.⁴¹ We see that sensitivity in the various explanatory footnotes and annexed text in the 2012 US Model BIT that, for example, limit the fair and equitable treatment standard to the customary international law standard for the treatment of aliens,⁴² or that reaffirm that “Except in rare circumstances, non-discriminatory regulations that are designed and applied to protect legitimate public welfare objectives...do not constitute indirect expropriation”⁴³, or that clarify that whether a regulatory grant of permission to engage in an activity is not a covered “investment” if the grant of authority does not also “create any rights protected under domestic law”.⁴⁴

On the other hand, and despite such attempts to narrow and clarify the protections provided by the US model BIT, there remains significant debate and uncertainty as to the content of such terms as “fair and equitable treatment”.⁴⁵ That lingering uncertainty leaves open the possibility that an arbitral tribunal might interpret the language of an EU-US investment chapter expansively, despite the addition to the treaty text of cautionary footnotes and annexed clarifications. In turn, continued uncertainty as to the content of international investment law means that investors may have an incentive to bring “long-shot” claims against the UK, in particular where the investor has colourably suffered large damages. In some cases, a long-shot claim may result in an arbitral interpretation and application of treaty text that goes beyond UK domestic law.

For example, the tribunal in the recent case of *Occidental v. Ecuador II* read into the fair and equitable treatment provision of the US-Ecuador BIT an obligation on the state to treat the investor “proportionately” when the state exercises a contract-based right to terminate its commercial relationship with the investor upon the investor’s breach of the contract.⁴⁶ While

⁴¹ Caplan and Sharpe 2013, 756.

⁴² 2012 US Model BIT, Annex A.

⁴³ 2012 US Model BIT, Annex B.

⁴⁴ 2012 US Model BIT, Art. 1 footnote 2.

⁴⁵ Kläger 2011, 87-88 (discussing the failure of the US Model BIT’s clarifications on the meaning of “fair and equitable treatment” to actually clarify the meaning of the phrase).

⁴⁶ *Occidental v Ecuador II*, ICSID Case No ARB/06/11, Award, 5 October 2012 [383].

the principle of proportionality has some operation as a ground of review in the administrative law of the UK, English *contract* law does not require an innocent party to exercise a right to terminate a contract proportionately. If one party breaches a contract and if that breach creates a right to terminate, the innocent party is entitled to exercise that right to terminate at its discretion.⁴⁷ While there are other complexities in *Occidental II* that may bear on how the case would be resolved if it had been litigated under the English law of contract, we think a dispute akin to *Occidental II* may well be decided differently if it were litigated under English law. As such, the case provides a helpful illustration of the point that apparently restrictive concepts such as the minimum standard of treatment required by customary international law are sometimes interpreted by arbitral tribunals in ways that can grant foreign investors more generous rights than would be recognised under UK law.

Despite the potential of expansive interpretations of uncertain treaty text, an EU-US investment chapter would still probably *by design* confer greater rights on US investors that they would be entitled to under UK law, at least in certain areas. As we observed in the EU-China report, the general rule in the UK is that legislation passed by Parliament cannot be challenged in the courts. This is relevant also when considering political costs, as noted below, as investment tribunals authorised to override acts of Parliament is politically sensitive. Moreover, while the actions of the executive can be challenged in UK courts, pecuniary remedies are only rarely awarded in such cases.⁴⁸ In both respects, the position under an EU-US investment treaty would differ from the position under UK law.

One important additional issue is the question of potential UK liability for actions taken by the EU itself, or for actions taken by the UK as required by EU law. For example, in a pair of recent Energy Charter Treaty arbitrations, investors challenged certain changes in Hungary's electricity pricing regime that were arguably required under EU law.⁴⁹ Under the Draft Financial Responsibility Regulation mentioned above, the EU, and not the Member State, would incur direct financial responsibility for the costs of ISDS (adverse awards, litigation

⁴⁷ *Union Eagle Ltd v Golden Achievement Ltd* [1997] AC 514 per Lord Hoffmann

⁴⁸ Craig 2012.

⁴⁹ *Electrabel S.A. v the Republic of Hungary* (ICSID Case No. Arb/07/19); *AES Summit Generation Limited and AES-Tisza Erőmű Kft v. The Republic of Hungary*, ICSID Case No. ARB/07/22.

costs) where the investor challenges a Member State action that itself was “required by the law of the Union,” or where the challenge is to treatment “afforded by the institutions, bodies, or agencies of the Union.”⁵⁰ The Regulation, if implemented, would thus offer the UK some protection from the direct costs of at least some kinds of legal challenges. However, it might be said that Member States would still be paying at least some portion of those costs indirectly—even where the challenged treatment is of the kind for which the EU takes “financial responsibility”—through their own national contributions to the EU budget.

Overall, our view is that the UK faces meaningful risk that US investors will seek to invoke an EU-US investment chapter’s ISDS provisions to bring claims against the UK government. This assessment is primarily due to (i) the large amount of US investment in the UK; (ii) the fact that US investors appear to have been relatively aggressive in bringing actions against other states, including Canada, under investment protection instruments that are likely to be very similar to an EU-US investment chapter; and (iii) the continued uncertainty over the proper meaning of key concepts in international investment law, such as “fair and equitable treatment”. In particular, investors can be expected to bring some number of “long-shot” claims against the UK, some of which the UK may lose. Moreover, so long as the investor has some chance of success, the mere act of filing an arbitral claim may give the US investor leverage against the UK government in terms of encouraging the UK government to settle the case, even if only to avoid litigation costs and any possible damage to the UK’s reputation as a welcoming environment for foreign investment. This is an important point. For example, in the well-known Ethyl NAFTA litigation, Canada settled the case by agreeing to pay the US investor USD 13 million. Thus, while we do not expect the UK to incur many high-value awards in favor of US investors, this does not mean the UK will not incur considerable litigation-related costs under an EU-US investment chapter. These include the costs of more favourable settlements than would otherwise be agreed as well as fees to lawyers and tribunals. The later are expected to average at approximately USD 4 million per claim per party, but individual claims could involve much higher legal costs. We view it as virtually certain that such costs under an EU-US investment chapter will be higher than under the status quo, as we assume that currently the vast bulk of existing US investment in the UK is

⁵⁰ European Commission, *Draft Financial Responsibility Regulation* COM(2012) 335 final, 2012/0163 (COD), 21 June 2012, Art. 3.

not covered by an investment treaty. Under an EU-US investment chapter, in contrast, all US investment in the UK would be covered.

THE RISK OF INVESTMENT DIVERSION

Another potential economic impact of an EU investment treaty with the US is on US foreign investors' location decisions with the EU. Diversion effects may constitute either a cost or a benefit for the UK. If an EU-wide investment treaty with the US increases the relative attractiveness of the UK as a destination for outward US investment as compared to other EU states, diversion effects would likely benefit the UK. The converse is also true. In assessing the likelihood of diversion effects it is important to note our analysis in Section 3, above, which suggests that the presence or absence of an investment treaty is unlikely to play a significant role in the location decisions of US investors. This observation implies that, even if an EU-US investment treaty alters the relative strength of investment protections available to US investors in various states within the EU, this legal change is unlikely to induce significant diversion effects. This is a crucial point. The observations below about the extent to which an EU-US investment treaty might divert foreign investment from the UK are therefore primarily of theoretical interest.

Our analysis here is simplified by the fact that the US has relatively few BITs in place with EU Member States. The US has BITs with the following members of the EU: Bulgaria (1992); Czech Republic (1991); Estonia (1994); Latvia (1995); Lithuania (1998); Poland (1990); Romania (1992); Slovakia (1991). The US also has a BIT with Croatia, an acceding member of the EU (1996). All of those BITs contain comprehensive dispute settlement and pre- and post-establishment NT, as well as other provisions common to the US model. An EU-US investment chapter should, in theory, make the UK relatively more attractive as a destination for US foreign investment than it already is, at least as to those states. This is because an EU-US investment chapter will be essentially redundant to the US BITs already in force for EU members who already have a BIT with the US.

On the other hand, none of the Northern and Western European states that are geographically proximate and economically similar to the UK—and thus presumably most likely to be

competing with the UK for US investment—currently have an investment treaty with the US. Unless those states currently have particular investment-relevant disadvantages that may be effectively addressed in an EU-US investment chapter, and only if the UK itself does *not* currently have those disadvantages, an EU-US investment chapter may in theory increase the *relative* attractiveness of other Northern and Western European states, and thus divert some US outbound investment from the UK. However, we do not think there are significant investment-treaty-relevant differences between the UK and, say, Denmark, Finland, France, Germany, Norway, or Sweden. For example, the PRS Group’s ICRG Investment Profile index rates the UK approximately as favourably (or even slightly less favourably) than the six Northern and Western European states mentioned in the previous sentence. While the PRS Group index is not a perfect indicator of the kinds of factors that are both relevant to foreign investors and effectively addressed through investment treaties, the data support our general sense that the UK’s current success in attracting US foreign investment is not due to investment-treaty-relevant deficiencies in other Western and Northern European states.

In short, even if an EU-US investment protection chapter was important for establishment decisions of American investors – which no evidence suggests it would be – we would not expect an EU-US investment treaty to have much if any diversionary impact on US investment flows to the UK.

5. POLITICAL BENEFITS OF AN EU-US INVESTMENT TREATY

DE-POLITICISING INVESTMENT DISPUTES

In our Analytical Framework report, we identify de-politicisation of investment disputes as a potential political benefit from ‘strong’ investor state arbitration provisions in investment treaties. In our China report we emphasised the importance of recognizing the special political sensitivities of the UK-China relationship. Those concerns are not present here. As the British embassy in Washington, D.C. notes on its webpage, “The United Kingdom and the United States have a partnership that is without rival in the international community.”⁵¹ This “special relationship” means that the risk of investor-state disputes between US investors in the UK,

⁵¹ <http://ukinusa.fco.gov.uk/en/about-us/working-with-usa/>.

and UK investors from the US, becoming undesirably “politicized” in the absence of ISDS is probably quite low.

UK as a home state

In principle, an EU-US investment treaty could allow the UK government to avoid being drawn into investment disputes on behalf of British investors in the US in ways that could compromise broader foreign policy goals. If the British government has had problems saying ‘no’ to UK investors in the US seeking government assistance to resolve sensitive disputes, a strong investment treaty could provide an opportunity to refer British investors to international arbitration. It is only possible to assess the extent to which this would constitute a benefit with comprehensive information about the susceptibility of the UK government to pressure by British industry to exercise diplomatic protection in situations that could lead to foreign policy complications. This is information we do not have, but which BIS could obtain from consultations with the Foreign and Commonwealth Office.

It may be helpful for BIS to make inquiries regarding the UK government’s experience in helping to resolve, or in being asked to help resolve, high-profile incidences of conflict between UK investors and the US government. One example could be BP’s recent experiences in dealing with the US government in the wake of the Gulf of Mexico oil spill. Here, the analyst would examine the extent to which the UK government was asked to be involved, or was in fact involved, in diplomatic attempts to ensure that BP was treated fairly in the US government’s response to the spill. The analyst would also consider whether any UK government involvement was helpful or unhelpful in encouraging BP and the US government to reach a settlement, and whether a right for BP to independently pursue international arbitration against the US government for unfair treatment might have either exacerbated or alleviated any risk of political controversy between the US and UK.

However, it is also important to note that an investment chapter may be unlikely to provide meaningful access to ISDS for the kinds of foreign investment disputes that are both most likely to arise between the US government and UK investors, and that are likely to raise political sensitivities. Foreign investment in the US is generally non-controversial, and enjoys de facto national treatment, pre- and post-establishment, and that treatment in virtually all

cases will exceed any international minimum standard. However, on occasion a proposed foreign acquisition of US assets will generate significant political controversy, ostensibly for national security reasons. The US maintains a limited investment-screening apparatus (CFIUS), and as mentioned above the CFIUS process has sometimes served as the focal point of intense political pressure on the US Executive to block the acquisition. The Dubai Ports World incident, in which a Dubai firm was pressured into abandoning a plan to acquire several US port operations (through DPW's acquisition of the UK firm P&O) is an important example.⁵² However, an EU-US investment chapter is almost certain to include a self-judging national security exception similar to Article 17 of the 2012 Model US BIT. In that case, decisions by the US government to block acquisitions by UK investors on national security grounds may be essentially unreviewable in arbitration, leaving diplomatic protection the investor's only option to challenge the denial of permission to invest.

UK as a host state

As a host state, the UK could also potentially benefit from treaty-based investor state arbitration by adjudicating investment disputes with US investors without the involvement of the US state. Diplomatic pressure on the British government to resolve the dispute in favour of US investors could be avoided if settlement of the dispute is delegated to a neutral international arbitration forum.

In our China report, we emphasised that this possibility was especially relevant given the fact that a great portion of existing and future Chinese investments in the UK involve, or are likely to involve, state-affiliated entities (e.g. Chinese sovereign wealth funds or state-owned enterprises). That consideration is not present to the same degree in the case here, as the US federal government does not maintain an SWF, and US federal government-owned or – sponsored enterprises are rare.⁵³ On the other hand, some US states do maintain public pension funds of quite important size that invest abroad. For example, the California Public

⁵² See generally Savuant, Sachs and Jongbloed 2013.

⁵³ Perhaps the most important exception is the US federal government sponsorship of mortgage finance companies Fannie Mae and Freddie Mac. However, those companies do not invest abroad. Rather, they issue debt, of which investors in the UK appear to hold a significant amount.

Employees' Retirement System, or CalPERS, has assets of approximately USD 250 billion, and invests extensively in international debt and equity markets, including the UK. For the purposes of this Report, however, we assume that US state public investment funds are unlikely to pose the same sensitivities as their Chinese counterparts.

Also, as we point out in the Analytical Framework report, the extent to which governments are vulnerable to company pressure to involve themselves in investment disputes partly depends on the nature of their political system. In the case of the US, the open and democratic political system can be assumed to provide various pathways for aggrieved US investors in the UK to attempt to convince politicians to pressure the US Executive to intervene on their behalf in disputes with the UK. On the other hand, the U.S. Department of State formally maintains a restrictive policy toward diplomatic espousal of investment claims, requiring, for instance, full exhaustion of local remedies.⁵⁴ And while the US executive has historically been drawn into investment disputes in numerous developing countries,⁵⁵ the high quality of the US-UK political relationship combined with UK's favourable investment climate makes us expect that incidences of US pressure on the UK on behalf of US investors is rare. We nonetheless recommend that BIS make appropriate inquiries with other UK government offices to gauge the extent to which the UK government has been subject to investment-related US diplomatic pressure in the recent past.

To summarize: we do not believe that an EU-US investment chapter will provide significant political benefits by depoliticizing investment disputes. This evaluation is driven largely by two main factors. First, the positive investment climates in the US and UK mean that major, sensitive investor-state disputes are unlikely to arise in the first place. Second, the political relationship between the US and the UK means that investment disputes that do arise are unlikely to result in serious diplomatic tensions between the two states, as the US and UK have a significant and positive history of political and diplomatic cooperation. While we should stress again that BIS should inquire with relevant government departments, we find it

⁵⁴ www.state.gov/s/l/c7344.htm.

⁵⁵ Maurer 2013.

unlikely that either government would allow their investors to drag them into investment disputes that could compromise the “special relationship”.

OTHER POLITICAL BENEFITS

Two additional potential political benefits are worth highlighting. First of all, the Commission has argued that an EU-US agreement will increase EU’s bargaining power in future negotiations with countries such as India and China. Somewhat analogously to the OECD-based Multilateral Agreement on Investment (MAI), an investment agreement negotiated between the largest trading and investment blocks in the world could set a de-facto *global* standard, which other partner countries would be inclined to follow.⁵⁶ As we expect an EU-US agreement to very closely follow the US BIT model, this would essentially mean that the (hypothetical) global standard would follow American rather than European investment treaty practise.

This would be a political benefit *unique* to an investment treaty with the US and is therefore not included in our framework report. We urge caution about the plausibility of this scenario however. As noted in our China report, Beijing has adopted investment treaties for decades and the Chinese leadership has developed a somewhat distinct investment treaty practice tailored to its perception of China’s national interest. At the time of writing, it has proven impossible for the United States to get China to sign up to its BIT model, and given China’s leverage in investment treaty negotiations we do not expect that an EU-US agreement is going to change that stance. The same might be said about India, which is currently in the process of re-visiting its investment treaty program as a result of a series of high-profile claims.⁵⁷ So while an EU-US agreement may well have influence on EU’s bargaining power with less significant investment partners – such as in parts of Africa – it is at least questionable whether it is going to make countries like India and China more, or less, likely to agree to an investment treaty with the EU.

⁵⁶ For a similar argument of major powers ‘going it alone’ in the trade regime; see generally Gruber 2000.

⁵⁷ ‘BIPA talks put on hold,’ *The Hindu*, January 21, 2013.

A second political benefit advanced by the Commission is that the EU could use an investment protection chapter as a ‘bargaining chip’ vis-à-vis the US in order to obtain gains elsewhere in a comprehensive trade and investment agreement. We caution about this argument as well, as it is not at all clear how committed Washington is to an investment protection chapter with the EU. (Indeed, if one compares that USTR’s notification to Congress of its negotiating agenda⁵⁸ with the EU draft negotiating mandate,⁵⁹ it would appear that it is the European Commission, rather than the US, that is more strongly committed to the inclusion of investment protection within the Transatlantic Partnership.) If the Obama administration is concerned about the risks such a chapter could entail for the US, for instance because it could result in considerable claims by European investors, the Commission would be unable to use it as a bargaining chip in parallel negotiations.

In short, we are not convinced that an EU-US investment protection treaty would have significant bearing on whether China and India are willing to enter into an investment treaty with the EU. Nor are we convinced that the US is willing to offer significant ‘side-payments’ in other parts of a trade and investment agreement in return for an investment protection chapter. It is important to stress, however, that this is impossible to adequately assess without inside information from Beijing, Delhi, and Washington, so BIS may want to raise this with the Foreign and Commonwealth Office.

6. POLITICAL COSTS OF AN EU-US INVESTMENT TREATY

THE POLITICAL COST OF REDUCED POLICY SPACE

In our Analytical Framework report, we suggest that an EU-US investment treaty would impose costs on the UK to the extent that it prevents the UK government from regulating in the public interest. We use the term ‘policy space’ to refer to this potential cost. In assessing the impact of an EU-US investment treaty on the UK government’s policy space, we do not

⁵⁸ USTR, letter to John Boehner, 20 March 2013.

⁵⁹ European Commission, *Recommendation for a Council Decision authorising opening of negotiations on a comprehensive trade and investment agreement called the Transatlantic Trade and Investment Partnership, between the European Union and the United States of America* COM(2013), 136 Final, 12 March 2013.

propose a theory of what sorts of policies would be in the UK ‘public interest’. Rather, we suggest that it is for the government of the day to make its own assessment of the public interest. Thus, the impact of an EU-US investment treaty on UK policy space can be understood as the extent to which the treaty prevents the government of the day from adopting policies that the government would have preferred to adopt in the absence of the treaty.

Assessing the likely size of this cost raises many of the same issues that were considered in our assessment of the likely economic cost to the UK of adverse arbitral awards under the EU-US investment treaty. The size and composition of US investment stocks in the UK is relevant to the impact of an EU-US investment treaty on UK policy space. Given the sheer size of stock of US investment in the UK, the likelihood of disputes between US investors and the UK government is high. The composition of US investment in the UK is also potentially relevant because investments in particular sectors have proven more likely to result in investment treaty disputes in the past. In Section 1 of this report we note that there are substantial stocks of US investment in all sectors of the UK economy, including in extractive industries and public utilities, both of which have proven particularly prone to investment treaty claims in the past.

In reconciling our assessment of the political costs associated with lost UK policy space under an EU-US investment treaty and our assessment of the economic costs associated with adverse arbitral awards, it is important to acknowledge the risk of double-counting the same costs. If the UK fully complies with its obligations under an EU-US investment treaty it will not incur any economic costs as a result of adverse arbitral awards. However, it may refrain from regulating in ways that it would otherwise regard as desirable. In contrast, if the UK ignores the risk of claims under an EU-US investment treaty it will not suffer from any reduction in policy space *in practice*. It would, instead, expose itself to the risk of economic costs associated with adverse arbitral awards.

As we understand it, the UK government does not currently have a whole-of-government system in place to ensure compliance with its existing investment treaty obligations, nor are there plans to implement such a system. This is almost certainly because the UK government has never been the subject of a successful investment claim, so has never felt the need to establish such a system. In the event of a dispute with a US investor, there would be processes

within the UK government to respond to and manage the dispute. Yet, the absence of a system that screens and reviews the compliance of government policy with the EU-US investment treaty in advance means the protections of the treaty are unlikely be internalised within the UK government in a way that discourages or prevents government decision-makers from pursuing preferred policies prior to specific investment disputes arising. This significantly decreases the likelihood of an EU-US investment treaty interfering with UK policy space *in practice*.

Yet, there are other ways in which the treaty could affect UK policy space. We have noted the size of US outward FDI stocks in the UK and the fact that US investors seem particularly likely to rely on their legal rights as a bargaining tool. If an EU-US investment treaty did enter into force, we expect that the UK would be regularly faced with US investors opposing new UK government policies on the grounds of the treaty. This opposition could be expressed either through lobbying, through submissions to government inquiries or by initiating arbitration proceedings under the treaty. To the extent that these activities encouraged UK government decision-makers to modify or abandon preferred measures, it would count as a political cost of the treaty.

In assessing the ability of US investors to persuade the UK government to modify or abandon preferred policies two considerations are relevant: the quality of legal advice available to UK government decision-makers; and the extent to which the EU-US investment treaty grants US investors greater rights than they would otherwise have under UK law. With respect to the first point, high quality legal advice is available throughout the UK government. Accordingly, the UK government should be well placed to manage tactical use of threats of litigation by US investors, insofar as those threats lack legal foundation.

On the other hand, as we observed in the EU-China report, the availability of good quality legal advice may make UK government decision-makers *more* likely to amend or withdraw policies when those policies raise serious risks of non-compliance with an EU-US investment treaty. A clear example of this phenomenon is the recent announcement by New Zealand relating to its policy on tobacco plain packaging. While the New Zealand government has made clear that its preferred policy would be to introduce tobacco plain packaging, in light of legal objections raised by tobacco companies it has decided to delay the enactment of

legislation until after the investment treaty claim concerning Australian tobacco plain packaging, *Philip Morris v Australia*, has been resolved.⁶⁰ Similarly, in *SD Myers v Canada* the Canadian government revoked a ban on hazardous waste exports to the US after a US investor initiated arbitration.⁶¹ The Canadian government judged – correctly as it turned out – that it was likely that the measure would be found to be inconsistent with NAFTA. A third example of this potential political cost associated with investment treaties is the case of *Ethyl v Canada*, a claim brought by a US investor under NAFTA. It seems that this claim played at least some role in encouraging the Canadian government to abandon the environmental measure that was the subject of the dispute.⁶² The settlement agreement required the payment of damages (as noted above) and the withdrawal of the measure, thereby entailing both economic and political costs to Canada.⁶³ In short, in circumstances where a foreign investor opposes a preferred government policy on the basis of an investment treaty, and where that policy is at serious risk of non-compliance with the investment treaty, developed states comparable to the UK have amended, delayed or withdrawn preferred policies.

In this light, the second question – the extent to which an EU-US investment treaty grants US investors in the UK more generous legal rights than they would otherwise have under UK law – assumes particular importance. In earlier sections of this report we observe that an EU-US investment treaty would likely follow the US model BIT in including text that limits and clarifies the substantive protections provided by the treaty. These clarifications redress some of the most obvious ways in which an EU-US investment chapter could confer greater rights on US investors that are otherwise available under UK law – notably, some of the broader interpretations of the doctrine of ‘legitimate expectations’ adopted by earlier arbitral tribunals. Nevertheless, in our section on Economic Costs, we identified particular ways in which an EU-US investment treaty would still grant US investors legal rights that they would not otherwise have in the UK. This could strengthen the bargaining position of US investors in

⁶⁰ Turia 2013.

⁶¹ *SD Myers v Canada* Partial Award, 13 November 2000.

⁶² Tienhaara 2009.

⁶³ There are some complications in assessing the extent of political cost implied by the events surrounding the Ethyl case, as the abandoned measure, in its original form, was also ruled inconsistent with Canadian law.

negotiations to settle contractual disputes with the UK government, for instance, which would count as a cost to the UK.

While we are not in position to conduct a full comparative examination of the extent of legal protection provided by UK law and by a prospective EU-US investment treaty, our more rudimentary comparison has identified particular areas in which the US model BIT goes beyond UK law is significant. On these grounds, and in light of the scale of US investment in the UK, we think that there is a significant risk of political costs to the UK arising from future preferred policies being abandoned or modified on account of objections from US investors in the UK.

THE POLITICAL COST OF CONTROVERSIAL CLAIMS

Another potential political cost of an EU-US investment treaty is the controversy engendered by high profile claims against the UK government. The political cost of the controversy itself is distinct from, and additional too, any economic costs to the UK of adverse arbitral awards and any political costs associated with loss of UK policy space. In our Analytical Framework report we suggested that the assessment of political costs attributable to public controversy associated with high profile investment treaty claims should be handled with great caution. Disagreement and controversy about public affairs is a normal feature of democratic society. The possibility of controversy surrounding high profile claims against the UK government under an EU-US investment treaty should not, in itself, be understood as a political cost to the UK government. Rather, it is only if controversy around a *specific* claim triggers such widespread opposition to treaties and international cooperation *in general* that it limits the ability of the government of the day to pursue preferred policies on the international plane that this public backlash could be considered a cost.

The risks of controversial claims under an EU-US treaty are very different to those under an EU-China investment treaty. In the case of an EU-US investment treaty, any risk of controversial claims stems from the potentially controversial subject matter of claims, rather than the (state) ownership of US investors in the UK. US investors have brought claims against other developed countries arising from: banking regulation (*Genin v Estonia*); domestic ownership and domestic content requirements on media organisations (*CME v*

Czech Republic); regulation of the transboundary movement of hazardous waste (*SD Myers v Canada*); regulation of national monopolies (*UPS v Canada*); the ability of private health providers to operate alongside a host state's public health system (*Howard and Centurion Health v Canada*); and the phase out of carcinogenic pesticides (*Chemtura v Canada*). While the majority of these claims were resolved in favour of respondent governments, the fact that US investors are known to frequently bring controversial claims is important, as a particularly sensitive case can provoke a broader political backlash.

Overall, we find that there is a risk that controversial claims by American investors against the UK could result in political costs for the UK government. This is important given the frequency with which US investors resort to investment treaty arbitration, including in politically sensitive cases. The US government itself has realised that sensitive claims can result in a political backlash. When a Canadian company, Loewen, filed a NAFTA claim concerning its treatment by a Mississippi state court, one of the arbitrators was told informally by the US Department of Justice that "if we lose this case, we could lose NAFTA."⁶⁴ Similarly, if a US investor seeks to override an Act of the UK Parliament, for instance, or files a claim concerning sensitive areas of public regulation, such as environmental or public health regulation, this could potentially provoke a political response with systemic consequences for the ability of the UK government to support investor-state arbitration as a governing institution.

THE OPPORTUNITY COSTS OF AN EU-US INVESTMENT TREATY

A final set of potential political costs are the opportunity costs of diplomatic and bureaucratic resources expended in the negotiation and implementation of an EU-US investment treaty. Our primary focus is on the commitment of the UK's diplomatic and political resources necessary to negotiate and implement the EU treaty. However, the scale of commitment of EU resources is also relevant, to the extent the EU resources might otherwise be devoted to other initiatives that would be of greater benefit to the UK.

⁶⁴ See the discussion in Schneiderman 2010.

Negotiations for an EU-US agreement on investment protection are likely to proceed as one element of wider negotiations for an EU-US economic agreement. The fact that the EU and the US will, in any case, be negotiating on economic issues means that the incremental political costs of adding investment protection to the negotiating agenda are likely to be relatively small. One factor that could significantly increase the political costs associated with the negotiation of an EU-US investment treaty is if the EU holds out for an investment treaty based on the model investment treaties of Western European states. As we explained above, Western European investment treaties are typically short documents that set out standards of investor protection in simple, terse language. In contrast, the US 2012 model BIT is a much longer document that clarifies the standards of treatment provided and defines the procedure for investor-state arbitration with much greater specificity. The US has, historically, been unwilling to compromise on its model BIT. Therefore, if the EU declines to accept the terms of the US model BIT, negotiations could become much longer and more complex. Based on reports that the EU is, in its negotiations with Canada, preparing to accept an investment chapter similar to the US model BIT, we think it is relatively unlikely that the EU will hold out for an investment treaty based on Western European states' model treaties.

The question of bureaucratic resources required to implement an EU-US investment treaty in the UK can also be addressed succinctly. We understand that there are no plans to create any new processes or agencies within the UK government to ensure compliance with a prospective EU-US investment treaty. Instead, we understand that the UK government intends to rely on the assumption that treating foreign investors in accordance with UK law will be sufficient to meet its obligations under an EU-US BIT. If our understanding is correct, there are unlikely to be any meaningful political costs associated with the implementation of an EU-US investment treaty.

Overall, we conclude that there are likely to be some political costs associated with the diplomatic and bureaucratic resources required to negotiate and EU-US investment treaty. Assuming that the EU is willing to accept the terms of the 2012 US Model BIT, these political costs are likely to be so small as to be essentially irrelevant to our overall assessment of the net benefit of an EU-US investment treaty.

7. CONCLUSION

In this report, we have offered an informed qualitative assessment of the likely costs and benefits of an EU-US investment treaty as compared to a continuation of the legal status quo. As in the China report, we have not attempted to value these costs and benefits in monetary terms as we find this entirely unfeasible, even with more time and resources than were available to us. To summarise our findings, we conclude that:

- (1) *There is little reason to think that an EU-US investment chapter will provide the UK with significant economic benefits.* No two countries in the world exchange more investment than the UK and the US, and there is no evidence that US or UK investors view either country as suffering from the kinds of political risks against which investment treaties are supposed to protect. Moreover, existing evidence suggests that the presence of an EU-US investment chapter is highly unlikely to encourage investment above and beyond what would otherwise take place. US investors have generally not taken much notice of investment treaties in the past when deciding where, and how much, to invest abroad – even when dealing with far more questionable jurisdictions than the UK.
- (2) *There is little reason to think that an EU-US investment chapter will provide the UK with significant political benefits.* The political relationship between Washington and Whitehall is exceptionally strong, and we are aware of no evidence that it is vulnerable to a meaningful risk of investor-state disputes that would become undesirably “politicized” in the absence of an investment treaty. Secondly, we find it unlikely that an EU-US agreement would make significant negotiating partners – like India and China – more or less willing to agree to an investment treaty with the EU. Finally, it is unclear whether the US is particularly keen on an investment protection chapter with the EU, which means the Commission may not be able to use such a chapter as an effective ‘bargaining chip’ in other trade and/or investment negotiations with Washington. However, these are all issues that BIS might wish to explore in further detail.
- (3) *There is some reason to expect an EU-US investment chapter will impose meaningful economic costs on the UK.* Based on Canada’s experience under NAFTA, we would

expect an EU-US investment chapter to be regularly invoked by US investors against the UK for governmental actions that would normally not be challengeable under UK law. While we would not expect the UK to lose many of these cases on the merits, the UK will necessarily incur costs to defend itself. Legal costs in investment treaty claims are substantial. The UK government may also find itself subject to pressure to settle some claims, even when there are reasonable prospects of successfully defending the claim on the merits. Finally, given the uncertain meaning of key elements of international investment law, it is possible that the UK would occasionally lose some arbitrations on the merits and be liable for significant damage awards.

(4) *There is some reason to expect an EU-US investment chapter to impose meaningful political costs on the UK.* Under investment treaties similar to a likely EU-US investment chapter, US investors have brought claims that raise potentially controversial questions. Should US investors bring similar claims against the UK, this will increase the chances that a particular dispute could provoke a backlash against the EU-US economic agreement as a whole or, perhaps more broadly, investor-state arbitration as a governing institution.

In sum, an EU-US investment chapter is likely to provide the UK with few or no benefits. On the other hand, with more than a quarter of a trillion dollars in US FDI stock, the UK exposes itself to a significant measure of costs. Using Canada's experience under NAFTA as an example, we would expect those costs to be manageable overall, but nevertheless considerable. Unlike in the UK at the time of writing, investment treaty arbitration has become politically controversial in Canada because of the frequency and character of investor challenges to Canadian government policies, and the Canadian government has had to invest considerable resources in an investment-treaty defence capacity as a result of its more than 30 NAFTA claims. While few of these cases were lost on the merits, Canada has faced incentives to settle cases either by paying compensation or, in some reported cases, by changing government policies. We would expect the UK to have an approximately similar experience under an EU-US investment chapter, though the larger stock of US investment in Britain could imply that the UK may be subject to an even greater number of disputes – and thus potential costs - than Canada.

In none of our former reports have we made explicit policy recommendations for the UK government, and neither will we here. However, our assessment does raise questions whether the UK government might consider one of two options in negotiating an EU-US investment treaty. The first is to exclude investment *protection* provisions from the agreement, and solely focus on investment liberalization. Recall that to our knowledge British investors have not expressed general concerns about their legal protection in the US. A pure liberalization agreement would thereby allow the UK government to focus on the *actual* concerns of British investors – market access – without at the same time exposing the government to potentially expensive and controversial investment treaty claims. An alternative option is to include investment protection provisions, but exclude comprehensive ISDS from the agreement. As noted, the US (hesitantly) agreed to this in its FTA with Australia, which could provide a model for an EU-US investment treaty as well. This, too, would imply that the UK would be able to support an EU-US investment treaty overall, without being exposed to the types of investment disputes that otherwise could result in net costs for the UK government.

BIBLIOGRAPHY

- APEC (2011). 2010 Guide to Investment Regimes of APEC Member Countries, 2nd revised edition. Singapore: APEC Secretariat.
- BURKE-WHITE, WILLIAM & ANDREAS VON STADEN (2008). 'Investment Protection in Extraordinary Times: The Interpretation and Application of Non-Precluded Measures Provisions in Bilateral Investment Treaties,' *Virginia Journal of International Law*, 48.
- CAPLAN, LEE M & JEREMY K. SHARPE (2013). 'United States,' in: Chester Brown, ed., Commentaries on Selected Investment Treaties. Oxford: Oxford University Press.
- CFIUS [COMMITTEE ON FOREIGN INVESTMENT IN THE UNITED STATES] (2012). Annual Report to Congress. Washington DC: CFIUS.
- CRAIG, PAUL (2012). Administrative Law. Oxford: Oxford University Press.
- EUROPEAN COMMISSION, *Draft Financial Responsibility Regulation* COM(2012) 335 final, 2012/0163 (COD), 21 June 2012
- FAGAN, DAVID (2010). 'The U.S. Regulatory and Institutional Framework for FDI,' in: Karl Sauvant, ed., Investing in the United States: Is the U.S. Ready for FDI from China? Cheltenham: Edward Elgar.
- FRANCK, SUSAN (2007). 'Empirically Evaluating Claims About Investment Treaty Arbitration,' *North Carolina Law Review*, 86.
- (2011). 'Rationalizing Costs in Investment Treaty Arbitration,' *Washington University Law Review*, 88.
- GALLAGHER, KEVIN AND ELEN SHRESTHA (2011). 'Investment Treaty Arbitration and Developing Countries: A Re-Appraisal,' *Global Development and Environment Institute Working Paper No. 11-01*.
- GRUBER, LLOYD (2000). *Ruling the Word*. Princeton: Princeton University Press.
- HODGSON, MATTHEW (2012). Counting the Costs of Investment Treaty Arbitration. Allen & Overy
- KLÄGER, ROLAND (2011). Fair and Equitable Treatment in International Investment Law. Cambridge: Cambridge University Press.
- MAURER, NOEL (2013). *Empire Trap*. Princeton: Princeton University Press.

- PEINHARDT, CLINT AND TODD ALLEE (2012). 'Failure to Deliver: The Investment Effects of US Preferential Economic Agreements,' *The World Economy* 35:6.
- OECD (2012). 'Scoping Paper for "Investor-State Dispute Settlement Public Consultation," available at: oecd.org/investment/internationalinvestmentagreements/50291642.pdf.
- POULSEN, LAUGE (2010). 'The Importance of BITs for Foreign Direct Investment and Political Risk Insurance: Revisiting the Evidence,' *Yearbook on International Investment Law & Policy 2009-2010*. Oxford: Oxford University Press.
- SAUVANT, KARL, LISA SACHS AND WOUTER SCHMIT JONGBLOED (2013). Sovereign Investment. New York: Oxford University Press.
- SCHNEIDERMAN, DAVID (2010). 'Judicial Politics and International Investment Arbitration: Seeking an Explanaton for Conflicting Outcomes,' *Northwestern Journal of International and Business Law*, 30.
- TIENHAARA, KYLA (2009). The Expropriation of Environmental Governance. Cambridge: Cambridge University Press.
- TURIA, TARIANA (2013). 'Government moves forward with plain packaging of tobacco products' *Beehive.govt.nz: The Official Website of the New Zealand Government*, 19 February 2013
- UKTI (2013). Establishing a business presence in the USA. London: UKTI.
- VANDEVELDE, KENNETH J. (2009). U.S. International Investment Agreements. Oxford: Oxford University Press.
- VANDEVELDE, KENNETH J. (2010). Bilateral Investment Treaties: History, Policy and Interpretation. Oxford: Oxford University Press.
- WHICHARD, OBIE. (2008). 'Multiple Indicators for Multiple Issues: United States Statistics on Foreign Direct Investment,' presented at OECD Global Forum on International Investment VII, 27-28 March 2008.
- YACKEE, JASON W. (2010). 'Do Bilateral Investment Treaties Promote Foreign Direct Investment? Some Hints from Alternative Sources of Evidence,' *Virginia Journal of International Law* 51:2.