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Investment Agreements and the Regulatory State: Can Exceptions Clauses Create a Safe Haven for Governments?

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Investment Agreements and the Regulatory State: Can Exceptions Clauses Create a Safe Haven for Governments?¹

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1. Introduction

One of the most complicated issues arising from the growing number of international investment agreements (IIAs)² and investor-state arbitrations is the relationship between investor protections and the regulatory function of states. It is axiomatic that investments in all jurisdictions will be regulated, and that these regulations will change over the life of an investment. This includes both foreign and domestic investors. Indeed, one of the most fundamental elements of state sovereignty is both the right and the duty of governments to regulate economic activity and actors in the broader public interest.

The right to regulate arises out of the basic attributes of the sovereignty of states. The duty to regulate arises from a range of domestic law elements (constitutions, administrative requirements, legislative mandates, etc.) as well as from the international level. The latter includes international agreements relating to the environment, trade, competition policy, human rights, human health, and more. It also includes basic customary international law obligations on states, such as the obligation not to allow activities within one's own territory to cause harm in the territory of other states.

All states regulate investors for a wide variety of purposes and at various levels of detail. The question posed by the growing application of international investment agreements is to what extent they in turn regulate governments in their ability to establish new rules applicable to foreign investors or to maintain existing rules. In trade law terms, one might ask to what extent IIAs discipline government regulatory action?

The issue is important. A large number of investor-state cases have already had new regulatory measures as the basis of their claim. While it may be important to protect investors from capricious and discriminatory government actions, if IIAs require compensation for foreign investors in order for governments to enact otherwise appropriate new regulatory measures affecting them, then this will certainly have a major impact on the ability of governments to regulate in the public interest.

The issue is also not about a theoretical dichotomy between state sovereignty and international law. The most critical premise of international law is that it can and should regulate decision-making by governments on domestic issues as well as international issues. If international law does not do this, it is not functioning at all. The issue, therefore, is not a simplistic choice between

¹ This paper is based on a larger draft paper prepared by IISD Intern Suzy H. Nikièma, "Nature Et Portée Des Exceptions Relatives Au Développement Durable Dans Les Accords Internationaux D'investissement". The final version of this paper will be available in November, 2007.

² We include bilateral investment treaties, foreign investment promotion and protections agreements, and investment chapters in Free Trade Agreements within this broad category of IIAs.

international law and state sovereignty, but is about how well balanced and appropriate the international law rules that states adopt in this field are.

This paper provides an initial briefing on the relationship between IIAs and the regulatory function of states. It seeks to provide a platform for discussion rather than a comprehensive analysis of all the issues involved, or the case law relating to them. The paper looks first at the kind of measures that form the basis of the concerns. This is followed by a short note on how investor-state tribunals have reacted to the issue and, in effect, put it on the negotiator's agenda whether they wanted it or not.

The paper then looks at how both arbitrators and negotiators have begun to respond to the issues raised. It focuses for this purpose on exceptions and other mechanisms to protect government regulatory space, using exceptions as a rather broad concept. A number of specific examples of such exceptions and mechanisms are found in the Annexes to this paper.

2. Regulatory Measures: Some Issues of Scope

There is no accepted definition of "regulatory measure" for the purposes of this discussion. Indeed, this is part of the problem: it is hard to address a legal and policy question when the scope of what is being addressed is not clear.

For purposes of this paper, we consider government measures to protect the public welfare against harm from economic activity and measures to promote the general welfare in relation to economic activity as the nub of the issue. Some examples may be helpful as to what is or is not included in this scope may be useful, though bearing in mind that a simple definition is not possible, and some grey areas will always emerge. Some examples of what are considered normal regulatory measures include measures to:

- protect human health from harmful products;
- protect the environment from pollutants;
- ensure the conservation of natural resources;
- ensure employee health and safety at work;
- protect and enhance human rights;
- protect against criminal activity or activity contrary to public morals;
- prevent anti-competitive practices; and
- promote consumer knowledge, awareness and protection.

Some examples of the kind of measures not included in what is meant by regulatory measure for the purposes of this paper may be more controversial, but will hopefully help delimit the concept. They include measures to:

- effectively transfer private held land to the state for a public purpose, such as building a school, hospital, or ecological park;
- transfer economic activity between actors doing the same thing in the same manner;
- measures that are otherwise an abuse of government regulation-making powers to achieve ulterior purposes; or
- promoting one business over another.

Using these examples as a launching pad, rather than striving for a simple definition, one can see that the nature and purpose of a measure are both relevant. The form of a measure, be it legislation or regulatory, will also be relevant, but not definitive.

What is important, in our view, is to understand these factors in the context of the question raised in this paper: is the manner in which IIAs currently apply to normal regulatory measures well balanced and appropriate in light of the regulatory role states have in relation to all investments?

3. The Legal Dimension of the Issue: Investor-State Disputes Speak, But What Do They Say?

The potential conflict between normal regulatory measures of the type described above and IIAs first emerged in the *Metalclad v Mexico* investor-state arbitration (returned to shortly below), based on the interpretation of indirect expropriation under Article 1110 of NAFTA. This article, like almost all similar provisions on expropriation in IIAs, notes that it is illegal to directly *or indirectly* expropriate the property of a foreign investor without paying compensation. The immediate question that arose is whether a regulatory measure can constitute an expropriation under such a provision.

Four categories of measures can be identified as *potentially* being in breach of a provision on expropriation:

- the taking of title to property, in whole or in part;
- the use of police, administrative or legal powers to take control of the operation of an investment, or shut the investor out of its rights of control and ownership, without the transfer of title;
- creeping expropriation: the use of a series of measures that cumulatively rather than individually accomplish the removal of ownership or control of an investment; and
- regulatory taking, whereby the diminution of economic value due to a regulation that protects the public interest becomes the basis for a finding of expropriation.

Of these, the first is a direct expropriation, while the remaining three categories are indirect expropriations. It is the last one that remains very much in dispute.

What do the investor-state cases to date say about this last category? This is summed up in the results of two cases, both under NAFTA but both with adherents in all or part in BITs-based cases as well.

The *Metalclad v. Mexico* arbitration decision was the first investor-state case to address the issue of regulatory taking.³ That decision was and remains controversial due in large part to how it addressed the issue of expropriation. At its nub, the decision held that the only test for an expropriation under the provisions of NAFTA's Chapter 11 on Investment was the economic impact of a measure on the investor.⁴ It further held that the purpose of the measure taken was not a matter that the tribunal should enquire into.⁵

The combined effect of these two legal positions would have a broad impact in turning a wide array of normal regulatory measures into compensable measures under IIAs. In the *Metalclad* case they led to a finding that the measure in question – converting the land into a state ecological reserve with no economic activity – was an indirect expropriation. (The reason it was seen to be indirect is that the shares of the company or title to the land were not taken, but its uses were irrevocably altered and constrained to an ecological reserve.)

³ *Metalclad Corp. v. United Mexican States*, Case Arb(AF)97/1, Final Award, 30 August 2000.

⁴ *Ibid.* para. 103.

⁵ *Ibid.*, para. 111.

In fact, in 2001, IISD argued that had the Metalclad tribunal taken another tack it would have come to the same conclusion but in a less far-reaching and controversial way.⁶ Instead of arguing that the only test was the economic impact on the investor and that the purpose was irrelevant, the Tribunal could have analyzed the precise measure in question. It had taken all rights to use property out of the hands of the foreign investor (Metalclad) and put the use and value of the property into state hands as an ecological reserve. What is clear today is that a measure that does this, whether regulatory or otherwise in form, engenders compensation in almost all countries around the world. The fact it is by a regulation and is for a public purpose is not dispositive: rather, the nature of the measure in this case and how it impacts the property holder's rights and the public patrimony is. Such an analysis would have taken perhaps one or two pages. The broad statements that were made instead of such an analysis have created many thousands of pages of analysis, and much risk to government regulatory measures of all kinds.

This single test of the economic impact on the investor has since been adopted by other tribunals. However, it has also been rejected by investor-state tribunals, led by the *Methanex v. United States* arbitration, also in relation to Article 1110 of NAFTA.⁷ In that case, the principle adopted was much more closely akin to a classic interpretation of what is known as the police powers rule:

.... But as a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and, which affects, inter alios, a foreign investor or investment is not deemed expropriatory and compensatory...⁸

This approach does two things contrary to the Metalclad decision. First, it necessitates an investigation into the nature and purpose of the measure taken. Second, it rejects the economic impact on the investor as the sole test for a determination of indirect expropriation. Indeed, the economic impact on the investor does not even appear as part of the reasoning of the tribunal in the Methanex case. In short, Methanex and Metalclad are irreconcilable decisions. Yet both stand as binding awards, and both have adherents in the literature and in other arbitral decisions.

This highlights the precise problem facing states today: there is no certainty coming from the arbitration process as to what approach the tribunal will take to the interpretation of a provision on expropriation. The arbitration decisions highlight this problem, they do not solve it, creating considerable uncertainty for states in this area.

The uncertainty is important. No state, but especially developing countries, can afford to pay foreign investors for taking new regulatory measures to protect the public. And even if it could, how could any government justify paying only foreign investors if domestic investors are also impacted by the measure? The result would be a significant impact on the ability of governments to regulate. Indeed, many analysts already express concern for the problem of regulatory chill arising from IIAs: it is widely understood that foreign investors can and do threaten the possibility of initiating investor-state arbitrations in order to lobby against new measures that will impact on them.

The issue is also critically important because almost all foreign investors that are "covered" by an IIA today have the right to initiate an investor-state arbitration challenging the government

⁶ IISD/WWF, *Private Rights, Public Problems*, 2001, available at www.iisd.org/investment.

⁷ *Methanex Corporation v. United States of America, In the Matter of An Arbitration under Chapter 11 of the North American Free Trade Agreement and the UNCITRAL Arbitration Rules*, Final Award of the Tribunal, August 7, 2005.

⁸ *Ibid*, Final Award, Part IV, Chapter D, para 7. There is an important caveat, that if the state in question had committed not to take the type of measure then having taken it may constitute an expropriation. This type of additional commitment raises additional issues beyond the more illustrative scope of this paper.

measures that have an impact upon them and seeking economic damages as compensation for that impact. This places the host governments in a position of potential vulnerability as regards foreign investors. This vulnerability adds heft to the threat of an investor-state claim, in part due to the increasing size of damage awards in investor-state cases already noted.

As a result of the importance of the issue and the lack of clarity in the arbitral decisions, other mechanisms for achieving some semblance of clarity and certainty for states in this area have begun to be investigated. The next sections of this paper consider several of these mechanisms.

Before turning to this however, it is important to note that the provisions on expropriation are not the only ones capable of producing findings in relation to regulatory measures. In a separate paper in this series, the issue of fair and equitable treatment is discussed. Also of note are the provisions on national treatment and most-favoured nation treatment. Both of these types of provisions can lead to a finding that a regulatory measure has been discriminatory as between the foreign investor and domestic investor, and hence violates these obligations of the host state. While these provisions will not be addressed in detail, they should also be understood to be relevant to this paper.

4. What Kinds of Mechanisms are Available?

There are a number of mechanisms that states can adopt to ensure a greater degree of certainty that their normal regulatory measures will not be found to be in breach of the provisions of an IIA. These fall into two broad categories, the reinforcement of the customary international law rule on police powers; and the drafting of other treaty-based exceptions or exclusions. Each will be considered below.

4.1 Reinforcing the Police Powers Rule as Customary International Law

The police powers rule, that normal regulatory measures, taken in a *bona fide* manner, are not compensable measures, has been understood as part of the international law on expropriation for decades.⁹ Indeed, it was not widely understood as threatened until the notion of “regulatory takings” from American jurisprudence was transposed onto Chapter 11 of NAFTA.

This is not the place to investigate the ins and outs of the US regulatory takings doctrine. It suffices, rather, to note that its scope is often overstated in the context of expropriation under IIAs: to date, no compensation has been paid in the US for measures to protect the environment from pollution, to protect human health from carcinogens or other toxics, to prevent criminal activity by business, to ensure anti-competitive practices are stopped, and so on. In other words, even under US law, the kinds of measures being discussed here as potentially being indirect expropriation have never been seen as expropriatory or as requiring compensation. Thus, one should not assume the plea for a regulatory expropriation determination is nothing more than an application of US law to the international level. In fact, it would be a significant extension of it.

For clarity, it is important to note that the reason such measures are not compensable is that they do not fall within the definition or scope of expropriation. In strict legal terms, the police powers rule is a “carve out” from the definition or scope of expropriation. It is *not* about an expropriation that is non-compensable. Rather, it addresses a measure that is not compensable because it is not an expropriation. The distinction is not just esoteric, but impacts significantly on the burden of proof and other factors in arbitrations around this issue.

⁹ This goes back at least to Louis B. Sohn and R.R. Baxter, Draft Convention on the International Responsibility of States for Injuries to Aliens, Harvard Law School, 1961.

Because the prospect of regulatory measures being ruled as indirect expropriations are new to international law, it has not been considered in many of the existing IIAs. Only the newest generation, in fact, seeks to address this issue. Some key examples of this treatment follow.

4.1.1 The Use of the Preamble and “Objectives” Clauses

A common feature of arbitration decisions under IIAs is reference to the preamble and objectives clauses of such agreements. These are used, consistent with the general rules on treaty interpretation under international law, as an interpretive aid for the substantive provision of the treaty.

For the most part, to date, the preamble and objectives of IIAs have focused on the protection of the investor as the basis for attracting higher levels of investment. Few actually contain references to such matters as protection of the environment, sustainable development, protection of human health, the need for recognition of the right or duty of states to regulate, etc. Hence, to date, most arbitral decisions have focused on the object and purpose of protecting the investor as the principle interpretational aid in relation to the substantive provisions of the IIA.

However, this is not exclusively the case. Some IIAs, indeed a growing number of them, do include references to issues beyond the protection of the investors. Some examples of this are found in Annex 1. These examples highlight the fact that there are options available for negotiators to move beyond the previous limited statements of purely economic objectives, whether in a preamble or in an objectives clause, to encapsulate the relationship of investments to the host state in a broader way. When these issues are addressed in the preamble or an objectives clause, it increases the likelihood that a tribunal called upon to interpret the substantive clauses will take a more balanced view of them. If the regulatory rights of states are expressly noted in a preamble or objectives clause, it can also improve the chances that the police powers rule, even if not expressly stated, can be more easily invoked as an interpretational guide to any provision on expropriation.

4.1.2 The Inclusion of Regulatory Measures Articles

Another option is to include in the substantive provisions of an IIA specific references to the regulatory rights or duties of states. While still not common, there is at least one important example, as seen in Annex 2.

When included in the substantive part of a treaty, it is likely that such articles can have a significant impact on the interpretation of a treaty. It is fundamental in treaty interpretation that all the provisions of a treaty must be interpreted in the light of the other provisions to ensure that each is given effect. Where the general expectation of further regulation of investments is expressly noted, it is most likely that this will require an understanding that the taking of such measures by a state (assuming here that they are *bona fide* and not intended to be disguised measures for other purposes) would find greater support in the police powers rule and be seen as non-expropriatory and thus non-compensable measures, even if this is not specified in the specific provisions on expropriation, etc.

Perhaps the most extensive example of such an approach is found in the Energy Charter Treaty (ECT), a treaty whose primary purpose is to promote and protect investments into all facets of the energy sector. The ECT is a pan-European and Asian agreement, concluded in 1994, designed to generate more sources of energy in Europe and Asia through investment by western European energy companies in generation and transportation facilities across the region. It includes the

traditional investor protection provisions found in all IIAs. But it also includes two special provisions relating to regulation, one on the sovereign right to regulate in general and one more specific to the environment.¹⁰ These are found in Annex 2. Drafted primarily by western European governments, this agreement highlights the legitimacy of recognizing future regulation as a need in the context of an IIA.¹¹

A closely related approach that has emerged in a recent series of FTAs involving mainly the United States and Canada with developing countries is the inclusion of environmental (and sometimes labour) chapters in the agreement. This approach is generally patterned after the NAFTA approach, with its accompanying North American Agreement on Environmental Cooperation. Such chapters can include specific references, similar in intent to what is seen in the ECT, on the expectation of future regulatory measures, as well as provisions relating to enforcement of environmental laws and a complaints mechanism for the review of government enforcement of these laws. An extract of one agreement with this approach is also found in Annex 2.

While there are several constructive uses of regulatory authority provisions, it is very important to be aware of supposed regulatory exception clauses that are deceptive. NAFTA's Article 1114, titled Environmental Measures, offers the quintessential example of this, with a very deliberate drafting:

1. Nothing in this Chapter shall be construed to prevent a Party from adopting, maintaining or enforcing any measure otherwise consistent with this Chapter that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns.

This article has been replicated in a large number of US and Canadian agreements as well, including with Chile, Peru, and the Central American states.

The problem with this article is that legally it accomplishes nothing, a result that was not accidental. While it appears to create a broad exclusion for environmental law measures specifically, in reality the key words "otherwise consistent with this Chapter" make the paragraph not just flawed but meaningless. It does nothing to save a claim against a government that a measure is a breach of the Chapter. Indeed, each of the three NAFTA Parties have considered its legal value in specific investor-state arbitrations,¹² and none have placed any real reliance on it as significant part of a defense to claims by an investor of a breach of Chapter 11 of NAFTA.

Finally, one may note that there is a predominant focus on environmental regulatory issues in many of the examples discussed. Undoubtedly, this reflects the very vocal interests of environmental NGOs in the 1990s, when the issues first became popularized during the NAFTA negotiations. At that time, the developing country interest was largely defensive: preventing the imposition of environmental standards inappropriate for them or that would become market access barriers. In the present context, and focusing specifically on investment agreements, however, the issue is much more closely tied to ensuring that developing states preserve their own policy space for existing and future public welfare measures. This should be a commensurate objective with developing and developed country negotiating partners. In this context, it should

¹⁰ Energy Charter Treaty, Arts. 18, 19.

¹¹ Unfortunately, at the same time the ECT defers to other investment treaties with higher levels of protection for the investor in the event of an investor-state dispute, thus potentially negating the benefits of these provisions for states that also are party to more traditional IIAs where such issues are not expressed.

¹² This is understood from personal conversations the author has had with officials in each of the three NAFTA governments.

be noted that the issue is not limited to environmental measures, but also includes other public welfare issues such as human health, human rights, worker safety, and more. Provisions included in a text should not focus on the environment to the exclusion of such other issues.

4.1.3 Limitations on Scope of Expropriation

Specifically in relation to the interpretation of expropriation provisions, and in response to much criticism from the public in the US and Canada, both of these states have begun to incorporate special provisions interpreting the scope of the traditional article on expropriation that they still use. Full texts are found in Annex 3. Incorporated originally into their respective model BITs, these texts are now finding their way into final treaty texts as well.¹³

While the US and Canadian texts appear very similar, and indeed are, they differ in two key aspects specifically in relation to regulatory expropriation. Both texts provide three criteria for determining if an indirect expropriation has taken place:

- (a) The determination of whether an action or series of actions by a Party, in a specific fact situation, constitutes an indirect expropriation, requires a case-by-case, fact-based inquiry that considers, among other factors:
 - (i) the economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred;
 - (ii) the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and
 - (iii) the character of the government action.¹⁴

The US Model differs in that it also adds, prior to the above, that

1. Article 6 [Expropriation and Compensation](1) is intended to reflect customary international law concerning the obligation of States with respect to expropriation.¹⁵

This should reinforce the police powers rule. However, both Models also add a rider specifically in relation to regulatory measures. The US text reads:

Except in rare circumstances, non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations.¹⁶

The Canadian text adds some additional language:

Except in rare circumstances, such as when a measure or series of measures are so severe in the light of their purpose that they cannot be reasonably viewed as having been adopted and applied in good faith, non-discriminatory measures of a Party that are designed and applied to protect legitimate public welfare objectives, such as health, safety and the environment, do not constitute indirect expropriation.¹⁷

¹³ This includes the US-Peru FTA and US-CAFTA. It is anticipated that this will also appear in the recent Canada-India BIT, but the text has not been made public as of writing.

¹⁴ US Model BIT, 2004, Annex B, Expropriation; Canada Model FIPA, Annex B.13(1), Expropriation. The text of the Canadian Model is marginally different.

¹⁵ US Model Bit, *ibid.*

¹⁶ US Model BIT, 2004, *Ibid.*

¹⁷ Canadian Model FIPA, n. 14.

It may be noted here that the Columbia Model BIT discussed in this Forum has adopted language close to the Canadian text above.¹⁸

Where the Canadian language seems to focus on the issue of *bona fides* of the measure taken, the US language is open ended. It is not clear if this means the same three factors noted as relevant to a finding of expropriation in general can be resorted to here, whether the economic impact on the investors can be made a central feature, etc.? As well, whether the Canadian language will be sufficient to focus a tribunal only on issues concerning the *bona fides* of a measure and thus stay more closely tied to the bright line in the sand drawn by the Methanex case also remains to be seen. It would seem, however, that under the US formulation an investor is invited to make a broader array of arguments as to why the regulation in question should fall into the category of rare.

Any interpretation of these texts will, of course, have to factor in the incantation that a claim to regulatory expropriation can rarely be founded. The irony of this, however, is that under the NAFTA interpretation in Methanex, a bright line in the sand was drawn: *bona fide* regulatory measures are not expropriations and are not compensable. Under the more recent Canadian and US texts, both intended to fix the flaws in NAFTA, additional arguments may be available to investors to cross this bright line. Investors covered by NAFTA can also now have recourse to the later provisions via the most-favoured nation provision in NAFTA to the texts of other agreements that include this additional opening.

4.2 Other Treaty-based Mechanisms

Turning to other examples of exceptions that are relevant to regulatory measures, there are a number of key examples. Four examples are considered below: general exceptions through annexes, specific exceptions from the expropriation provision; a general exclusion clause modelled on Article XX of the GATT; and the introduction of greater clarity on key terms.

4.2.1 General Exclusions Through Annexes

The construction of IIAs has followed two general directions: those with general exclusion annexes, and those without. Usually, the use of annexes for exclusions has accompanied those IIAs that include investment liberalization provisions.¹⁹ But this is not exclusively, and need not necessarily be, the case.

As discussed in more detail in the accompanying paper in this series on investment liberalization provisions, many IIAs contain three types of annexes:

- Excluding specific sectors from some or all of the obligations of the IIA;
- Excluding existing measures from the obligations of the IIA;
- Excluding future measures from the obligations of the IIA.

The more broadly based the exclusions, the greater the likelihood these types of exclusions can also include matters that can lead to claims of expropriation or other obligations relating to regulatory measures. However, it should be noted that this approach should not be used in such a manner as to create a back-door out of the obligations of an agreement.

¹⁸ Columbia Model Agreement for the Promotion and Protection of Investments, Article 6.2.

¹⁹ See the paper on investment liberalization in this series.

4.2.2 Specific Exclusions from Expropriation Clauses

Many agreements include specific provisions excluding certain types of measures from claims under an expropriation provision, most notably taxation measures. In many cases, compulsory licensing under intellectual property regimes is also excluded. There are multiple examples of this, one of which includes the Columbia Model BIT, Article II.4: “The provisions of this Agreement shall not apply to tax matters.”

Using this as an example, is it possible to include provisions in a text that also exclude other types of government measures from claims of expropriation, or other breaches of an IIA. For example, future environmental, labour, or human health protection measures can be expressly excluded from claims of indirect expropriation. This type of specific exclusion does not appear to have been used as yet for measures other than taxation and in relation to intellectual property, but it is certainly possible to do so.

4.2.3 General Exclusion Clauses Modelled on Article XX of the GATT

One of the more complex forms of exclusion clause is seen in the use of a general exclusion clause modeled on Article XX of the GATT. This transposition from trade law to investment is not straightforward, however.

An example of such a clause is found in Article 13 of the ASEAN Framework Agreement on Investment:

Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on investment flows, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member State of measures; (a) necessary to protect national security and public morals; (b) necessary to protect human, animal or plant life or health; (...)

The meaning of this text is not clear, most notably the issue it raises of discrimination between countries where like conditions prevail. As the application of this type of provision would be for measures enacted by a single government within its own borders, there is no apparent link to the connection of conditions in other countries.

A slightly different example is found in Article 10 of the Canadian Model FIPA:

General Exceptions

1. Subject to the requirement that such measures are not applied in a manner that would constitute arbitrary or unjustifiable discrimination between investments or between investors, or a disguised restriction on international trade or investment, nothing in this Agreement shall be construed to prevent a Party from adopting or enforcing measures necessary:

- (a) to protect human, animal or plant life or health;*
- (b) to ensure compliance with laws and regulations that are not inconsistent with the provisions of this Agreement; or*
- (c) for the conservation of living or non-living exhaustible natural resources.*

Here again, some serious questions arise: What standards, for example, would be used to gage unreasonable or arbitrary discrimination? Would trade law tests be the tests of first resort, some of which can be very restrictive? As well, what impact would trade law tests on necessity, also a

very restricted concept in the WTO system, have here? Further, it is most unclear why the issue of a disguised restriction on trade is raised, as this opens up a back door to investors raising trade law issues in order to confront a measure under an investment agreement.

Also, given the nature of remedies under IIAs, it is not clear if either of the above would have any impact in relation to an expropriation claim. On the surface it is not clear how it would be applied in such a case. Most unclear is whether it would be invoked to determine that a measure is not an expropriation, or that compensation is not required if it is an expropriation. The issue is important in relation to the notion that “nothing in this Agreement shall be construed to *prevent* a Party from adopting...” The emphasis on prevent here raises the question that nothing in the Agreements prevent an expropriation in the first place, they simply require compensation to be paid if a right or property is expropriated. Thus, if the consequence of an expropriation is payment of compensation under the IIA, it is not clear that the requirement to pay compensation would constitute a legal barrier to the adoption of the measure so as to permit the invocation of this article. Thus, the applicability of this type of article to an expropriation clause is far from clear.

The background to these provisions is not well known, and there has been no usage of them in an arbitration that we are currently aware of. Still, it is evident that such provisions can raise as many questions as they seek to answer. The importation of such general exception clauses from trade law should, it is submitted, be very carefully considered, from both a negotiating perspective and a litigation perspective.

4.2.4 Clarity of Key Terms

Finally, it is important to note the increasing need for IIAs to be based on clearer terms more generally. Examples of the growing complexity of IIAs are everywhere, from the 40 and 50 page model BITs of Canada and the United States to the extensive side letters, annexes and more in recently concluded agreements between developed and developing countries.

Some areas that may be considered for clearer provisions include fair and equitable treatment (discussed in the accompanying paper), national treatment and most-favoured national treatment, and of course expropriation.

The key issue in relation to national treatment and MFN is the basis for comparison between the foreign investor and domestic investors. In several cases to date, investors have argued for very simple tests to determine if they are in like circumstances to other investors. These arguments have come from trade law in the main,²⁰ and focused on whether the specific foreign investor is in economic competition with another domestic or foreign investor “in like circumstances” that is treated differently in terms of regulatory requirements. This type of test creates a wide berth for investors to argue against regulations based on such factors as geographical location, environmental and human health impacts of different production processes, local community impacts, and so on.

This broad competition-based basis for comparisons was adopted in the *S.D. Meyers v. Canada* case, but rejected in favour of a broader range of factors, including environmental factors, in the *Methanex v. United States* case. Although there does seem to be an emerging trend today towards the use of a wide range of factors in the comparative process, such a trend is far from secure. We are not aware of any IIAs that have tried to tackle this issue, leaving it purely to the determination of a tribunal in the event of a national treatment claim by an investor.

²⁰ They are based on the trade law test for discriminating between “like products”, for example under Article III of the GATT.

The IISD Model International Agreement does seek to address this issue in treaty language. This text can be found in Annex 4.

5. Concluding Remarks

Perhaps the most important factor to recall here is that IIAs have become extremely important legal documents. From virtually no investor-state arbitrations in the mid-1990s, we now have over 250 known cases. These cover all areas of investment and all types of government actions and measures. The most critical conclusion that a negotiator must, it is suggested, draw from these facts are that the agreements they negotiate will end up as the basis for an international arbitration against their state.

Each agreement must, therefore, be negotiated not just with an eye to the short term political benefit, but also, and even more so, the longer term legal implications of the text. The issue addressed in this paper is not nefarious conduct by governments, not bad faith by officials, and not underhanded maneuvering to secure advantages through improper means. Rather, the issue addressed here is the relationship between normal and prudent government measures and the reach of the IIAs. It is, at present, less than clear. The costs to developing countries of ignoring this relationship can, literally, be hundreds of millions of dollars.

The relationship between IIAs and the regulatory state is not a developing country versus developed country issue. Rather, it is an issue that is common to all states, but whose impacts may vary according to the wealth of the state, the levels of economic activity and in particular of foreign investment, and the rate of growth in such activity.

For developing countries today, the risks associated with a finding that normal, progressive, regulatory measures can be in breach of the provisions of an IIA are very high. There is a strong likelihood that developing countries will begin to generate more regulatory activity compared to developed countries in the upcoming years. This is because many of the legal and administrative measures needed to promote and protect the public welfare already exist in developed countries,²¹ whereas many developing countries lag behind. They can, however, be expected to catch up as changes in governance take root, and economic development both enables more scope for action and creates the societal need and demand for more action to be taken. This anticipated catch up will lead, proportionately, to higher levels of risk of investor-state arbitrations in developing countries. In addition, the levels of damages being awarded in investor-state arbitrations today when investors win their claim appears to be growing, with several cases now leading to awards over, and sometimes well over, \$100 million. This is a formidable sum for any country.

These realities, combined with the uncertainties that are associated with the investor-state process as it exists today, place a high burden on developing country negotiators to address the relationship between IIAs and regulations very carefully indeed.

²¹ This is not, of course, a comprehensive statement applying to all areas. Climate change is an example where regulatory development having an impact on economic activity is a requirement coming for all states.

ANNEX 1: SAMPLE PREAMBULAR AND OBJECTIVES PROVISIONS

NORTH AMERICAN FREE TRADE AGREEMENT

Preamble

The Government of Canada, the Government of the United Mexican States and the Government of the United States of America, resolved to:

STRENGTHEN the special bonds of friendship and cooperation among their nations;

CONTRIBUTE to the harmonious development and expansion of world trade and provide a catalyst to broader international cooperation;

CREATE an expanded and secure market for the goods and services produced in their territories;

...

ENSURE a predictable commercial framework for business planning and investment;

...

ENHANCE the competitiveness of their firms in global markets;

...

CREATE new employment opportunities and improve working conditions and living standards in their respective territories;

UNDERTAKE each of the preceding in a manner consistent with environmental protection and conservation;

PRESERVE their flexibility to safeguard the public welfare;

PROMOTE sustainable development;

STRENGTHEN the development and enforcement of environmental laws and regulations; and

PROTECT, enhance and enforce basic workers' rights;

US-CENTRAL AMERICA FREE TRADE AGREEMENT

PREAMBLE

The Government of the Republic of Costa Rica, the Government of the Dominican Republic, the Government of the Republic of El Salvador, the Government of the Republic of Guatemala, the Government of the Republic of Honduras, the Government of the Republic of Nicaragua, and the Government of the United States of America, resolved to:

STRENGTHEN the special bonds of friendship and cooperation among their nations and promote regional economic integration;

....

ENSURE a predictable commercial framework for business planning and investment;

....

CREATE new opportunities for economic and social development in the region;

PROTECT, enhance, and enforce basic workers' rights and strengthen their cooperation on labor matters;

CREATE new employment opportunities and improve working conditions and living standards in their respective territories;

BUILD on their respective international commitments on labor matters;

IMPLEMENT this Agreement in a manner consistent with environmental protection and conservation, promote sustainable development, and strengthen their cooperation on environmental matters;

PROTECT and preserve the environment and enhance the means for doing so, including through the conservation of natural resources in their respective territories;

PRESERVE their flexibility to safeguard the public welfare;

...

ENERGY CHARTER TREATY

Preamble:

Recognizing the increasingly urgent need for measures to protect the environment, including the decommissioning of energy installations and waste disposal, and for internationally-agreed objectives and criteria for these purposes,

ENERGY CHARTER DECLARATION (referred to in Energy Charter Treaty text as part of basic principles of Treaty)

Title I: Objectives:

The signatories are desirous of improving security of energy supply and of maximizing the efficiency of production, conversion, transport, distribution and use of energy, to enhance safety and to minimise environmental problems, on an acceptable economic basis.

.....

To this end, and in accordance with these principles, they will take action in the following fields:

....

3. Energy efficiency and environmental protection, which will imply:

- creating mechanisms and conditions for using energy as economically and efficiently as possible, including, as appropriate, regulatory and market based instruments;
- promotion of an energy mix designed to minimise negative environmental consequences in a cost-effective way through:
 - (i) market-oriented energy prices which more fully reflect environmental costs and benefits;
 - (ii) efficient and co-ordinated policy measures related to energy;
 - (iii) use of new and renewable energies and clean technologies;

EUROPEAN FREE TRADE AREA-SACU FTA

...

DESIRING to create new employment opportunities and to improve working conditions and living standards in their respective territories while promoting sustainable development;

REAFFIRMING their commitment to the principles and objectives set out in the United Nations Charter and the Universal Declaration of Human Rights;

...

ANNEX 2: SAMPLE PROVISIONS ON REGULATORY AUTHORITY OF STATES

US-CENTRAL AMERICA FREE TRADE AGREEMENT

Chapter Seventeen: Environment

Article 17.1: Levels of Protection

Recognizing the right of each Party to establish its own levels of domestic environmental protection and environmental development policies and priorities, and to adopt or modify accordingly its environmental laws and policies, each Party shall ensure that its laws and policies provide for and encourage high levels of environmental protection, and shall strive to continue to improve those laws and policies.

ENERGY CHARTER TREATY

ARTICLE 18: SOVEREIGNTY OVER ENERGY RESOURCES

(1) The Contracting Parties recognize state sovereignty and sovereign rights over energy resources. They reaffirm that these must be exercised in accordance with and subject to the rules of international law.

(2) Without affecting the objectives of promoting access to energy resources, and exploration and development thereof on a commercial basis, the Treaty shall in no way prejudice the rules in Contracting Parties governing the system of property ownership of energy resources.

(3) Each state continues to hold in particular the rights to decide the geographical areas within its Area to be made available for exploration and development of its energy resources, the optimalization of their recovery and the rate at which they may be depleted or otherwise exploited, to specify and enjoy any taxes, royalties or other financial payments payable by virtue of such exploration and exploitation, and to regulate the environmental and safety aspects of such exploration, development and reclamation within its Area, and to participate in such exploration and exploitation, inter alia, through direct participation by the government or through state enterprises.

(4) The Contracting Parties undertake to facilitate access to energy resources, inter alia, by allocating in a non-discriminatory manner on the basis of published criteria authorizations, licences, concessions and contracts to prospect and explore for or to exploit or extract energy resources.

ARTICLE 19: ENVIRONMENTAL ASPECTS

(1) In pursuit of sustainable development and taking into account its obligations under those international agreements concerning the environment to which it is party, each Contracting Party shall strive to minimize in an economically efficient manner harmful Environmental Impacts occurring either within or outside its Area from all operations within the Energy Cycle in its Area, taking proper account of safety. In doing so each Contracting Party shall act in a Cost-Effective manner. In its policies and actions each Contracting Party shall strive to take precautionary measures to prevent or minimize environmental degradation. The Contracting Parties agree that the polluter in the Areas of Contracting Parties, should, in principle, bear the

cost of pollution, including transboundary pollution, with due regard to the public interest and without distorting Investment in the Energy Cycle or international trade. Contracting Parties shall accordingly:

- (a) take account of environmental considerations throughout the formulation and implementation of their energy policies;
- (b) promote market-oriented price formation and a fuller reflection of environmental costs and benefits throughout the Energy Cycle;
- (c) having regard to Article 34(4), encourage co-operation in the attainment of the environmental objectives of the Charter and co-operation in the field of international environmental standards for the Energy Cycle, taking into account differences in adverse effects and abatement costs between Contracting Parties;
- (d) have particular regard to Improving Energy Efficiency, to developing and using renewable energy sources, to promoting the use of cleaner fuels and to employing technologies and technological means that reduce pollution;
- (e) promote the collection and sharing among Contracting Parties of information on environmentally sound and economically efficient energy policies and Cost-Effective practices and technologies;
- (f) promote public awareness of the Environmental Impacts of energy systems, of the scope for the prevention or abatement of their adverse Environmental Impacts, and of the costs associated with various prevention or abatement measures;
- (g) promote and co-operate in the research, development and application of energy efficient and environmentally sound technologies, practices and processes which will minimize harmful Environmental Impacts of all aspects of the Energy Cycle in an economically efficient manner;
- (h) encourage favourable conditions for the transfer and dissemination of such technologies consistent with the adequate and effective protection of Intellectual Property rights;
- (i) promote the transparent assessment at an early stage and prior to decision, and subsequent monitoring, of Environmental Impacts of environmentally significant energy investment projects;
- (j) promote international awareness and information exchange on Contracting Parties' relevant environmental programmes and standards and on the implementation of those programmes and standards;
- (k) participate, upon request, and within their available resources, in the development and implementation of appropriate environmental programmes in the Contracting Parties.

(2) At the request of one or more Contracting Parties, disputes concerning the application or interpretation of provisions of this Article shall, to the extent that arrangements for the consideration of such disputes do not exist in other appropriate international fora, be reviewed by the Charter Conference aiming at a solution.

NAFTA, CHAPTER 11

Article 1114: Environmental Measures

1. Nothing in this Chapter shall be construed to prevent a Party from adopting, maintaining or enforcing any measure otherwise consistent with this Chapter that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns.

2. The Parties recognize that it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures. Accordingly, a Party should not waive or otherwise derogate from, or offer to waive or otherwise derogate from, such measures as an encouragement for the establishment, acquisition, expansion or retention in its territory of an investment of an investor. If a Party considers that another Party has offered such an encouragement, it may request consultations with the other Party and the two Parties shall consult with a view to avoiding any such encouragement.

IISD MODEL INTERNATIONAL AGREEMENT ON INVESTMENT FOR SUSTAINABLE DEVELOPMENT:

Article 25: Inherent rights of states

(A) Host states have, in accordance with the general principles of international law, the right to pursue their own development objectives and priorities.

(B) In accordance with customary international law and other general principles of international law, host states have the right to take regulatory or other measures to ensure that development in their territory is consistent with the goals and principles of sustainable development, and with other social and economic policy objectives.

(C) Except where the rights of a host state are expressly stated as an exception to the obligations of this Agreement, the pursuit of these rights shall be understood as embodied within a balance of the rights and obligations of investors and investments and host states, as set out in this agreement, and consistent with other norms of customary international law.

(D) *Bona fide*, non-discriminatory, measures taken by a Party to comply with its international obligations under other treaties shall not constitute a breach of this Agreement.

(E) Host states may, through their applicable constitutional processes, fully incorporate this Agreement into their own domestic law so as to make the provisions herein enforceable before domestic courts or other appropriate processes.

ANNEX 3: SAMPLE PROVISIONS ON INTERPRETATION OF EXPROPRIATION

US MODEL BIT, 2004:

Annex B: Expropriation

The Parties confirm their shared understanding that:

1. Article 6 [Expropriation and Compensation](1) is intended to reflect customary international law concerning the obligation of States with respect to expropriation.
2. An action or a series of actions by a Party cannot constitute an expropriation unless it interferes with a tangible or intangible property right or property interest in an investment.
3. Article 6 [Expropriation and Compensation](1) addresses two situations. The first is direct expropriation, where an investment is nationalized or otherwise directly expropriated through formal transfer of title or outright seizure.
4. The second situation addressed by Article 6 [Expropriation and Compensation](1) is indirect expropriation, where an action or series of actions by a Party has an effect equivalent to direct expropriation without formal transfer of title or outright seizure.
 - (a) The determination of whether an action or series of actions by a Party, in a specific fact situation, constitutes an indirect expropriation, requires a case-by-case, fact-based inquiry that considers, among other factors:
 - (i) the economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred;
 - (ii) the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and
 - (iii) the character of the government action.
 - (b) Except in rare circumstances, non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations.

CANADIAN MODEL FIPA, 2004:

Annex B.13(1): Expropriation

The Parties confirm their shared understanding that:

- a) Indirect expropriation results from a measure or series of measures of a Party that have an effect equivalent to direct expropriation without formal transfer of title or outright seizure;
- b) The determination of whether a measure or series of measures of a Party constitute an indirect expropriation requires a case-by-case, fact-based inquiry that considers, among other factors:
 - i) the economic impact of the measure or series of measures, although the sole fact that a measure or series of measures of a Party has an adverse effect on the economic value of an investment does not establish that an indirect expropriation has occurred;
 - ii) the extent to which the measure or series of measures interfere with distinct, reasonable investment-backed expectations; and

iii) the character of the measure or series of measures;

c) Except in rare circumstances, such as when a measure or series of measures are so severe in the light of their purpose that they cannot be reasonably viewed as having been adopted and applied in good faith, non-discriminatory measures of a Party that are designed and applied to protect legitimate public welfare objectives, such as health, safety and the environment, do not constitute indirect expropriation.

IISD MODEL INTERNATIONAL AGREEMENT ON INVESTMENT FOR SUSTAINABLE DEVELOPMENT:

8(I) Consistent with the right of states to regulate and the customary international law principles on police powers, *bona fide*, non-discriminatory regulatory measures taken by a Party that are designed and applied to protect or enhance legitimate public welfare objectives, such as public health, safety and the environment, do not constitute an indirect expropriation under this Article.

JAPAN-VIET NAM AGREEMENT FOR THE LIBERALIZATION, PROMOTION AND PROTECTION OF INVESTMENT

Article 15 (General exceptions)

1. Notwithstanding any other provisions in this Agreement other than the provisions of Article 10, each Contracting Party may:

- (a) take any measure which it considers necessary for the protection of its essential security interests;
 - (i) taken in time of war, or armed conflict, or other emergency in that Contracting Party or in international relations; or
 - (ii) relating to the implementation of national policies or international Agreements respecting the non-proliferation of weapons;
- (b) take any measure in pursuance of its obligations under the United Nations Charter for the maintenance of international peace and security;
- (c) take any measure necessary to protect human, animal or plant life or health; or
- (d) take any measure necessary for the maintenance of public order. The public order exceptions may be invoked only where a genuine and sufficiently serious threat is posed to one of the fundamental interests of society.

2. In cases where a Contracting Party takes any measure, pursuant to paragraph 1 above, that does not conform with the obligations of the provisions of this Agreement other than the provisions of Article 10, that Contracting Party shall not use such measure as a means of avoiding its obligations.

3. In cases where a Contracting Party takes any measure, pursuant to paragraph 1 of this Article, that does not conform with the obligations of the provisions of this Agreement other than the provisions of Article 10, that Contracting Party shall, prior to the entry into force of the measure or as soon thereafter as possible, notify the other Contracting Party of the following elements of the measure:

- (a) sector and sub-sector or matter;
- (b) obligation or article in respect of the measure;
- (c) legal source of the measure;
- (d) succinct description of the measure; and
- (e) purpose of the measure.

4. Notwithstanding the provisions of paragraph 1 of Article 2, each Contracting Party may prescribe special formalities in connection with investment activities of investors of the other Contracting Party in its Area, provided that such special formalities do not impair the substance of the rights of such investors under this Agreement.

ANNEX 4: IISD MODEL INTERNATIONAL AGREEMENT TEXT ON NATIONAL TREATMENT

Article 5: National treatment

(A) Each Party shall accord to investors of another Party treatment no less favourable than that it accords, in like circumstances, to its own investors with respect to the management, conduct, operation, expansion and sale or other disposition of investments. Where a foreign investor may, under domestic law, establish an investment, this Article shall apply to the extent it is not inconsistent with such domestic law relating to the establishment or acquisition of investments.

(B) Each Party shall accord to investments of investors of another Party treatment no less favourable than that it accords, in like circumstances, to investments of its own investors with respect to the management, conduct, operation, expansion and sale or other disposition of investments.

(C) Measures taken in accordance with government procurement policies specifically for the purchase of goods or services by any level of government shall not be considered a breach of this Article.

(D) The treatment accorded by a Party under Paragraphs (A) and (B) means, with respect to a non-national level of government, treatment no less favourable than that government accords, in like circumstances, to investors and to investments within the jurisdiction of the government in question.

(E) For greater certainty, the concept of “in like circumstances” requires an overall examination, on a case-by-case basis, of all the circumstances of an investment, including, inter alia:

- a) its effects on third persons and the local community;
- b) its effects upon the local, regional or national environment, or the global commons;
- c) the sector the investor is in;
- d) the aim of a measure of concern;
- e) the regulatory process generally applied in relation to a measure of concern; and
- f) other factors directly relating to the investment or investor in relation to the measure of concern.

The examination shall not be limited to or biased toward any one factor