Submission to International Trade Committee Inquiry on UK Trade Negotiations – Windfall Taxes and Investment Treaties

1. During the Committee's oral evidence session on Investor–State Dispute Settlement (ISDS) on 18 January 2023 the Committee Chair asked me a question about potential liability for windfall tax measures (transcript Q9). The purpose of this written submission is to supplement my oral answer by providing the Committee a fuller response on the issues arising in relation to possible State liability for windfall tax measures under investment treaties. The aim of this brief submission is to outline the relevant legal issues for the Committee – obviously it does not constitute legal advice.

2. The Committee should be aware that there is a history of ISDS claims under investment treaties in relation to windfall tax measures in the resources sector. For example, three cases under investment treaties were litigated by foreign investors against Ecuador in relation to a windfall tax imposed by that State on the oil sector in the mid-2000s in response to a dramatic increase in the price of oil, and one case has been litigated against Mongolia in relation to a windfall tax imposed on gold mining. Overall, a careful reading of these prior arbitral decisions suggests that a well-designed windfall profits tax should comply with standard investment protection obligations as found in the UK's investment treaties.

3. I note that in May 2022, when the UK enacted a 25% windfall tax on extraordinary profits in the oil and gas sector (additional to existing taxation of profits in the sector), at least one major law firm publicised to its clients that it may be possible to challenge this measure under the UK's existing Bilateral Investment Treaties (BITs).[1] The relevant publication did not provide any detailed legal analysis to support this claim, but it suggests that this could become a live issue for the UK. The UK has since increased the oil and gas windfall tax to 35% and imposed an 'electricity generator levy' on low-carbon electricity generators of 45% on revenues above a benchmark price.

4. **Windfall taxes and indirect expropriation claims**: The existing case law suggests that an investor would face major difficulties in establishing that the imposition of a windfall profits tax amounted to an indirect expropriation. Essentially this is because the existing case law is clear that an indirect expropriation has a high threshold, requiring that the investor has been substantially deprived of the control and use of the investment, as if the investment had ceased to exist. Where the investor remains in control of the investment, a mere partial loss of profitability is not sufficient to establish an indirect expropriation.[2] As a general matter, ISDS tribunal recognise that taxation laws will not constitute an indirect expropriation, however that are certain limited circumstances where there can do so, for example where a tax is confiscatory, or, in other words, has such a severe effect that it destroys the ongoing commercial viability of the investment.[3]

[1] Squire Patton Boggs, 'UK 25% Windfall Tax on Oil and Gas Companies May Give Rise to BIT Claims for Compensation' 26 May 2022 https://www.squirepattonboggs.com/en/insights/publications/2022/05/uk-25-windfall-tax-on-oil-and-gas-companies-may-give-rise-to-bit-claims-for-compensation

[2] See eg *Perenco Ecuador Ltd v Ecuador*, ICSID Case No ARB/08/6, Decision on Remaining Issues of Jurisdiction and on Liability (12 September 2014) paras 672-3, *EnCana Corp v Ecuador*, LCIA Case UN3481, Award (3 February 2006) para 173-4, 177. See also discussion in Prabhash Ranjan, 'Investor-state dispute settlement and tax matters: limitations on state's sovereign right to tax', forthcoming, *Asia Pacific Law Review* p. 5-6 https://doi.org/10.1080/10192557.2022.2102588.

[3] *Burlington Resources Inc v Ecuador*, ICSID Case No ARB/08/5, Decision on Liability (14 December 2012)

5. In two of the three cases concerning Ecuador's windfall profits tax in the oil sector, investment treaty tribunals ruled on and rejected the claim that the imposition of the windfall tax constituted an indirect expropriation. Ecuador's windfall profits tax was initially set at 50% of revenues above a reference price, and then increased to 99% of revenues above the reference price. Even in relation to the windfall tax at 99% of extraordinary profits, the two tribunals that addressed the issue held that this did not amount to an indirect expropriation, because the investor remained in control of the investment and the investment was still able 'to generate a commercial return', despite profitability being reduced.[4] Similarly, Mongolia's windfall profits tax was held not to constitute an indirect expropriation because the investor continued to control the investment, and while the investor claimed it had recorded a loss of around US$1m in the year the windfall tax was imposed, such a loss did not destroy the ongoing enterprise bearing in mind its 'long history of strong annual profits and a context of substantial increases in the price of gold in the subsequent years'.[5]

6. **Fair and Equitable Treatment Standard and Windfall Taxes**. Fair and Equitable Treatment (FET) claims could pose a somewhat bigger threat to windfall tax measures because the FET standard can potentially be violated by measures that merely reduce the profitability of an investment, but do not reach the threshold for an indirect expropriation. The aspect of the FET standard this is most likely to be invoked in relation to windfall tax measures is the part of the standard (as elaborated in existing case law) that protects the investor's legitimate expectations and provides a limited guarantee regarding the stability of the host State's regulatory system. <u>So long as a State does not promise or represent to the investor that the tax laws applicable to the investment will not change over the lifetime of the investment (known as a 'stabilization' promise), a windfall tax is unlikely to amount to a violation of the FET standard</u>. The existing case law is clear that if an investor has not obtained a promise of tax stabilization, they cannot reasonably expect that the State's tax laws will not change in future, and it is the investor that will bear the risk of such changes.[6] Indeed, in the existing case law concerning windfall taxes in the resources sector arbitral tribunals have repeatedly emphasised that in a context of 'dramatic unforeseen increases in the prices of certain commodities' investors should expect that a host State may wish to increase taxation of the relevant sector.[7]

7. In the cases concerning Ecuador's windfall tax in the oil sector, two of three tribunals found they had jurisdiction over FET claims made by investors. Both tribunals held that the initial windfall profits tax, imposed at 50% of revenues above the reference price, did not breach the FET standard.[8] One of these tribunals highlighted that the relevant investor–State contract did not contain a stabilization clause and the windfall tax at 50% of extraordinary revenues did not fundamentally change the operation of the contract, with the investor still able to earn more revenue that before the oil price rise.[9] In contrast,

---

paras 391-399. *EnCana Corp v Ecuador* (n 2) para 177.

[4] *Burlington v Ecuador* (n 3) para 456. *Perenco v Ecuador* (n 2) paras 684-685.

[5] *Sergei Paushok and ors v Mongolia*, Award on Jurisdiction and Liability (28 April 2011) UNCITRAL, para 334.

[6] *Paushok v Mongolia* (n 5) paras 302, 305. See also discussion in Ranjan (n 2) 12-13.

[7] *Paushok v Mongolia* (n 5) para 305, *Perenco v Ecuador* (n 2) paras 588, 595; *Murphy Exploration & Production Company – International v Ecuador*, PCA, UNCITRAL, Partial Final Award (6 May 2016) paras 276, 280.

[8] *Perenco v Ecuador* (n 2) para 602. *Murphy v Ecuador* (n 7) para 280.

both of these tribunals held that Ecuador's increase of the windfall profits tax to 99% of revenues above the reference price breached the FET standard, as this measure was held to have been a means for Ecuador to unilaterally alter the economic basis of the investor–State contracts that were in place (effectively changing them from 'participation' to 'service' contracts), contrary to the investor's legitimate expectation that the basic terms of the contract would only change through a negotiated agreement.[10] The UK's current windfall taxes are not comparable to Ecuador's windfall tax imposed at 99%, which had the purpose of forcing a renegotiation of the contracts between Ecuador and the oil producers and was accompanied by various other coercive measures.

8. **Non-discrimination and arbitrariness**: In short, the UK's windfall taxes would be very unlikely to breach the part of the FET standard that protects investors against arbitrary or discriminatory measures, or other BIT provisions that protect against unreasonable or discriminatory impairment of investments. This is because there are legitimate public policy rationales for the measures, given the dramatic increases in energy prices (sometimes unrelated to the costs of production) and, as far as I am aware, the measures apply equally to all producers covered by the terms of the measures (whether domestic or foreign-owned).[11]

9. **Absence of general carve-outs for taxation measures in almost all the UK's BITs:** <u>The Committee should be aware that unlike many recent investment treaties, the UK's BITs do not include a carve-out that removes taxation measures from the scope of ISDS or from the scope of the investment protection obligations most commonly invoked by investors in ISDS</u>. There is one exception to this observation which is the Colombia–UK BIT, the last BIT the UK concluded before the EU obtained competence over foreign investment issues. Similarly to many investment treaties of the last 20 years, the Colombia–UK BIT contains a carve-out which provides that the agreement does not apply to taxation measures, except for the obligation on expropriation and the provision on ISDS.[12] Importantly, the Colombia–UK BIT also creates a process to govern the application of this tax carve-out to specific investor claims. It provides that if an investor invokes the expropriation provision in relation to a tax measure, it must, when notifying the treaty party of the dispute, refer the issue of whether the tax measure constitutes an expropriation to the competent tax authorities of the treaty parties, who shall consult and have 6 months in which they can reach an agreement that the measure does not involve an expropriation. If the competent tax authorities of the treaty parties do not reach such an agreement, the investor is permitted to submit its claim that a tax measure constitutes an expropriation to ISDS. This is an example of the point I mentioned in my oral evidence that in terms of the effectiveness of carve-outs, it is worth considering whether a process is created by the treaty that gives the treaty parties (or their authorities) joint control over the application of the carve-out to specific investor claims. Such a process can enable the relevant issue (here whether a tax measure constitutes an expropriation) to be determined by domestic authorities with specialist expertise, without the issue proceeding to ISDS (with the associated costs and time). Because this procedure requires the agreement of the both treaty parties' tax authorities for the carve-out to apply it contains an important safeguard against abuse and opportunistic behaviour by host states.[13]

---

[9] *Murphy v Ecuador* (n 7) para 276-280; *Perenco v Ecuador* (n 2) para 602.
[10] *Perenco v Ecuador* (n 2) paras 606-607; *Murphy v Ecuador* (n 7) paras 282, 292.
[11] See *Paushok v Mongolia* (n 5) paras 310-316.
[12] UK–Colombia BIT art XIII(3).
[13] Anne van Aaken, 'Delegating Interpretative Authority in Investment Treaties: The Case of Joint

10. The vast majority of the UK's BITs include a provision that with some variations creates a limited exception to the national treatment and most-favoured-nation treatment standards. Specifically, it provides that these provisions 'shall not be construed so as to oblige one Contracting Party to extend to the investors of the other Contracting Party the benefit of any treatment, preference or privilege resulting from any international agreement or arrangement relating wholly or mainly to taxation or any domestic legislation relating wholly or mainly to taxation'.[14] The purpose of this provision is to prevent the UK from having to extend to investors of the relevant BIT partner any privileges resulting from either a double taxation agreement or from domestic tax laws (eg allowances under UK tax law that are only available to UK residents).[15] This exception is unlikely to be relevant to a windfall tax imposed by the UK on all economic actors in a sector (irrespective of nationality) and obviously only applies to the national treatment and MFN standards, which are only rarely invoked as the basis for ISDS claims.

Administrative Commissions', in Jean E Kalicki and Anna Joubin-Bret (eds), *Reshaping the Investor-State Dispute Settlement System: Journeys for the 21st Century* (Brill Nijhoff, 2015) pp. 38, 40–41.

[14] UK–Mexico BIT art 5(b).

[15] See Chester Brown and Audley Sheppard 'United Kingdom' in Chester Brown (ed), *Commentaries on Selected Model Investment Treaties* (OUP 2013) p. 741, quoting the Foreign Office commentary to the original 1972 UK Model BIT.