

Conflict and Coordination Pathways Between International Investors' Legitimate Expectations and Host State Regulatory Authority Amid Climate Change Controversy

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Abstract. Climate change stands as a critical issue for global sustainable development, prompting nations worldwide to enact climate governance policies in response to this challenge. However, the ambiguous delineation of host countries' regulatory authority under International Investment Agreements (IIAs), coupled with arbitration tribunals' tendency to prioritize protecting investors' legitimate expectations, creates practical dilemmas. This, combined with the sudden and differentiated nature of host country's regulatory measures, frequently leads to frequent climate-related investment disputes. The conflict between host states and investors over the duty of reasonable expectations arising from the fair and equitable treatment standard under IIAs is increasingly prominent. Harmonizing investor rights protection with climate objectives has become a critical issue requiring urgent resolution. This study finds that to advance global climate governance objectives, IIA reform must establish a multi-stakeholder responsibility framework balancing public and private interests of host countries and investors. Arbitration practice should incorporate review mechanisms and clarify reasonable expectations standards to promote equitable adjudication. Host countries must maintain stability in domestic investment policy and safeguard international investors' legitimate rights to ensure sustainable development. Ultimately, efforts should strive to achieve a balance between investors' reasonable expectations and host countries' climate regulatory authority.

Keywords: Climate change, international investment, legitimate expectations, host state regulatory authority.

1. Introduction

As global climate governance accelerates, host countries face increasingly prominent conflicts between actively fulfilling their emission reduction obligations under the Paris Agreement and the legitimate expectations of international investors arising from fair and equitable treatment provisions within the framework of IIAs. Currently, the low-carbon reform of international economic rules is distinctly dominated by developed countries or regions. The successive announcements by European nations such as Spain, Germany, and France to withdraw from the Energy Charter Treaty demonstrate that even developed countries struggle to fully address the dual challenges posed by investment arbitration rules under climate governance and the energy transition. For instance, in the case of *CMS Natural Gas Transmission v. Argentina*, the arbitral tribunal rejected the host country's claim of exemption from liability based on economic crisis. Similarly, in Spain's renewable energy series of cases, tribunals emphasized that fiscal constraints cannot serve as grounds for exempting obligations of fair and equitable treatment. The integration of climate issues and the iterative nature of climate governance are reshaping investors' expectations regarding legal stability and the legitimate boundaries of host countries' regulatory authority. Balancing public and private interests have become an urgent issue in international investment. Scholars globally acknowledge the inevitability of conflict and identify coordination dilemmas: At the rule-oriented level, traditional IIAs lack consideration for global climate interests, granting broad investor protections that often clash with host states' climate governance actions. Climate investments depend on stable legal environments, creating tension with host states' dynamic exercise of regulatory power to safeguard public interests [1, 2]. At the level of international practice, arbitral tribunals exhibit significant divergences in their application of rules, often adopting expansive interpretations to prioritize the protection of investors' legitimate

expectations arising from non-discriminatory regulatory actions. This poses substantial obstacles to host countries implementing climate policies [3, 4]. Against this backdrop, this paper examines the focal points of conflict between international investors' legitimate expectations and host countries' regulatory authority in the context of climate change disputes. It explores coordination pathways from both domestic and international perspectives, aiming to provide a new paradigm for achieving a balance between global climate governance and international investment protection.

2. Literature Review

Against the backdrop of climate change, the conflict between international investors' legitimate expectations and host countries' climate regulations highlights the blurred boundaries of regulatory frameworks, reflecting the deep-seated tension between global climate imperatives and the public-private interests of investors.

Existing research reveals specific challenges to the principles of legitimate expectations and traditional regulatory power theory in the context of climate change. First is the climate shift in the principle of legitimate expectations: arbitration tribunals have expanded the scope of determination from specific contractual commitments to general legal frameworks and policy orientations. Investors need only demonstrate the existence of a policy trend to claim damaged expectations, thereby transforming the normal iteration of climate policy into a compensation obligation. Second is the climate gap in traditional regulatory power theory. Arbitral tribunals' evolving interpretation of essential security interests remains confined to political, military, and economic grounds, applying a "least restrictive alternative" test that requires host states to prove direct links between climate policies and national security. This approach overlooks the complexity and volatility of climate risks, trapping some developing nations in a self-evidence dilemma due to technological and resource constraints.

International practice reveals three divergent stances. First, investor primacy sees tribunals progressively broadening the scope of reasonable expectations, prioritizing protection of investors' subjective anticipations and interests. For instance, in the investor v. Spain renewable energy cases, tribunals shifted from requiring explicit commitments to accepting general laws or regulations aimed at attracting foreign investment as grounds for establishing reasonable expectations [5]. Second, host-state regulatory approaches advocate explicitly incorporating climate change measures into the specific circumstances of security exception clauses within IIAs, thereby enabling host-state climate regulations to qualify for exemptions from investment protection obligations. Examples include the early Article 10 of the Senegal-United States of America BIT, China-Singapore BIT Article 11, which extends the security exception's scope to the entire agreement and adopts the concept of "fundamental security interests." More recently, IIAs like the Myanmar-Singapore BIT reaffirm in their preambles the host state's regulatory authority to pursue public interests such as sustainable development, environmental protection, and climate action [1]. Third, a balanced approach seeks to harmonize investment and climate protection, creating favorable conditions for climate-friendly investment. For instance, Chapter VI of the WTO's Investment Facilitation Agreement, formally concluded on July 6, 2023, innovatively incorporates provisions on sustainable investment and extensively discussed during negotiations how to achieve Sustainable Development Goals.

Academic consensus holds that the uncertainty surrounding the core "fair and equitable treatment" clause enables investors to more readily assert the crucial element of "legitimate expectations." Arbitration tribunals' tendency to protect such expectations increases host countries' arbitration risks, thereby constraining climate regulatory space [5]. Disputes primarily center on two aspects: First, the ambiguous boundaries of host countries' climate regulatory authority. New developments in the interpretation and application of IIA security exception clauses may offer feasibility for legitimizing host state climate governance actions, but their applicability to climate change—a non-traditional security domain—remains limited [6]. Concurrently, the policy stability required by fair and equitable treatment rules and reasonable expectations conflicts with low-carbon emissions necessary for climate change mitigation. Second, the criteria for determining investors' reasonable expectations

exhibit bias. The current international legal framework lacks mechanisms to ensure host states fulfill their obligations to protect foreign investors through counterclaims. Most IIAs only stipulate protections for foreign investors without explicitly defining investor obligations [7]. When investors resort to arbitration due to losses caused by host state measures, tribunals often overemphasize investors' subjective expectations, focusing solely on whether host states breached protection obligations while neglecting the public interest nature of policies. This leads to excessive restrictions on host states' regulatory authority. Academic circles have proposed coordination solutions to address this conflict. For instance, at the institutional level, incorporating climate change into security exceptions and introducing environmental exception clauses, with necessary reviews to safeguard host state public interests and maintain balance in exception clause application [6]. At the dispute resolution level, tribunals should cautiously apply the reasonable expectations test, accord full respect to host state authorities' interpretation and application of domestic legislation and management actions, give equal consideration to public interests, and introduce jurisdictional filters and state counterclaim mechanisms. When defining the scope of the fair and equitable treatment obligation, consider the relevant climate change obligations of contracting parties and the resulting aggregate consequences, including investors' reasonable reliance on the enforceability of a state's commitments under its nationally determined contributions [8].

Existing research delves deeply into these conflicts but lacks consideration of differences in coordination among countries at varying levels of development. This paper builds upon this foundation to further refine the framework, offering more effective approaches for the coordinated development of global climate governance and international investment.

3. Specific Manifestations of Conflict

3.1. Resolving the Conflict Between Regulatory Suddenness and Investors' Stable Expectations

In the realm of climate investment, host countries must honor the incentives and commitments offered to foreign investors to stabilize investment expectations and reduce policy risks, thereby attracting foreign capital to participate in domestic climate governance and green industry development. However, to address the climate crisis and pressures to fulfill international treaty obligations, or in response to emergencies, host countries may introduce high-intensity regulatory measures in the short term—such as sudden bans on fossil fuel development, reductions in photovoltaic power subsidies, or changes to currency exchange policies—based on public interest and order. These actions can cause drastic changes in the investment environment, including legal, regulatory, and commercial frameworks, significantly increasing investment costs. Investors may find their initial investments unrecoverable due to the lack of a "reasonable transition period." This creates a conflict between state actions and their legal obligation to ensure stable investor operations [9].

3.2. Regulating Conflicts Between Public Interest and Investor Compensation

Host states argue that climate regulations serve public interest protection and thus do not require compensation for investor losses. Investors contend that such regulations cause significant diminution of investment values such as asset depreciation or zero returns—constituting "indirect expropriation." They assert that legislators or judicial bodies exhibit malicious discrimination, protectionism, or intent to harm their interests, thereby incurring compensation liability. On one hand, except for extremely rare exceptions, non-discriminatory management measures adopted by host states to protect legitimate public welfare—such as public safety, health, and ecology—are typically excluded from indirect expropriation determinations. This exclusion stems from such measures directly serving the broader societal interest, reflecting the priority accorded to public welfare in regulatory actions. On the other hand, when a host state imposes regulatory measures specifically targeting certain investors or categories of investment that are detrimental to climate governance objectives, such

actions are likely to be deemed discriminatory treatment. In such cases, investors' property rights suffer harm and face difficulties in obtaining reasonable remedies, thereby creating legal risks that the host state's actions may be characterized as indirect expropriation.

3.3. Regulatory Differentiation and the Conflict with Investors' Fair Expectations

Host countries implement differentiated climate regulations for domestic and international investors. For instance, host countries may grant certain high-carbon domestic traditional industries grace periods or special policies, permitting gradual reductions in carbon emissions to facilitate their transformation and upgrading. This approach prevents direct industrial collapse caused by overly stringent climate regulations. Conversely, for international investors engaged in similar industries, host countries may raise market access thresholds, requiring them to meet higher climate standards immediately. This protects the competitive interests of domestic counterparts in international markets. The EU has enacted key carbon barrier legislation such as the Carbon Border Adjustment Mechanism and the New Battery Law. Developed nations like the United States and Canada are also devising carbon barriers through policy frameworks and green standards to reduce domestic emissions, prevent carbon leakage, shift mitigation costs, and safeguard the competitiveness of their products. Consequently, investors may readily invoke violations of "national treatment" and "fair and reasonable expectations" to initiate arbitration claims.

4. Pathways for Coordinating Conflicts Between the Two Under Climate Change Disputes

4.1. At the Level of International Investment Treaties

First, advance climate-friendly reforms. First, prioritize climate justice. Introduce special climate change provisions in Bilateral Investment Treaties (BITs) and other IIA chapters, broaden the application of sustainable development clauses, incorporate Paris Agreement obligations into statutory "public interest exceptions," and explicitly recognize the legitimacy of host countries' climate regulatory authority under carbon neutrality goals. Safeguard host countries' regulatory powers across multiple critical interest areas. Such regulatory measures to achieve climate goals should not, in principle, violate investors' legitimate expectations, thereby guarding against the risk of expansive arbitration interpretations. Second, implement systemic reforms at both substantive and procedural levels. This includes clarifying investment definitions, strengthening investor obligations, refining investment promotion measures, and excluding the litigability of reasonable climate governance measures under investor-state dispute settlement mechanisms.

Second, it clarifies the conditions for "legitimate expectations." Only expectations formed based on the host country's public, explicit, and lawful long-term climate policies are protected, excluding those based on short-term or unlawful policies. Furthermore, investors cannot demand the immutability of relevant laws and regulations when the host country has not made specific commitments regarding the stability of the investment environment.

Third, establish a multilateral investment framework to advance multilateral climate cooperation. Led by the United Nations Conference on Trade and Development (UNCTAD), this framework should reconcile the interests of developed and developing countries, clarify the application of "common but differentiated responsibilities" in the investment sphere, and prevent developing countries from avoiding environmental regulations due to investment concerns. Additionally, actively pursue South-South and North-South cooperation on climate issues to narrow development gaps between developed and developing countries and eliminate trade barriers to green technology transfer.

Fourth, refine the definition of "like circumstances." Some international investment treaties define "like circumstances" too broadly, failing to adequately account for core differences such as countries' stages of development and industrial structures. Appropriate standards should be adopted to distinguish between carbon-intensive and low-carbon energy investments, granting them

differentiated legal treatment. This avoids imposing one-size-fits-all requirements on developing and developed countries, providing nations with clear criteria for assessing investment nature. Such measures reduce enforcement disputes and responsibility evasion stemming from ambiguous definitions, ultimately ensuring effective implementation of climate goals [10].

4.2. Dispute Resolution Mechanism Level

First, incorporate host country climate governance and investor risk assessment obligations into the scope of review. Develop practical guidelines and publish guiding precedents to promote fair and reasonable arbitration. Arbitral tribunals should assess whether the host state failed to exercise due diligence to prevent climate-related harm to foreign investments, including obligations to take preventive actions against potential climate damage. Furthermore, when reviewing the host state's due diligence, tribunals should consider the host state's obligations under climate treaties pursuant to Article 31(3)(c) of the Vienna Convention on the Law of Treaties [11].

Second, refine the criteria for determining reasonable expectations. Arbitral tribunals must assess the reasonableness of investor expectations from three perspectives. First, the policy basis: whether expectations are grounded in the host state's written commitments, such as policy stability clauses in investment agreements and specific promises regarding investor treatment and returns. Second, foreseeability: whether the investor could reasonably foresee potential adjustments to the host state's climate regulations at the time of investment. If the investor knew or should have known about extreme instability in the host state's policy environment—such as social, economic, or energy supply conditions—or about the host state's weak stance on climate protection, it would be difficult to establish a reasonable expectation that its investment regulatory regime would remain unchanged. Third, behavioral reasonableness: whether the investor took risk mitigation measures. Investors should make investment decisions only after conducting due diligence to clarify the host country's investment risks and prospects. This approach helps avoid being caught off guard by the host country exercising its regulatory authority and reduces the likelihood of arbitration disputes.

4.3. Host State Policy Level

First, establish a climate regulation impact assessment system. Before enacting climate regulations, host states must conduct investment impact assessments to analyze the potential effects of regulatory measures on international investors. The specific requirements for host states to perform due diligence under international investment law remain relatively ambiguous. Arbitration practice has identified two core elements: the principle of foreseeability—meaning the ability to foresee harm or potential harm—and the principle of avoidability—meaning the capacity to prevent harm. The urgency of climate change and its impact on human society and sovereign states have largely established predictability at the macro level. However, achieving predictability at the micro level is more pressing. This involves specifically assessing the actual damage caused to individual investments by regulatory measures under the climate crisis, comprehensively determining the extent of damage around physical and transition risks, thereby more effectively establishing relief pathways for investors [12]. Furthermore, policy transparency and stability must be strengthened. During climate policy formulation and adjustments, investor concerns should be fully incorporated through mechanisms like public consultations. This prevents policy surprises that leave investors passive due to information lags, thereby supporting reasonable expectations under fair and equitable treatment.

Second, disclose long-term climate policies. A stable and predictable policy environment is essential for sustaining long-term climate investments, particularly in the energy sector where attention to long-term risks, sensitivities, and vulnerabilities is paramount. Host countries should publish national climate investment plans focused on national "dual carbon" goals and climate adaptation needs. These plans should integrate domestic climate action with economic development while providing investors with stable expectations and safeguarding their legitimate interests. Concurrently, host countries should grant reasonable transition periods. Based on project characteristics and climate policy types, scientifically set recovery or transition timelines. For

regulatory adjustments impacting investor interests—such as subsidy cancellations or project bans—establish 1-3 year transition periods to facilitate smooth policy transitions.

Third, establish compensation and incentive mechanisms for climate regulations. First, compensation mechanisms should primarily cover investors whose legitimate interests are inevitably harmed by climate regulatory adjustments—such as the early closure of compliant projects to achieve carbon neutrality—with particular attention to entities with long investment cycles and highly specialized assets. Second, incentive mechanisms should offer preferential treatment—such as additional subsidies or expedited approvals—for investments aligned with host country climate objectives, including carbon capture and renewable energy. Priority support should also be granted to investors who exceed emission reduction targets ahead of schedule, as well as those engaged in high-risk investments or climate sectors with significant social benefits.

5. Conclusion

This paper employs case analysis, comparative analysis, and legal text analysis to examine the relationship between international investors' legitimate expectations and host country regulatory authority in climate change disputes, structured around conflict manifestations and coordination pathways. The core conflict stems from the enduring tension between public climate interests and private investment interests. Disputes over the suddenness, public interest nature, and differentiation of host country regulations versus investors' legitimate expectations are hindering sustainable climate governance and investment. Therefore, this study recommends coordinating the implementation of investors' legitimate expectations and the effectiveness of host country regulatory measures through three dimensions: reforming international investment treaties, optimizing dispute resolution mechanisms, and improving host country policies. Future research should strengthen studies on developing countries, explore governance pathways tailored to their transition needs, and enhance long-term tracking and dynamic coordination between climate policies and investment behaviors. Ultimately, this will achieve a high-quality balance between global climate governance and international investment.

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