From Regulatory Chill to Regulatory Concussion: NAFTA’s Prohibition on Domestic Performance Requirements and an Absurdly Narrow Interpretation of Country Specific Reservations

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Award commented on:
Mobil Investments Canada Inc. and Murphy Oil Corporation v Canada, ICSID Case No ARB(AF)/07/4. Decision on Liability and Principles of Quantum, dispatched to the parties, May 22, 2012, redacted version released in the fall of 2012. Both the majority award (206pp) and a partial dissenting award (Professor Philippe Sands QC) are available here.

Case commented on:
Hibernia Management and Development Company Ltd. v Canada-Newfoundland and Labrador Offshore Petroleum Board, 2008 NLCA 46 (CanLII)

In this Award a NAFTA Tribunal (by a Majority) found that Canada was in breach of the prohibition on domestic performance requirements of Article 1106 of NAFTA when the Canada Newfoundland Offshore Petroleum Board (CNOPB or Board) established and imposed a research investment target (the 2004 Guidelines) on operators working on the Newfoundland continental shelf. In doing so the Majority of the Tribunal ruled that Canada could not rely upon its country specific reservation. While Canada’s reservation protected the performance requirements that were in place at the time that NAFTA was entered into it did not protect the 2004 Guidelines. In reaching this conclusion the Majority severely constrains the ability of the host state to adopt new subordinate measures (e.g. regulations, guidelines and policies) to give effect to a reserved power. In effect, the Majority has adopted a one-way ratchet in which any subordinate measure adopted by a state that does not fully exploit the entire space offered by the text of a reservation may make it impossible for the host state to recover the lost ground. This, as the Dissent lucidly demonstrates, is an unreasonably narrow construction of the power of each NAFTA state to take a reservation to its general commitment not to impose domestic performance requirements on investors.

Less controversially, the Tribunal unanimously reached the conclusion that Canada was not in breach of Article 1105 of NAFTA. Here the Tribunal offers some useful guidance as to the limited scope of protection offered by the NAFTA version of the minimum standard of treatment. In particular, an investor cannot complain of regulatory change absent proof of promises, assurances or representations made by a government to the effect that the existing regime (here a benefits regime) would not change.
The background

Both Murphy and Mobil have interests in the Hibernia project (gross capital investment $5.8 billion, current production about 140,000 bbls per day) and the Terra Nova project (gross capital investment of about $3 billion, current production now less than 100,000 bbls per day) on the Newfoundland continental shelf. The projects are approved and regulated under the terms of federal and provincial mirror legislation implementing the Atlantic Accord. The federal legislation is the Canada-Newfoundland Atlantic Accord Implementation Act, SC 1987, c 3. The Act is principally administered by the Canada-Newfoundland Offshore Petroleum Board (the Board). Section 45 provides that the Board cannot approve a development plan for an offshore project without approving a Canada-Newfoundland benefits plan. Such a plan must include a proposal for research and development (R & D) and education and training (E & T). Section 15.1 (added in 1992, well before NAFTA entered into force on 1 January 1994) authorizes the Board to issue and publish guidelines on a number of matters including benefits plans. The Board first issued guidelines in 1986 and revised them successively in 1986, 1987, 1988 and 2004. The early versions of the guidelines focused on the exploration phase rather than the development phase of project activities. The 2004 Guidelines introduced the idea of an industry wide benchmark against which to measure R & D contributions. The Board introduced the Guidelines because of concerns that R & D investments were falling as the projects moved into the production phase.

Benefits Plans were established for each of the projects (Hibernia 1985 and Terra Nova 1997). Plans for both projects were heavy on principles rather than detailed commitments. The 2004 Guidelines require operators to make certain levels of expenditure on R & D matters for each of the exploration, development and production phases of the project. The Board calculated these expenditure targets based on Statistics Canada data for average R & D expenditures in the industry. In default thereof, operators were required to contribute any shortfall to a Board administered R & D Fund. The Guidelines were made enforceable by making them a condition of the operator’s Production Operations Authorization (POA).

It was these 2004 Guidelines that gave rise to the dispute. The applicants argued that these new requirements breached both the minimum standard of treatment (Article 1105) and the prohibition against domestic performance requirements provisions of NAFTA (Article 1106). The applicants further argued that the new requirements did not fall within the country specific reservation that Canada had taken upon ratification of NAFTA. Efforts by the operators to contest the validity of the Guidelines in the Newfoundland courts failed: see reference above and discussed at various points in the Award (e.g. at paras 86 and especially at paras 167 – 169 (in the context of the FET standard) and 354 - 355).

The performance requirement issue

Article 1106 of NAFTA, so far as relevant, provides as follows:

1. No Party may impose or enforce any of the following requirements, or enforce any commitment or undertaking, in connection with the establishment, acquisition, expansion, management, conduct or operation of an investment of an investor of a Party or of a non-Party in its territory:

   …

   (b) to achieve a given level or percentage of domestic content;
(c) to purchase, use or accord a preference to goods produced or services provided in its territory, or to purchase goods or services from persons in its territory;

3. No Party may condition the receipt or continued receipt of an advantage, in connection with an investment in its territory of an investor of a Party or of a non-Party, on compliance with any of the following requirements:

(a) to achieve a given level or percentage of domestic content;

(b) to purchase, use or accord a preference to goods produced in its territory, or to purchase goods from producers in its territory;

4. Nothing in paragraph 3 shall be construed to prevent a Party from conditioning the receipt or continued receipt of an advantage, in connection with an investment in its territory of an investor of a Party or of a non-Party, on compliance with a requirement to locate production, provide a service, train or employ workers, construct or expand particular facilities, or carry out research and development, in its territory.

5. Paragraphs 1 and 3 do not apply to any requirement other than the requirements set out in those paragraphs.

6. Provided that such measures are not applied in an arbitrary or unjustifiable manner, or do not constitute a disguised restriction on international trade or investment, nothing in paragraph 1(b) or (c) or 3(a) or (b) shall be construed to prevent any Party from adopting or maintaining measures, including environmental measures:

(a) necessary to secure compliance with laws and regulations that are not inconsistent with the provisions of this Agreement;

(b) necessary to protect human, animal or plant life or health; or

(c) necessary for the conservation of living or non-living exhaustible natural resources.

It is also necessary to set out the provisions relating to reservations. Thus, Article 1108 provides that Article 1106 does not apply to:

(a) any existing non-conforming measure that is maintained by

   (i) a Party at the federal level, as set out in its Schedule to Annex I or III,

(b) the continuation or prompt renewal of any non-conforming measure referred to in subparagraph (a); or

(c) an amendment to any non-conforming measure referred to in subparagraph (a) to the extent that the amendment does not decrease the conformity of the measure,
as it existed immediately before the amendment, with Articles 1102, 1103, 1106 and 1107.

A reservation extends to and encompasses both the non-conforming measure and “any subordinate measure” (at para 264, referring to the text of Annex I). A reservation must identify (Annex I, para 2), (a) sectors, (b) subsectors, (c) industry classification, (d) type of reservation, (e) level of government, (f) laws, regulations or other measures for which the reservation is taken (g) description, and (h) if to be phased out.

In this case, the law set out in the Annex is the federal Act and the description refers to the requirements for a benefits plan. The reservation did not identify any particular section. The parties agreed that section 45 of the federal Act was an existing non-conforming measure (at para 273). Section 15.1 (the section pursuant to which the guidelines were adopted (at para 274)) was more contentious. However, the tribunal appears to accept (at paras 279 – 281) that section 15.1 in principle is covered by the reservation while at the same time concluding that not every guideline adopted under the authority of the section will be covered (more on that momentarily).

In addition to “measures” (i.e. the federal Act), NAFTA also refers to “subordinate measures.” But, as the tribunal acknowledges, (at para 284):

> Articles 1106 and 1108 of the NAFTA do not refer to the term “subordinate measure,” and it is not found in Chapter 11 of the NAFTA at all. However, it appears in paragraph 2(f) of Annex I. Provided it meets certain conditions, a subordinate measure forms a part of a reservation made by a NAFTA Party with respect to existing measures that do not conform with obligations imposed by Article 1106. (Emphasis supplied)

**Did the Guidelines Constitute a Domestic Performance Measure?**

The most important part of the Award deals with the interpretation of the reservations provisions of NAFTA as they apply to Article 1106, but before discussing those provisions the Tribunal first had to conclude that the Guidelines were domestic performance requirements within the meaning of Article 1106. On that issue there were two preliminary points, first, did the R & D and E & T requirements of the Guidelines fall within the scope of Article 1106(1) at all, and if so, second, did the Guidelines impose a duty to acquire goods or services locally?

**Did the R & D and E & T requirements of the Guidelines fall within the scope of Article 1106(1)?**

The Tribunal acknowledged (at para 215) that Article 1106 does not specifically refer to R & D and E & T issues but took the view that the term ‘services’ as used in Article 1106(1)(c) (at para 216) “covers a broad range of economic activities, and R & D and E & T may be seen as mainstream forms of service sector activity.” Such a reading was also consistent with how services are treated more broadly in the text of NAFTA (at paras 219 and 225) and in any event (at para 222) “the requirement to utilize domestic sources of R & D and E & T appears rather clearly to be a form of performance requirement imposed on an investor.”
Did the Guidelines impose a duty to acquire good or services locally?

The Tribunal was equally dismissive (and rightly so) of Canada’s efforts to suggest that there was no necessary domestic content to the Guideline and that it might be possible for an operator to meet the terms of the Guidelines without purchasing domestic goods and services. That was clearly unrealistic (at paras 237 and 238): “In practice, the Tribunal fails to see how the operators could, in reality, be required to spend millions of dollars on R & D and E & T in the Province without in practice being required to purchase, use, or accord a preference to domestic goods or services.” Furthermore, unlike earlier NAFTA cases R & D and E & T spending was not just an ancillary element of the regulatory regime “it was a central feature” of the 2004 Guidelines (at para 242).

The Article 1108 Exceptions

A preliminary point with respect to the Exceptions arguments was the question of whether the exceptions should be interpreted in any different manner than any other provisions of NAFTA. The Claimants in particular evidently wished to argue that they should be interpreted restrictively but at the end of the day all the parties seemed to accept that they should be interpreted (as with all of the other provisions of NAFTA) in accordance with the interpretation rules (Articles 31 – 33) of the Vienna Convention on the Law of Treaties (VCLT) (at paras 250 and 254; and see also Dissent at para 4):

Each NAFTA Party was free to identify and put forth its own reservations, which represented one Member’s binding commitment. That said, it is important to stress that the reservations are an integral part of the NAFTA. The task of ascertaining the meaning of a reservation, like the task of interpreting any other treaty text, involves understanding the intention of the NAFTA Parties, and it is to be achieved by following the customary rules of interpretation of public international law, as reflected in Articles 31 and 32 of the VCLT. There is no dispute on this point between the parties. The Tribunal proceeds on that basis.

In doing so the Tribunal understood that it should not presumptively accord a broad or narrow meaning to the reservations. The Tribunal was very much aware that its interpretation might have implications for the “system of reservations as a whole” embedded in NAFTA.

The System of Reservations

NAFTA contemplates that each of the contracting parties should be able to make reservations with respect to existing non-conforming measures pertaining to performance requirements. This is provided for by Article 1108 and the relevant Annexes, especially Annex I. In order to claim a reservation, Annex I requires each party to provide detailed information as to the elements of the reservation (at paras 260 – 263). By contrast (and as the Dissent emphasizes at several points (Dissent at paras 11 & 36)) there is no requirement in Article 1108 or anywhere else for a Party to set out any ‘subordinate measure’ that has been adopted or maintained. The reservation once made extends to the non-conforming measure itself including: (1) the continuation or prompt renewal of that measure or an amendment to the measure (provided that it does not decrease the conformity of the measure), and (2) any subordinate measure of the non-conforming measure.

The existing measure in this case was the federal Accord Act (at para 269) (hereafter the reserved measure). The description element refers to benefits plans but does not refer to any specific
section of the *Accord Act*. That led to some discussion as to the scope of Canada’s reservation. Canada argued that the reservation covered the entire statute while the claimant suggested that it should be confined to section 45 (problematic from Canada’s perspective since it was agreed (at para 274) that the Guidelines were adopted under section 15.1). Faced with these two alternative positions the Majority (moving seamlessly from the statutory provisions themselves to the Guidelines) reasoned as follows (at para 279):

The Tribunal considers that the more plausible approach is to examine the reserved measure as qualified by the “Description element,” and then in accordance with the VCLT determine whether a particular provision of the Federal Accord Act is covered or not. In the present case, the qualification addresses the requirement that the Benefits Plan ensure that expenditures be made for research and development to be carried out in the province, and for education and training to be provided in the province. Section 151.1 of the Federal *Accord Act* is not specifically mentioned in the “Description element” but looking at the Federal *Accord Act* as a whole, the 2004 Guidelines issued pursuant to Section 151.1 provide a means, not necessarily the only means, by which guidance is offered on how to ensure that expenditures on research and development are carried out in the Province.

What the Tribunal seems to be saying here (and what the subsequent paragraphs of the Award clarify) is that section 15.1 is included in the reserved Measure but that the Guidelines themselves constitute a subordinate measure the validity or conformity of which is still to be examined. The Tribunal also concluded that Board decisions approving particular Plans are not themselves reserved Measures but might qualify as subordinate measures.

In view of this approach it then became crucial for the Tribunal to determine under what circumstances something might qualify as a subordinate measure not least because (at para 284) “Provided it meets certain conditions, a subordinate measure forms a part of a reservation made by a NAFTA Party with respect to existing measures that do not conform with obligations imposed by Article 1106.”

There are three principal qualifying elements for a subordinate measure. First, such a measure must be “adopted or maintained,” second it must derive its “authority” from the reserved measure, and third it must be consistent with the measure. The controversial issue here related to the scope of the consistency analysis.

*Adopted or maintained*

The Tribunal held that the two terms were not synonymous and concluded that the term “maintained” refers to a subordinate measure that was in force when NAFTA came into effect whereas “adopted” refers to a measure that came into force after NAFTA came into effect (at para 297): i.e. a “new subordinate measure”. The implications in this case were as follows (at paras 298 – 299):

… the Hibernia Benefits Plan and Decision 86.01, having been adopted before January 1, 1994, are “subordinate measures” that are “maintained,” within the meaning of paragraph 2(f)(ii) of Annex I.
With respect to the Terra Nova Benefits Plan and Decision 97.02, as well as the 2004 Guidelines, (having been adopted after January 1, 1994) they are “subordinate measures” that have been “adopted,” within the meaning of paragraph 2(f)(ii) of Annex I, and are each to be considered “new subordinate measures.”

Under the Authority of the Measure

The Tribunal made surprisingly heavy weather of this issue. It soon concluded (at para 329) that “it is the reserved measure that provides the legal basis or origin of the subsequent measure” but that led to another “what is the applicable law” for determining authority? Is it national law, NAFTA or both? The Dissent was firmly of the view that the issue must be determined by national law (and that it had been – see the judgement of the Newfoundland Court of Appeal) and the United States and Mexico seemingly agreed with that as well – and perhaps even the majority at certain points (see here at para 350). But at other points the Majority (who by this time were carefully paving the way for their holistic take on the concept of consistency) were much more equivocal. Here is what the Majority had to say on the issue of authority (at para 330):

In the Majority’s reading, “authority” certainly requires that the subordinate measure must be determined in relation to the reserved measure. Whether other existing subordinate measures, in addition to the reserved measure, are also a critical part of that evaluation of “the measure” will depend on the facts of the case. On the facts we have before us, the Hibernia and Terra Nova Benefits Plans and related Board Decisions are “under the authority” of the Federal Accord Act. The 2004 Guidelines are also issued pursuant to the Federal Accord Act. It clearly makes no sense to suggest that the 2004 Guidelines, which are measures of general application, have to be “under the authority” of the Hibernia and Terra Nova Benefits Plans and Board Decisions, which are subordinate measures that apply to particular investment projects. Both sets of subordinate measures are authorized separately by the Federal Accord Act in a vertical relationship to that Act, but are not in a vertical relationship with each other. In this case, “the measure” that is the necessary reference for determining the “authority” of the 2004 Guidelines is the Federal Accord Act alone. It does not necessarily follow that this fact pattern will always be the case. The Majority can envision other factual circumstances, arguendo, where there are a number of subordinate measures that are in a vertical relationship to each other, such that a new rule or regulation is specifically introduced in order to implement a provision of an existing subordinate measure, both of which legally owe their existence to the reserved measure. In such circumstances, to understand whether the new subordinate measure is under the authority of the reserved measure, the treaty interpreter would be required to look at the reserved measure as well as other subordinate measures in the vertical chain in order to make sense of the legal framework.

And even if the matter was to be determined by domestic law, there was (at least from the claimants’ perspective and perhaps also from the perspective of the Majority) the problem of just what it was that the Court of Appeal had decided. After all, in the pluralistic world of domestic administrative law, it is not as if a Court sitting on a judicial review application is typically determining correctness. A Court sitting in review generally owes some degree of deference to
the tribunal and accordingly the standard of review is more likely to be reasonableness than correctness. That was indeed the case here (see 2008 NLCA 46 especially at paras 32 - 58). While the Majority of the Tribunal ultimately deferred to the authority of the domestic law and the domestic court on the issue one gets the sense (see especially at para 355) that they did so with some reluctance.

*The measure with which the subordinate measure must be consistent*

The question here was whether the context for assessing consistency and authority was confined to the federal Act (i.e. the reserved Measure itself) or whether, as the claimant contended, the subordinate measure must also be consistent with other relevant subordinate measures and in particular (at para 310) the Hibernia and Terra Nova benefits plans and related Board decisions. The Majority found for the claimant on this point (at para 325) relying in large part (at para 324) on an interpretative note to a Party’s Schedule to an Annex which provides that the term “measure” refers to the reserved measure (in this case the Act) and “includes subordinate measures adopted or maintained under the authority of and consistent with the measure.” The Majority justified this conclusion and expanded upon the consequences of this interpretive approach as follows (at para 326):

The Majority agrees with the argument advanced by the Claimants that there is nothing in the interpretative note that provides an exception so as to exclude a subsequent subordinate measure that meets the test in paragraph 2(f). In our reading of this text, once a subordinate measure passes the crucial test laid out in paragraph 2(f)(ii), it is correctly “included” within the ambit of the non-conforming and expressly listed measure for the purposes of evaluating a subsequent subordinate measure. Thereafter, and depending on the facts of the case, the reserved measure and the subordinate measure should be interpreted together for the purposes of Annex I. It is in this way that the non-conforming measure includes the subordinate measure.

Such an approach demanded a complex analytical structure. The Majority provided the necessary elaboration through a series of questions designed to test the consistency of the 2004 Guidelines with the Federal *Accord Act*, the Hibernia and Terra Nova Benefits Plans and related Board decisions (at para 392):

1. can there be a change in the methodology for requiring and calculating the expenditures to be made for research and development to be carried out in the province, and for education and training to be provided in the province, as compared with that which pertained on 1 January 1994, and what are the key characteristics of the methodology introduced by these 2004 Guidelines as compared with the existing measures;

2. can there be an extension of the requirement to make such expenditures in relation to the development and production phase, as compared with it being limited to the exploration phase as pertained on 1 January 1994, and what are the consequences of this extension;

3. can the amounts of such expenditures to be imposed in a Benefits Plan be specified, rather than determined through the self identified needs of the project
operator, and also increased beyond those that would have pertained under the previous Benefits Plans as now required by the 2004 Guidelines; and

(4) can additional oversight and reporting requirements be introduced that reduce the discretion of the operators via the now mandatory pre-approval process, and against what standard should such adjustments … be evaluated?

The Majority was however careful to caution that these questions and the answers to them must be read contextually – there was no bright line. For example, the Majority suggested (at para 394) that a mere change in the methodology for determining the level of required expenditures was not itself problematic. Neither was the extension of the benefits requirements from the exploration phase of the projects to the development and production phases (at para 399), nor the mere fact that additional expenditures might be required (at para 400) What seems to have been fatal here was a combination of things: (1) the decision to base the level of contributions on industry norms thereby severing the connection between these particular projects and the requirements of the Guidelines (see in particular at paragraph 397, “requirements based on a methodology that is unrelated to the specific needs of the project”), (2) the substantially increased amounts of domestic expenditures over what the Plans would have required during the development and production phases of the project (at para 401), and (3) the enhanced monitoring and reporting requirements that were imposed (paras 402 – 404). The result of the analysis was unequivocal for the Majority (at para 398):

The particular approach contained in the 2004 Guidelines has introduced expenditure requirements, reporting requirements, and financial administrative adjustments that result in a set of additional obligations with respect to the Hibernia and Terra Nova projects that are different in nature and degree than those previously applied to these investment projects. Examining all of these attributes together, the Majority is of the view that the changes that have been introduced and applied to Hibernia and Terra Nova amount to more than mere changes in the methodology, but in fact reflect a fundamentally different approach to compliance, compared to the Federal Accord Act and the Hibernia and Terra Nova Benefits Plans.

Taken together this resulted in (at para 409) a “local content regime that [was] … more non-conforming with Article 1106 than was the case when the measures that applied to the Hibernia and Terra Nova investment projects were defined by the Federal Accord Act, the Hibernia and Terra Nova Benefits Plans, and related Board Decisions.”

**Article 1105 and the Minimum Standard of Treatment**

While there are several other NAFTA decisions that deal with Performance Requirements, none have provided such a detailed and sophisticated interpretation of the relevant texts as has this Award. Indeed as the Tribunal acknowledges some important part of its decision were matters of first impression (e.g. at para 249). But this was clearly not the case with respect to Article 1105 which has already been the subject of numerous arbitral awards as well as an agreed Interpretation Note (2001) issued by the contracting parties and designed to curb some of the more expansive interpretations of the fair and equitable treatment standard (FET) that were emerging in the jurisprudence. For the text of the Interpretation Note see [here](#).
The claimants made two arguments under Article 1105 (at para 111): first that Canada had failed to provide a stable regulatory framework for the claimants’ offshore petroleum development operations, and second that Canada had frustrated the claimants’ legitimate expectations with respect to that regulatory framework.

In its Award the Tribunal (and the Tribunal was unanimous on the Article 1105 issues) carefully reviewed the existing arbitral jurisprudence before concluding as follows (at paras 152 and 153) as to the applicable standard:

152. On the basis of the NAFTA case-law and the parties’ arguments, the Tribunal summarizes the applicable standard in relation to Article 1105 as follows:

(1) the minimum standard of treatment guaranteed by Article 1105 is that which is reflected in customary international law on the treatment of aliens;

(2) the fair and equitable treatment standard in customary international law will be infringed by conduct attributable to a NAFTA Party and harmful to a claimant that is arbitrary, grossly unfair, unjust or idiosyncratic, or is discriminatory and exposes a claimant to sectional or racial prejudice, or involves a lack of due process leading to an outcome which offends judicial propriety.

(3) in determining whether that standard has been violated it will be a relevant factor if the treatment is made against the background of (i) clear and explicit representations made by or attributable to the NAFTA host State in order to induce the investment, and (ii) were, by reference to an objective standard, reasonably relied on by the investor, and (iii) were subsequently repudiated by the NAFTA host State.

153. This applicable standard does not require a State to maintain a stable legal and business environment for investments, if this is intended to suggest that the rules governing an investment are not permitted to change, whether to a significant or modest extent. Article 1105 may protect an investor from changes that give rise to an unstable legal and business environment, but only if those changes may be characterized as arbitrary or grossly unfair or discriminatory, or otherwise inconsistent with the customary international law standard. In a complex international and domestic environment, there is nothing in Article 1105 to prevent a public authority from changing the regulatory environment to take account of new policies and needs, even if some of those changes may have far-reaching consequences and effects, and even if they impose significant additional burdens on an investor. Article 1105 is not, and was never intended to amount to, a guarantee against regulatory change, or to reflect a requirement that an investor is entitled to expect no material changes to the regulatory framework within which an investment is made. Governments change, policies changes and rules change. These are facts of life with which investors and all legal and natural persons have to live with.

The Tribunal then proceeded to apply the standard to the facts concluding that the claimants had been unable to establish that the governments and/or the Board had made any promises or representations that there would be no changes to the regulatory regime (at para 156). There were
no such representations in the relevant legislation (at paras 159 – 160) and this was equally true of the approved plans themselves (at para 161). The plans did not amount to a contract (at para 166) and there was no evidence (at para 169) that the claimants had sought assurances that the benefits requirements would not change as a result of the Board’s monitoring activities if those activities suggested that R & D expenditures were insufficient (so long as such changes could be made consistently with Canadian law, a matter already established by the Newfoundland Court of Appeal).

**Damages for breach of the prohibition on domestic performance requirements**

The claimants sought compensation for the incremental expenditures that they would incur as a result of the application of the Guidelines from the time that they came into force until 2036 (at para. 414) (the Hibernia property was projected to continue producing until 2036 (see para. 49)). Article 1116(1) provides that “An investor of a Party may submit to arbitration under this Section a claim that another Party has breached an obligation [of Chapter XI]…and that the investor has incurred loss or damage by reason of, or arising out of, that breach.” This language as well as the decisions of other arbitral awards led Canada to argue that the Tribunal could not award damages for prospective losses and could only make an award in relation to losses actually incurred (at paras 415 – 419). The majority of the Tribunal however took a broader view concluding (at para 427), at least as a matter of jurisdiction, that:

> A breach giving rise to future and prospective damage may, in general terms, fall within Article 1116. There is nothing in the language of Article 1116 (1) that convinces us that the provision is directed only to damages that occurred in the past and does not extend, in principle, to damages that are the result of a breach which began in the past (the adoption of the 2004 Guidelines) and continues (the implementation of the 2004 Guidelines) resulting in the *incurring* of losses which crystallise (i.e. become quantifiable) and must be paid sometime in the future (hereafter “future damages”). We consider by extension that the same reasoning applies to damages in the past which are already identified or quantified, but must be paid in the future.

That was not conclusive of the Claimants’ claim to prospective damages since they still had to show (at para 431) “whether the amount of these damages can be established with sufficient certainty to be compensated.” As to the relevant principles for determining these issues the Majority concluded that (at para 437)

> … the Claimants do not have to prove the quantum of damages with absolute certainty. The Majority further accepts that no strict proof of the amount of future damages is required and that “a sufficient degree” of certainty or probability is sufficient. However, the amount claimed “must be probable and not merely possible.”

The Majority also had to address the actual losses claimed by the claimants as of the date of the Award. The issue was significant here since the claimants’ own liability under the Guidelines was in the alternative. The claimants either had to make the actual R & D expenditures calculated under and required by the Guidelines (rather than on some notional business as usual (BAU) position under the relevant benefits plans) or they had to make a contribution to the fund, and to this point there had been a degree of forbearance by the Board in realizing any obligation pending the outcome of both the domestic proceedings and the arbitration. Given these
circumstances when did the claimants actually incur a loss for which they could seek restoration (at para 440):

In the Majority’s view, actual damages occur when there is a firm obligation to make a payment and there is a call for payment or expenditure, or the occurrence of payment or expenditure has transpired. Indeed, expenditure of money is not always required for damages to be compensable. Expenditures which have not yet been paid may be included as compensation if a claimant can prove that they are under an obligation to pay such expenses (e.g. there has been some kind of call for payment).

Whatever view one takes of the Claimants’ claims it is clear that there are a number of variables that have to be taken into account in quantifying the scope of the Claimants’ obligations under the Guidelines and therefore any possible claim to damages. These variables included: production volumes, oil revenues (calibrated either in US dollars or perhaps Canadian dollars); the BAU R & D and E & T expenditures; the qualification of R & D expenses; the relevant Statistics Canada benchmark; and Board determinations as to level of deductibility of R & D and E & T expenses. At a later point in the Award (at para 474) the Majority helpfully categorizes these factors as two different types of variables: “One group of variables consists of objective, market-based factors, and the second consists of the results of the Board’s regulatory decisions.”

Having established the relevant tests the Majority divided the Claimants’ claims into three relevant periods: 2004 – 2008; 2009; and 2009 – 2036. The first of these periods was obviously the period for which the Claimants and the Tribunal had the most complete information, but even here the Majority concluded that the matter was not yet ripe for the Tribunal to award damages, principally it seemed because the Claimants’ obligations had yet to crystallize (at para 470):

With regard to the 2004 – 2008 period, the various actions of the Board to implement the 2004 Guidelines, such as the calculation of the required incremental expenditures, the crediting for actual expenses and the determination of the spending shortfall, the conditioning of the POA on compliance with the 2004 Guidelines, all confirm that the Board was seriously pursuing the Claimants’ spending obligation under the 2004 Guidelines for the 2004 – 2008 period. However, we are not aware that the Respondent has actually required the Claimants to make such payments by a certain date, nor whether it has indicated the prospect of sanctions for noncompliance. The Claimants have indicated that there may have been actions the Board has taken to date in pursuance of the spending obligation, namely a requirement for HMDC and Suncor to provide a promissory note secured by a letter of credit, but they have not provided evidence as to any steps being taken in furtherance of this requirement to show that it amounts to a firm obligation to pay or has entailed costs. Until the Claimants submit evidence of actual damage, the claim for the cost of compliance with the 2004 Guidelines for the 2004 – 2008 period is not ripe for compensation by this Tribunal.

The same conclusion followed with respect to the 2009 period as it must for the 2009 – 2036 period, although with respect to this final period the Majority of the Tribunal did offer some useful additional observations. One important observation was that arbitral awards dealing with assessment of prospective losses in cases of expropriation were really not pertinent in a case (as here) in which the “investment is not destroyed but encumbered” (at para 476). In the case of
expropriation the tribunal “has no choice but to project future damages in the form of lost future profits.” But that is not this case. In this case the losses will at some time in the future become actual losses “thereby removing the necessity to forecast losses which has been present in other cases,” Even those cases in which tribunals had awarded compensation for future losses in other non-expropriation situations were not especially useful. In each of those cases the projections were relatively short term; here the situation was different (at paras 477 and 478):

While some variables in the current case may be more amenable to assessment than others (e.g. production level estimates for developed production sites in the near term may be more likely to be accurate than those that focus on longer term production forecasts), looking at the totality of relevant and necessary variables that would comprise the calculation of damages, we are simply unable to have confidence that the estimation of the entire picture is one that meets a test of “reasonable certainty.” The evaluation of future damages for such a long period is extremely hazardous and it does not, on balance, seem to us that the estimates are more probable than not.

... In our view, there is no basis to grant at present compensation for uncertain future damages. Given that the implementation of the 2004 Guidelines is a continuing breach, the Claimants can claim compensation in new NAFTA arbitration proceedings for losses which have accrued but are not actual in the current proceedings.

While this all seems correct, it does suggest that if the parties are unable to agree we will be looking at installment litigation/arbitration for many years to come.

The Dissent

In my view the Dissenting opinion of Professor Philippe Sands offers a devastating and persuasive critique of the majority opinion as it relates to the subordinate measures issues. Professor Sands is in agreement with the Majority on two important parts of the Award. Thus he agrees that there was no breach of Article 1105 and he also agrees that the Guidelines were caught by the Article 1106 rules relating to domestic performance requirements. But Sands fundamentally disagrees with the Majority on the interpretation and application of the subordinate measures provisions of Annex I. In his view the validity of a subordinate measure is to be examined solely by reference to the reserved measure itself and not by reference to other existing subordinate measures such as the earlier Benefits Plans adopted for the Hibernia and Terra Nova projects. Sands also dissented from the portions of the Majority dealing with damages, principally on the basis that since Canada was not in breach there was no damages issue for the Tribunal to consider.

The Dissent offers a number of different critiques of the Majority’s opinion but three points in particular stand out. First, Sands, like the Majority, emphasises that the NAFTA text draws a clear distinction between the reserved measure and subordinate measures. One particular important distinction is that while the text establishes that amendments to reserved measures must not decrease conformity with the basic Article 1106 standards there is no similar test with respect to existing or new subordinate measures (Dissent at paras 21 and 24); such measures need only be established under the authority of the reserved measure and consistent with the reserved measure – a requirement that, as Mexico offered (Dissent at para 29), must be determined under domestic law (which it had been). Second, Sands emphasizes that the Majority
has elevated the requirement of consistency from a formal jurisdictional requirement that a subordinate measure fall within the scope of the measure to an holistic and contextual demand for consistency with the “overall legal framework” that goes way beyond the text of the treaty and (Dissent at para 28) “seems to have been plucked out of the air.” Third, and as indicated in the introduction of this post, the effect of the Majority’s opinion is to introduce a one way ratchet in which the space available to the host state to protect its interests as contemplated by the reservation system is progressively reduced, and the ceiling (Dissent at para 37) on the range of acceptable measures gradually lowered. Not only does this afford different subordinate measures the same limiting effect as the higher norm of the measure itself (Dissent at para 37) but it will lead to increasing difficulties of application over time, especially since the state (as noted above) need not publish subordinate measures. But even if published the interpretive difficulties associated with establishing “authority” and “consistency” with an increasingly long list of previous measures will tax the ability of even the most highly paid arbitrators.

Commentary

The Majority’s interpretation of the subordinate measures provisions is startling. It carries the implication that every exercise of the power to make subordinate measures will necessarily limit any future exercise of the power. This applies equally to the situation where the state exercises the power to make subordinate measures after NAFTA enters into force (i.e. adopt) but also with respect to subordinate measures in force before NAFTA enters into force (i.e. maintains). In effect, what the Majority concludes is that when Canada listed the federal statute as a reserved measure, it was in reality only listing a gutted version of sections 45 and 15.1.

I can perhaps illustrate the point more graphically by asking the reader to imagine the power to make new subordinate measures (as described in the statute) as a full box (the statutory power describes the size of the box). The moment that the holder of the statutory authority exercises the power to adopt a subordinate measure we must empty the box of all of the unexercised powers contained within its corners. Subsequent subordinate measures must fall within the reduced content of the box. Or to put the matter another way, if the measure allows the statutory authority to adopt subordinate measures in relation to matters B to F; the exercise of the power in relation to matter B renders the statutory authority functus with respect to matters C to F. This is an extraordinary result and it is seemingly achieved by having the tail of the interpretive note wag the dog of the principal provisions of the text. While defending its conclusion in the name of a highly contextualized interpretive approach, the Majority ends up decontextualizing the simple claim made by the state reserving its authority to maintain domestic performance requirements. This one-way ratchet (which Professor Sands refers to as the progressive lowering of the acceptable regulatory ceiling (Dissent at para 37)) is fundamentally inconsistent with the discretion afforded to each NAFTA state to craft its own reservations and to decide upon the extent to which it was prepared to liberalize (and indeed eliminate) its domestic performance requirements. The treaty specifically contemplates that a party may establish the duration of the measure (i.e. a possible phase out commitment) and may make a liberalization commitment; and the clear inference is that a contracting party need not to do either. But the result of the Majority’s opinion is to commit each party to continuing liberalization. It seems incredible to think that any of the contracting parties thought that they were reserving less than the full box of power embraced by the relevant statutory provision.
One wonders about the implications of all of this for other domestic performance requirements (a.k.a. domestic benefit programs) in Canada whether developed under other federal oil and gas legislation (and in particular the *Canada Oil and Gas Operations Act*, RSC 1985 c. O-7 (*COGOA*), or under Yukon’s *Oil and Gas Act*), or under the terms of modern land claim agreements which routinely provide for the negotiation of impact and benefit agreements. Canada did file a reservation that referred to *COGOA* and to “Measures implementing Yukon Oil and Gas Accord” and the Northwest Territories Accord.” The reservation, so far as relevant, reads as follows:

1. Under the *Canada Oil and Gas Operations Act*, the approval of the Minister of Energy, Mines and Resources of a "benefits plan" is required to receive authorization to proceed with any oil and gas development project.

2. A "benefits plan" is a plan for the employment of Canadians and for providing Canadian manufacturers, consultants, contractors and service companies with a full and fair opportunity to participate on a competitive basis in the supply of goods and services used in any proposed work or activity referred to in the benefits plan. The Act permits the Minister to impose an additional requirement on the applicant, as part of the benefits plan, to ensure that disadvantaged individuals or groups have access to training and employment opportunities or can participate in the supply of goods and services used in any proposed work referred to in the benefits plan.

6. Provisions similar to those set out above will be included in laws or regulations to implement the Yukon Oil and Gas Accord and Northwest Territories Oil and Gas Accord which for purposes of this reservation shall be deemed, once concluded, to be existing measures. (Emphasis added)

A particular concern in this regard is that the federal government has long contented itself, at least during the exploration phase of northern oil and gas operations, with an especially vague and hortatory commitment to northern benefits requirements: see [here](http://ablawg.ca). This is not the place for a detailed analysis but the Majority opinion, as flawed as it clearly is, creates regulatory risk for Canada in the event that it, or a successor territorial government, elects to take a more aggressive approach to capturing local and industrial benefits in the future than are contained in the current requirements. In such a case the federal government may have inadvertently set the ceiling so low that northern Canadians won’t even be able to stand up! Or perhaps given the analytically demanding and highly contextualized approach of the Majority it will just be exceptionally difficult to figure out where the ceiling is until you bang your head; another, and perhaps especially acute form of regulatory chill, if not regulatory concussion. But perhaps the underlined text may allow a subsequent Tribunal to distinguish this Award.

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