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Tobacco companies are frequently turning to international trade and investment agreements as a tool to challenge domestic tobacco control measures. Cases to date include: Indonesia’s successful challenge before the World Trade Organization (WTO) of the U.S. exemption of menthol from its ban on flavoured cigarettes; the pending WTO claims by Cuba, the Dominican Republic, Honduras, Indonesia and Ukraine against Australia’s standardized packaging requirements for tobacco products; the ongoing action brought against those requirements by Phillip Morris Asia Limited under the Hong Kong–Australia bilateral investment treaty (BIT); and the ongoing challenge led by Swiss-based Phillip Morris companies against Uruguay’s rules on health warnings and marketing restrictions for tobacco products, brought under the Uruguay–Switzerland BIT.

As these latter three cases are proceeding, several major new agreements on international trade and investment are under negotiation, including the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP). Tobacco has become a contentious issue in the TPP talks, with Malaysia proposing the exclusion of all tobacco-related measures from the agreement. This article provides a brief survey of different options available to states when negotiating trade or investment agreements, to minimize the risk that the agreement could later be used to challenge tobacco control measures.

The potential for challenge under a TIA may undermine states’ willingness to enact tobacco control policies in two distinct ways. First, significant costs may arise simply from the use of dispute settlement mechanisms. If a measure is challenged under a TIA, the burden of having to defend the case carries with it the potential for high legal fees, long timeframes, and strain on human resources and expertise. Second, additional costs arise from an adverse finding or outcome in a dispute, which may require the state to pay compensation to companies or repeal or modify the measure at issue.

For ease of reference, the term “trade and investment agreements” (TIAs) is used to refer collectively to preferential trade agreements and international investment agreements.

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**Options that control the use of dispute settlement**
State–state adjudication is typically the only option available to resolve disputes regarding trade obligations, while most investment disputes initiated in the past 15 years have been made directly by investors under investor–state dispute settlement (ISDS) mechanisms. This section focuses on reforms to ISDS mechanisms, as...
these are often seen as the greatest threat to regulatory autonomy, although similar options could be applied in relation to state–state dispute settlement.

**Option A: Excluding ISDS from the relevant TIA**
The risk of tobacco control measures being challenged would be significantly reduced if an agreement did not provide for any ISDS mechanism. Excluding ISDS may be seen as weakening investment protection and therefore undermining incentives for foreign investment; as such, ISDS exclusion is unlikely in either the TPP or TTIP. Moreover, even if such an approach were feasible, experience with WTO cases related to tobacco and cigarette restrictions demonstrates that challenges may still be brought by states (often at the behest of the tobacco industry). An alternative, but related, approach would be to prevent an investor from challenging certain kinds of measures. The TIA could provide that investors may not challenge tobacco measures, or public health or welfare measures more broadly.

**Option B: Controlling access to ISDS**
In the TPP negotiations, the United States has proposed that, before any party initiates a dispute regarding another party’s tobacco measure, the health authorities of the two countries meet to discuss the measure. While this U.S. proposal appears to apply only to disputes initiated by a state, a similar mechanism could be created for referral of claims by investors. If the national authorities agreed that the measure satisfied criteria prescribed in the agreement (e.g., that it is a bona fide, non-discriminatory health measure), recourse to ISDS would not be permitted. This procedural requirement would provide an avenue for states to prevent unmeritorious claims from proceeding to litigation. Some investment agreements adopt a similar procedure to this when an investor claims that a taxation measure is tantamount to expropriation.

**Option C: Procedural reform of ISDS**
A range of procedural improvements to ISDS could be undertaken to reduce the harms it poses to states, including imposing: strict timeframes for different stages of proceedings to prevent unreasonable delay; limits on remedies available in cases involving public interest measures such as tobacco control; and stringent rules on costs to penalize investors that bring unmeritorious challenges to public welfare measures. These reforms could lessen the burden of litigation for states defending tobacco control measures, while reducing the costs associated with ISDS generally.

**Options that limit the scope or application of trade and investment obligations**

**Option D: Excluding tobacco measures from the scope of the TIA**
Malaysia has proposed that the TPP completely exclude tobacco measures from its scope. Such a carve-out would preclude the application of any TPP obligation to tobacco control regulations or policies. When designing this sort of clause, negotiators would need to closely consider its scope, and whether it should apply to all chapters or obligations contained in the agreement.

An additional question is whether the exclusion is self-judging, or whether a tribunal would have jurisdiction to determine whether it applied. A broad, self-judging exclusion would provide greater certainty for states seeking to implement tobacco control measures, but is less likely to be agreed to by states with a domestic tobacco industry.

This option may inadvertently increase the likelihood of other public health measures being found inconsistent with TIAs. A tribunal may infer from an exclusion of tobacco measures that the parties understood or intended that public health measures in general fall within the scope of the agreement—hence the need to specifically exclude tobacco regulations.

**Option E: Limiting the scope of substantive obligations**
Limiting provisions are commonly included in new international investment agreements, to clarify the scope of substantive obligations that have proven to be particularly broad or problematic in previous agreements. For example, many investment agreements now state that non-discriminatory measures enacted for a public purpose do not usually constitute an indirect expropriation of an investor’s property. Whether or not a tobacco control measure falls within the scope of the obligation, or is saved by the limiting provision, depends upon how the relevant tribunal interprets the key terms in the provision. Thus, even where a treaty includes language that limits the scope of a substantive obligation, states may find it difficult to determine in advance whether their measure complies.

**Option F: General exceptions for public health or welfare measures**
General exceptions are one of the most common approaches used in international trade agreements to safeguard regulatory autonomy, and are increasingly being incorporated into international investment agreements. Typically, general exceptions declare that no obligations in the agreement (or a particular chapter) should be construed to prevent a state from taking necessary action to protect public health or meet other social welfare goals. Including a general exception would have the benefit of applying to public health or welfare measures in general, and not just to tobacco measures. However, their scope is typically limited to measures that a state can prove ‘necessary’ for a public purpose, and it is often unclear whether a measure will meet this threshold until the claim is adjudicated. The United States has proposed that the TPP parties include a provision clarifying that the general exception applies to tobacco health measures.

**Conclusions**
As set out in Figure 2 (below), the strongest options for states to safeguard their autonomy to implement
tobacco control measures are to exclude such measures either from the scope of the relevant TIA entirely (Option D) or from the scope of ISDS (Option A). However, these options are also the least likely to be agreed to by countries where the tobacco industry is influential. Broader approaches—such as limiting the scope of substantive obligations (Option E), including general exceptions (Option F), or reforming dispute settlement procedures (Option C)—are likely to be more politically feasible, but do not provide a high degree of certainty for states considering implementing tobacco control measures.

Some of the options that provide the greatest protection to tobacco control specifically would do little to increase a state’s general regulatory autonomy. In contrast, some of the less targeted options, such as general exceptions, protect the broader right of states to enact measures to promote public health and welfare. States should consider the utility of each of these options on a case-by-case basis, perhaps combining a number of options in a given agreement. Further, additional treaty protections secured in new TIAs will provide little comfort to states should existing TIAs continue to provide avenues for investors to bring disputes under weaker provisions. Therefore, states considering how to protect regulatory autonomy in agreements under negotiation must also consider the relationship between the new agreement and existing agreements.

Figure 2: The Relative Strength of Options for Tobacco Control Measures

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**References**

6. A more detailed analysis of these options is provided in Mitchell, A., & Sheargold, E. Protecting the autonomy of states to enact tobacco control measures under trade and investment agreements. Tobacco Control (Forthcoming; published online October 31, 2014). Retrieved from [http://tobaccocontrol.bmj.com/content/early/2014/10/31/tobaccocontrol-2014-051853.abstract](http://tobaccocontrol.bmj.com/content/early/2014/10/31/tobaccocontrol-2014-051853.abstract).
Investment treaties protect foreign investors from a range of host state conduct that affects their investments. One influential view is that the purpose of these treaties is to provide legal stability for foreign investors. While this view is shared by arbitral tribunals, academic commentators, and lawyers acting for foreign investors, it finds relatively little support in the text of investment treaties. Instead, it rests on shared assumptions about the ‘problems’ that these treaties are designed to solve. These shared assumptions are that stability is desirable on fairness grounds—in the sense that it is unfair for a state to renege on an agreement with an investor—and that stability is desirable on economic grounds—in the sense that investors will be reluctant to incur the sunk costs associated with investments unless a state credibly commits to rules constraining its future conduct.

In other work, I have argued that the economic justifications for the legal stability the investment treaties provide are much weaker than is generally assumed. In this piece, I leave these economic questions to one side, and examine some of the tensions between legal stability and political change in countries bound by investment treaties. This article focuses specifically on investment treaty claims arising from transitions from authoritarian rule. In such situations, the tension between the stabilizing function of investment treaties and democratic aspirations for political change is clearly defined. The conclusions cast doubt on the assumption that stability is desirable on fairness grounds, and raise new questions about the impact of investment treaties on the consolidation of democratic rule.

This analysis is timely. Although waves of democratization swept through Southern Europe, Latin America, East Asia and Eastern Europe between 1970 and 2000, few of the states involved were bound by investment treaties at the time of their political transition. In contrast, the proliferation of investment treaties over the past twenty-five years means that recent events in Tunisia, Egypt, Libya and Myanmar—as well as future political transitions—are more likely to become the subject of investment treaty claims. Indeed, some claims related to political transitions already are before arbitral tribunals. The claim in Damac Properties v. Egypt arises from an Egyptian court’s decision following the fall of the Mubarak government. In this case, an Egyptian court rescinded the sale of land by the former tourism minister to an investor for an amount allegedly far below its fair market value. In another case, Veolia v. Egypt, the dispute appears to have arisen out of disagreement about whether a stabilization provision in a concession contract signed under the Mubarak regime required a government authority to compensate the concessionaire for increases in the minimum wage introduced by the incoming Morsi government.

The backdrop: relevant principles of general international law
Before turning to the specific issues concerning investment treaties, it is important to recall the basic principle of international law that change in the form of government within a state is irrelevant to the nature and content of that state’s treaty obligations. This follows from three foundational propositions of international law. First, the state is a unitary and continuing entity. Second, “an established government stands for, and has responsibility for, the State and its people for all or virtually all purposes.” Third, an established government within a state has “virtually unlimited” authority to bind the state for the future as a matter of international law. The combined effect of these three propositions was stated succinctly by the Iran–U.S. Claims Tribunal in the public debt case:

In spite of the change in head of State and the system of government in 1979, Iran remained the same subject of international law as before the Islamic Revolution. For when a Government is removed through a revolution, the State, as an international person, remains unchanged and the new Government generally assumes all the previous international rights and obligations of the State.

Thus, an incoming democratic regime remains bound by the same international legal obligations that bound its authoritarian predecessor, including any investment treaties in force.

The political economy of transition from authoritarian rule
Within the discipline of political science, there is a rich and sophisticated literature that seeks to understand the breakdown of authoritarian rule and the process.
of transition to more democratic forms of government. One insight from this literature is that authoritarian regimes are often sustained by networks of patronage and cronyism. In return for their allegiance to the regime, influential individuals receive economic privileges, such as monopolies and concession agreements awarded for a small fraction of their fair market value. Depending on the country in question, the individuals who comprise these networks of patronage may be citizens of that country, foreigners or a mixture of both.

Incoming democratic governments face pressure to enact social and economic reforms to redress the dominance of those with close links to the previous regime. Such demands are difficult to ignore. An incoming democratic regime must be supported by a sufficiently powerful coalition of actors to be viable. And because a nascent democratic regime is unlikely to be able to depend on the military for its viability, this means securing a broader basis of civilian support than that commanded by the outgoing regime. This requires a political and economic settlement—a compromise that garners sufficient civilian support to avoid the risk of authoritarian reversion.

For these reasons, a transitional process will normally require an incoming regime to reconsider the privileges granted to cronies of the former regime. This might involve terminating monopolies, renegotiating concession contracts and, perhaps, renationalizing state assets illegitimately transferred into private hands. Significant changes in laws of general application are also likely—for example, changes in laws governing labour, taxation, and the relationship between investors and the communities in which they operate. Such moves may be inconsistent with assurances and waivers granted by the prior regime and, in any case, will result in a very different regulatory environment to that anticipated by investors when they originally invested.

**Political change vs. legal stability**

Investment treaties pose an obstacle to this process of economic reorganization. Under most investment treaties, expropriation of a foreign investment requires fair market value compensation, regardless of whether the investment was originally acquired on a fair market value basis. Investment treaties also constrain governments’ ability to amend the contractual arrangements governing foreign investments. In treaties containing an umbrella clause, any unilateral amendment to an investment contract arguably constitutes a breach of the treaty. Even in treaties that do not contain an umbrella clause, the fair and equitable treatment (FET) standard has been interpreted as a guarantee of the stability of the legal framework governing foreign investments. On this view of the FET standard, attempts by a transitional government to unilaterally amend contracts, or to reform the basic legal framework governing investments could also give rise to liability under investment treaties. As is the case with expropriation, most tribunals have awarded compensation on a fair market value basis (or, more precisely, a prospective ‘but for’ basis) regardless of the circumstances in which the investment was acquired.

At this point, it is important to distinguish between two related concerns arising from the tension between political change and legal stability. The first concern is that investment treaties could hamper the emergence and consolidation of more democratic governments. Investment treaties could have this effect either by dissuading incoming governments from undertaking economic reorganization necessary for civilian coalition building or by requiring incoming governments to pay compensation when they engage in such economic reorganization, thereby placing greater strain on already stretched budgets. Whether investment treaties have these effects in particular states is an empirical question that has not yet been examined in detail. The experiences of different countries with differing systems of economic regulation and political dynamics are likely to vary.

The second concern relates to the fairness of a situation in which an incoming government is required to pay fair market value compensation for interference with investments acquired from the former regime through transactions that were not arm’s length. In this situation, the associates of the former regime obtain a windfall gain at the expense of the citizens of the host state. The issue of fairness arises regardless of whether the presence of the investment treaty hinders the consolidation of democracy in practice.

**What should be done?**

The constraints imposed by existing investment treaties provide few opportunities for arbitral tribunals to address the two concerns identified above. Nevertheless, insofar as there is interpretative space available within existing investment treaties, arbitral tribunals should use that interpretative space to ensure that investment treaties do not protect the beneficiaries of authoritarian rule from the economic restructuring necessary to secure the viability of an incoming democratic government. One example of such interpretative space is the debate about the extent to which the FET standard protects an investor’s ‘legitimate expectations’ and guarantees a ‘stable legal environment.’ Tribunals have taken very different views on this question. Some emphasize investors’ entitlement to stability, while others have argued that there are circumstances in which a state may legitimately amend the laws and contracts governing an investment. Arbitral tribunals can and should recognize a strong presumption that economy-wide legal and policy changes introduced by transitional or incoming democratic regimes are consistent with the FET standard.
In other respects, the concerns identified in this piece point to the need for changes in the way investment treaties are drafted. In particular, they raise serious doubts about the principles governing compensation under investment treaties. While fair market value may be an appropriate default rule for investments that were acquired through arm’s length transactions for fair market value, an investor that did not purchase an investment for fair market value should have no right to compensation calculated on that basis.

Finally, this paper raises further questions about the purposes of, and justifications for, investment treaties. Many proponents of investment treaties consider that the objective of providing legal stability is the primary purpose of investment treaties. Stability is a desirable characteristic of legal systems. But it is only one of many desirable characteristics of a legal system and, arguably, not the most important among them. Insofar as the objective of providing legal stability to investors and the process of democratisation are in tension, there are real questions about whether the former should prevail over the latter.

Author
Jonathan Bonnitcha is a consultant Legal Advisor to IISD and a Visiting Fellow in International Investment Law and Policy at the Australian National University. He currently lives in Myanmar. These are his personal views.


Notes
1 BG Group v. Argentina, Final Award, December 27, 2007, para. 307; Micula v. Romania (ICSID Case No. ARB/05/20), Award, December 11, 2013, para. 528; TecSor v. Mexico (ICSID Case No. ARB/AP(00)/02), Award, May 29, 2003, para. 164; CME v. Czech Republic, Partial Award, September 13, 2001, para. 611; all interpreting treaties which did not contain preambular references to the objective of stability. See also, Occidental Exploration and Production Company v. the Republic of Ecuador (LCIA Case No. UNSA467), Final Award, July 1, 2004, para. 183; LG&E Energy v. Argentina (ICSID Case No. ARB0021), Award, July 25, 2007, para. 124; CMS Gas v. Republic of Argentina (ICSID Case No. ARB01/8), Final Award, May 12, 2005, para. 273; Sempra Energy International v. The Argentine Republic (ICSID Case No. ARB02/16), Award, September 26, 2007, para. 300; all interpreting treaties which did contain preambular references to the objective of stability.


For policymakers charged with investment portfolios, the challenge is not simply about attracting greater flows of foreign direct investment (FDI). At least as important is trying to maximize the domestic economic and social benefits that result from those investments. This can be achieved with tax policies or targeted recruitment of specific investments with promising potential spillovers.

It can also be achieved by using performance requirements—a class of tools that is widely used, often illegal, and only recently redeemed after years of pariah status under the Washington Consensus.

This article reviews some of the most commonly used performance requirements, briefly surveying what we know about their effectiveness. It finishes by noting that many of the tools that have been (sometimes) effectively used are prohibited under international investment law.

What are performance requirements, and can they be effective?

Performance requirements aim to wring domestic benefits from investment, over and above what would normally occur. There are at least four types of performance requirements:

- Requirements that aim to strengthen domestic capacity in the regulated sector itself;
- Requirements that aim to build backward or forward linkages from a regulated sector;
- Requirements for regulated firms to improve social outcomes; and
- Requirements to contribute to macroeconomic balance.

Each of these involves different sorts of policy tools. What follows is a brief summary of those tools, and an assessment of their strengths and weaknesses in different circumstances.

Requirements that aim to strengthen domestic capacity in the regulated sector include technology transfer requirements, requirements to perform research and development (R&D) domestically, and joint venture requirements.

Technology transfer requirements mandate that the investor bring some specified level of technology (usually proprietary) to the host country, with the aim that investments operate at a global industry standard, or with best available technology. This type of requirement is featured, for example, in Nigeria’s Local Content Policy, which required oil and gas sector firms to submit an annual technology transfer plan (Nwaokoro, 2011). UNCTAD (2003) surveys the few instances of this type of requirement, and finds little evidence of its success. It argues that this should not be surprising; there are major challenges in monitoring such requirements and, more fundamentally, it is challenging for governments to identify what technologies particular firms in particular sectors and countries should be using in the first place.

Host governments may also require that R&D be carried out at some particular level, often specified as a percentage of operating costs. Like technology transfer requirements, these are most often used in the manufacturing sector, where they are usually formulated as voluntary performance requirements—conditions for receiving fiscal support. Mandatory applications of this sort of requirement are quite rare. And voluntary requirements tend to be ignored; the problem is that setting up an effective local R&D facility is particularly challenging in the absence of local capacity to absorb, adapt and develop the technology, and the costs of doing so often exceed the government incentives on offer (UNCTAD, 2003). To be successful, any such requirements need to be accompanied by national efforts at establishing working national systems of innovation, including support for education and training.

Joint venture requirements mandate that a foreign investor in a particular sector operate as an equity joint venture with some local partner. In practice, they are usually expressed as a demand that any investment have a certain percentage of domestic ownership. Prior to 1990, countries like India and Nigeria prohibited majority ownership of any investment by a foreign company (Miller, Glen, Jasperson, & Karmokolias, 1996). These requirements are most often aimed at building competitive capacity in domestic partners who, it is hoped, will be exposed to modern technologies, improved management practices, and global marketing channels and experience. China used these sorts of requirements heavily in its drive to foster globally competitive national champions in the manufacturing and heavy industries sectors, starting as early as the late 1970s (Pearson, 1991), but most prominently in the 1980s and 1990s.

Joint venture requirements are not easy tools to use effectively. First, they are not well received by investors. Joint ventures are ideally a union of entities with shared objectives and complementary strengths, but mandatory joint ventures in countries with under-developed partners will usually bring neither of these prerequisites for the foreign firm. Moreover, there is a basic element of mistrust in a forced arrangement, particularly with respect to the appropriation of technology. Moran (2002, cited in United Nations Conference on Trade and Development [UNCTAD], 2003, p. 27) finds that technology employed in mandatory joint ventures is on average 3 to 10 years out of date, and technical training provided to local affiliate staff is a fraction of that provided in wholly-owned subsidiaries. These unique characteristics of mandatory joint ventures may make them more prone to failure; citing a 1992 study by the Nigerian–British Chamber of Commerce, Baoteng and Glaister (2003) note that, of some 50 agricultural joint ventures set up in Nigeria in the mid-eighties, only 10 were still viable as of 1990.

The examples of China, Korea and others, however, show that joint venture requirements can be effectively employed. In the

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end, host countries need to delicately balance the benefits derived (both economic and non-economic) against the potential to deter foreign direct FDI. Only countries in a position of strength vis-à-vis the investor should contemplate the use of these policies.

**Requirements that aim to build backward or forward linkages from a regulated sector** include requirements for local/domestic procurement of input goods and services, and requirements that a sector’s products be processed in country.

The main objective of these sorts of measures is to move away from enclave operations that contribute very little outside of expenditures on core functions, import most inputs, technology and experts needed in the course of operation, employ few locals, and export largely unprocessed materials.

Local procurement requirements, which foster backward linkages into the economy, can be successful given the right circumstances and accompanying policies (UNCTAD, 2003; Sutton, 2005 [cited in Rodrik, 2006]). Brazil’s national agency for oil and gas and biofuels (ANP) uses local content as one of its three criteria for awarding petroleum rights, and has seen commitments to local content increase from 25 per cent in the year the program started to almost 80 per cent a decade later (Sigam & Garcia, 2012). Part of its success stems from the leadership demonstrated by Petrobras, the national oil champion, in fostering backward linkages in the sector. Credit also goes to Brazil’s long-standing drive for localization, its attention to the lessons of history, and a broad mix of policies of which performance requirements are only one part.

Those lessons include, first, that quotas should not be set higher than local suppliers are able to meet, though they should be set high enough to push suppliers to greater efficiencies. Some have argued, for example, that Nigeria’s draft Oil and Gas Industry Content Development Act was over-ambitious in its targets for local content, envisioning an increase from 2 per cent in 2009 to 35.5 per cent in 2010 and to 70 per cent by 2013 (Morris, Kaplaniski, & Kaplan, 2012). In other words, it is important to push suppliers, but not to push them to jump across a gulf they cannot span.

The most important lesson may be that local procurement requirements by themselves are not enough; support from both the government and the firms involved (in the form of supplier development programs, for example) is critical in helping build up the capacity to meet ambitious quotas. As well as capacity building, government support for lending to potential suppliers can also be effective; most are small and medium enterprises whose access to finance is difficult at best.

**Requirements for regulated firms to improve social outcomes** include requirements for a specified level of local employment (or management), and requirements to train local employees or build capacity in suppliers.

As in the case of local procurement requirements, the key with local employment and management requirements is to help ensure that there is in fact adequate quality local supply to fill the needs. In many countries the labour force skills do not match well with the needs of investors, who are forced to hire from abroad, especially at senior levels (Morris et al., 2012; Peek & Gantès, 2008). Implementing a demand for local hiring without addressing this problem—through consultation with the firms involved to gauge their needs, and appropriate investment in education and specialized training—greatly increases inefficiencies and costs in the regulated firms. As a positive example, since the 1990s Brazil has set aside a percentage of oil sector royalties for the Oil and Gas Sector Fund, which supports, among other things, specialized learning at existing institutions. It has provided over 5,000 post-graduate scholarships since 1999 for professionals destined for the oil, gas and biofuels sectors (Korinek, 2013).

Requirements for training of local employees are widely used. Countries such as South Africa and Malaysia have established skills development funds into which businesses must pay, and these have been relatively successful at improving employee skills (UNCTAD, 2003, p. 31). Often, such training is done as a quasi-voluntary effort by the firms involved in response to requirements for localization of the labour force to overcome the critical problem of lack of appropriate skills.

Requirements to build capacity in suppliers are less common. They seek to develop what Porter and Kramer (2011) call “shared value,” where the supplier firms are supported to become more globally competitive, and the regulated firm benefits from higher quality locally sourced inputs (often better adapted to local conditions than what might be available internationally). BHP Billiton’s Cluster Programme in Chile, for example, involves BHPB identifying a number of key operational challenges that it needs solved, identifying candidate domestic firms to set to the task of solving problems, and enabling them to work innovatively on solutions. Such programs may be most appropriate for countries that already have fairly advanced suppliers (Barnett & Bell, 2011). Programs focusing more on basic quality control training are more widely used. These are most effectively cast as collaborative efforts by firms, government and suppliers; a forced mandate to undertake training, without parallel supporting policies for suppliers, may produce reluctant efforts and unimpressive results.

**Requirements to contribute to macroeconomic balance** come in several types, usually focused on ensuring that firms are not exerting undue pressure on the balance of payments by importing more than they export. These are of a somewhat different character than the requirements discussed above, and are not assessed here.

**Are they legal?**

There are several types of law that might be applicable to a given performance requirement by a host government. One is the World Trade Organization’s Agreement on Trade-Related Investment Measures (TRIMs Agreement), which defines the types of measures that contravene non-discrimination provisions.

“... those which are mandatory or enforceable under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage, and which require the purchase or use by an enterprise of products of domestic origin or from any domestic source, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production; ...” (Paragraph 1(a), Annex, TRIMs – emphasis added).

In other words, the TRIMs Agreement prohibits any local content requirements (it also prohibits most requirements aimed at macroeconomic balance). While this is a fairly narrow discipline, it is also powerful, since local content requirements may be the most popular of all performance requirements. As well, it has force by dint of the broad membership of the WTO, currently at 160 members.

While local content requirements are a widespread policy tool, there have only been two WTO challenges that involved them. This may be because states are reluctant to challenge tools that they themselves are using. Or it may be that the oft-invoked threat of WTO challenge is enough to forestall or alter legislation that really matters to affected states.
Performance requirements are also addressed in a number of international investment agreements (IIAs): bilateral investment treaties and investment chapters in free trade agreements (FTAs). The North American Free Trade Agreement (NAFTA) was one of the first IIAs to address performance requirements; it essentially contains the TRIMs disciplines as well as a prohibition on technology transfer requirements (Article 1106). Post-NAFTA, a number of countries in the Organisation for Economic Co-operation and Development (OECD) have signed agreements with provisions on performance requirements, with varying degrees of stricture. The 2011 European Union–Colombia–Peru FTA does not address performance requirements at all. A leaked 2012 draft of the investment chapter in the Trans-Pacific Partnership contained the same NAFTA-style prohibitions, and was careful to add (in non-bracketed text) that parties were still free to condition advantages on requirements that investors “locate production, supply a service, train or employ workers, construct or expand particular facilities, or carry out research and development” in country. The 2012 ASEAN Comprehensive Investment Agreement incorporates the TRIMs obligations by reference, and commits to assessing whether more obligations are desirable. Most agreements between developing countries do not address performance requirements. The 2014 Canada–European Union Comprehensive Economic and Trade Agreement (CETA), in its investment chapter, contains the NAFTA prohibitions, and goes further to ban joint venture requirements and quotas for domestic employment. While IIAs may vary in their direct treatment of performance requirements, pretty much all contain obligations on national treatment, guaranteeing treatment for foreign investors no worse than that granted in like circumstances to domestic ones. This means that, if performance requirements are imposed only on foreign investments and investors, they would violate obligations. In any case, from an effectiveness perspective there is no compelling argument to regulate only foreign firms when imposing performance requirements.

What are the implications of these legal restrictions? At the outset, it is important to note that most of them cover only a limited range of the broad spectrum of available performance requirements that governments might want to use. Only rarely do they go beyond what is stipulated in the TRIMs Agreement, to which almost all countries are party. That said, the recent trends as exemplified in the CETA show a definite movement toward more restrictive limits on the use of performance requirements. Moreover, even incorporating TRIMs by reference in IIAs can have a legal impact: it can make those obligations subject to investor–state dispute settlement as provided in IIAs. The North American Free Trade Agreement (NAFTA) restricts on joint venture requirements at all. A leaked 2012 draft of the investment chapter in the Trans-Pacific Partnership contained the same NAFTA-style prohibitions, and was careful to add (in non-bracketed text) that parties were still free to condition advantages on requirements that investors “locate production, supply a service, train or employ workers, construct or expand particular facilities, or carry out research and development” in country. The 2012 ASEAN Comprehensive Investment Agreement incorporates the TRIMs obligations by reference, and commits to assessing whether more obligations are desirable. Most agreements between developing countries do not address performance requirements. The 2014 Canada–European Union Comprehensive Economic and Trade Agreement (CETA), in its investment chapter, contains the NAFTA prohibitions, and goes further to ban joint venture requirements and quotas for domestic employment.

While IIAs may vary in their direct treatment of performance requirements, pretty much all contain obligations on national treatment, guaranteeing treatment for foreign investors no worse than that granted in like circumstances to domestic ones. This means that, if performance requirements are imposed only on foreign investments and investors, they would violate obligations. In any case, from an effectiveness perspective there is no compelling argument to regulate only foreign firms when imposing performance requirements.

What are the implications of these legal restrictions? At the outset, it is important to note that most of them cover only a limited range of the broad spectrum of available performance requirements that governments might want to use. Only rarely do they go beyond what is stipulated in the TRIMs Agreement, to which almost all countries are party. That said, the recent trends as exemplified in the CETA show a definite movement toward more restrictive limits on the use of performance requirements. Moreover, even incorporating TRIMs by reference in IIAs can have a legal impact: it can make those obligations subject to investor–state dispute settlement as provided in IIAs.

The most widespread limitation on the use of performance requirements is on requirements for local content; its inclusion in the TRIMs Agreement makes it more or less universal. Here the good news is that this is only one of many policies that might be employed, leaving a wide range of tools available to policy makers. The bad news is that this is one of the most popular measures available, and properly so, since it does have potential for success if it is correctly used. As with any performance requirements, local content requirements have a mixed record of success, with more negative than positive results. But as noted above, the possibility of failure does not seem to be a strong rationale for prohibition. Best practices, guidance, or law based on what we know about best practice (for example, mandated sunset clauses) would seem to be better options.

Conclusions

There are good reasons for the widespread use of performance requirements, even in situations where the implementing country is legally obliged to shun them. For one thing, all states are looking for ways to have investment contribute more pervasively to their economic development. For another thing, even though performance requirements are hard to get right, they sometimes work.

Two conclusions stem from those widely understood realities. First, investment policy-makers need more guidance on the successful employment of these tools. Second, either the law or the practice should change (taking into account the evidence on effectiveness, among other things). As it stands now, the international community has agreed to ban tools that everyone continues to use.

Author

Aaron Cosbey is a Senior Associate at the International Institute for Sustainable Development. He manages IISD’s program of work on trade, investment and climate change.

References


The international investment regime (IIR) has been in crisis since it attracted the attention of the international community in the early 2000s. This crisis began with awards like *Metalclad v. Mexico* and *TECMED v. Mexico*, where tribunals promoted the stability of the legal and business framework while seriously constraining the policy space of host states. This brought about lots of criticism from academics and NGOs, and even from some insiders like Jan Paulsson, a prominent arbitrator, in his expert opinion before the Annulment Committee in *MTD v. Chile*.1 Subsequent awards responded to this criticism by adjusting the interpretation of some treaty standards, such as the fair and equitable treatment, and awards like *Saluka v. Czech Republic* became a landmark in investment arbitration as a result.2 At the same time, states like the United States and Canada updated their treaty models to reflect similar concerns with the awards of the early 2000s. José Alvarez described this reaction by states to the legitimacy crisis of the IIR as “recalibration.”3 For many countries, however, this recalibration was not enough. Not only leftist countries such as Ecuador, Bolivia and Venezuela, but also Australia and South Africa began reconsidering their participation in investment arbitration.4 The big crisis since it attracted the attention of the international community in the early 2000s. This crisis began with awards like *Metalclad v. Mexico* and *TECMED v. Mexico*, where tribunals promoted the stability of the legal and business framework while seriously constraining the policy space of host states. This brought about lots of criticism from academics and NGOs, and even from some insiders like Jan Paulsson, a prominent arbitrator, in his expert opinion before the Annulment Committee in *MTD v. Chile*.1 Subsequent awards responded to this criticism by adjusting the interpretation of some treaty standards, such as the fair and equitable treatment, and awards like *Saluka v. Czech Republic* became a landmark in investment arbitration as a result.2 At the same time, states like the United States and Canada updated their treaty models to reflect similar concerns with the awards of the early 2000s. José Alvarez described this reaction by states to the legitimacy crisis of the IIR as “recalibration.”3 For many countries, however, this recalibration was not enough. Not only leftist countries such as Ecuador, Bolivia and Venezuela, but also Australia and South Africa began reconsidering their participation in investment arbitration.4 The big news today is that even Germany—a historical promoter of the IIR—has resisted including investment arbitration in the Transatlantic Trade and Investment Partnership (TTIP), an agreement under negotiation between the European Union and the United States.5

### The IIR in crisis: an opportunity for change?

The ongoing backlash against the IIR could be an opportunity to improve the governance of foreign investment and multinational corporations (MNCs), and tackle some of the more fundamental criticisms made against the IIR. In 2003, Howard Mann noted that this regime was at a crossroad: it could crystallize as a new form of colonialism or evolve into a new field of global cooperation on development.6 In practice, there were probably four potential scenarios for the IIR: a) it could evolve towards a universal regime for domestic and foreign investors;7 b) it could consolidate its neo-colonial features; c) it could become a new field of global cooperation on development; or d) it could simply disappear. Unfortunately, today, we are witnessing a potential resurgence of the asymmetric structure of the IIR, in which economically powerful states impose investment arbitration on other nations in a one-sided manner. While promoting this regime in their relations with less developed countries, these economically powerful states resist investment arbitration whenever they may be in the position of capital importers. This is the position of some European countries or Australia in relation with the United States. This situation does not help to overcome the crisis of the IIR; on the contrary, as Lord Goldsmith noted recently:

### Understanding a history of disagreement on foreign investment governance

Historically, the one-sided character of investment agreements and the lack of a multilateral consensus on investment matters have been the rule, not the exception. The disagreement on foreign investment rules began in the 19th century, and extended throughout the 20th century as a generalized trend not only between developing and developed country states, but also among developed nations. The Bretton Woods Project, for instance, resulted in a draft treaty on both foreign investment and trade matters, which was then rejected by the United States. This was just one of many attempts led by developed countries that came to nothing. The most important were the two initiatives promoted within the Organisation for Economic Co-operation and Development (OECD). In the 1960s and again in the 1990s, developed countries agreed that the difficulties of negotiating an agreement on foreign investment were the result of the ideological division between the South and the North. The OECD thus seemed to be the ideal setting to negotiate such an agreement, which could be later moved to a multilateral forum.7 This view proved wrong both times, however, suggesting that the disagreement on foreign investment has never been an exclusively South/North question. The present difficulties in the negotiation of an investment chapter in the TTIP seem to corroborate this conclusion.

### The institutional limitations of the IIR

In the absence of a multilateral agreement on investment, a vast network of bilateral investment treaties presently governs many aspects of foreign investment. This presents some problems. A fundamental issue is that the IIR is mainly about litigation between foreign investors and states, while only the former can initiate...
disputes in practice. As a result, there is no debate within this regime about the general problems created by multinational corporate activity. These ranged, for instance, from the impact of financial crises on foreign investments to the regulation of tobacco consumption. While there are many global forums where these issues are discussed, like the International Monetary Fund or the World Health Organization, none of them has an institutional connection with the IIR. This regime, on the contrary, has a tendency to describe conflicts using an inter-parties narrative, along the lines of traditional commercial arbitration principles. Investment tribunals are therefore incapable of discussing larger policy questions or of hearing the voices of local populations, except for in the attempts to introduce the latter as amici curiae. This suggests that not only are we returning to a one-sided IIR, but also that the institutional structure of the regime is unable to accommodate a new field of global cooperation on development.

Against this background, an additional element to understand German, French and European resistance to investment arbitration may relate to the role of the IIR in the governance of foreign investment and MNCs. This poses the questions of whether foreign investment governance is only about resolving complaints of foreign investors, and of the implications of investment arbitration more in general. The political economy literature suggests, in fact, that things are more complex than in the traditional political risk narrative that dominates the IIR. Foreign investment and MNCs have a strong impact on host countries because of their authority to make decisions that affect people’s lives. The issue is the decisions that MNCs make on the use of tangible and intangible resources, and the correlative obligation of the rest of the society to respect those decisions. Put in these terms, the anxiety of some countries with the IIR would be the consequence of not only losing a particular dispute every couple of years, but also of facilitating multinational corporate activity to the detriment of democratic decision-making.

Rethinking foreign investment governance: Is an overlapping consensus a way forward?
The need for an international regime to govern foreign investment may seem unavoidable in the present global economy, but the current IIR may be unsuitable for this purpose. This regime cannot produce or articulate the necessary state and non-state cooperation. Paradoxically, the present negotiations do not highlight these institutional limitations, and some difficult issues concerning foreign investment are still discussed within the terms of investor–state dispute settlement, as if the only problem of globalization was how to resolve the troubles foreign investors are experiencing in host states. This approach overlooks the views that dominated the foreign investment agenda in the 1970s in both developing and developed countries. The position of the United States in 1973, for instance, was that:

The issue is the degree of freedom that should be allowed the multinational corporation or the nature and extent of regulation that should be imposed on its present operations and future growth in order to make it better serve divergent national interests.

While it is true that developing countries mainly demanded a code of conduct for MNCs, which is probably the opposite of the IIR, it is undeniable that forty years ago the debate about foreign investment was more holistic.

An international investment regime capable of considering foreign investment problems more comprehensively—along the lines suggested by Howard Mann—requires imagining alternative ways to tackle the problems posed by MNCs, including but not limited to arbitrary treatment of foreign investment by the host state. From this broader perspective,

The ongoing backlash against the international investment regime could be an opportunity to improve the governance of foreign investment and multinational corporations.

An interesting point is the extent to which the institutional limitations just described relate to the increasing difficulties in the negotiation of investment agreements. This is a relevant point because some of the negotiating parties, like the European Union, do have the bargaining power to explore alternative texts with their treaty partners. Is it possible, then, that the answer lies beyond the texts of the treaties? The dominant explanation for the resistance to investment arbitration from countries like Germany or France is that they simply do not need it, because they provide foreign investors with reliable legal systems. This position seems reasonable, but may also not explain the situation entirely. On the one hand, arbitrators like Jan Paulsson have noted that states that abide by the rule of law have nothing to fear of the IIR. On the other hand, as Lord Goldsmith has warned, the omission of investment arbitration from the TTIP would likely affect the ability of the UK and EU to negotiate these provisions in future trade deals with developing countries.
the problem of the IIR today may be the excessive ethos of lawyers and the absence of the ethos of diplomats and politics in general. The IIR has been defended because it promotes the depoliticization and legalization of investment disputes. However, a closer look at this regime shows that the IIR may be facilitating multinational corporate activity. This is a social and political choice—there is nothing apolitical about it—that may be at odds with promoting divergent national interests. It may therefore be necessary to open up the governance of foreign investment to other stakeholders and to local preferences and values. It is difficult to see countries around the world agreeing on substantive standards of investment and property protection when they disagree on issues such as climate change. Indeed, it may be undesirable in a plural world.

It may be necessary to open up the governance of foreign investment to other stakeholders and to local preferences and values.

An alternative is to explore an overlapping consensus on the way states, foreign investors, and local populations should govern foreign investment. This would be an acceptable consensus for those with opposing political and social views, in which institutions could promote discussions among all the stakeholders and solutions beyond the dichotomy of winners and losers. An overlapping consensus would not consolidate a universal regime for foreign and domestic investment. Its purpose would be quite different: to promote state and non-state cooperation on foreign investment matters, while reversing the neo-colonial features of the IIR.

19 The idea of an overlapping consensus was developed by John Rawls in his attempt to show that a reasonable level of pluralism and democratic governance are consistent and possible. See Rawls, J. (1987). The idea of an overlapping consensus. Oxford Journal of Legal Studies, 7(1), 1–25.
European Commission consultation shows public rejection of investor–state dispute settlement

On January 13, the European Commission published a report and an accompanying memo analyzing the results of its consultation on investment protection and investor–state dispute settlement (ISDS) in the Transatlantic Trade and Investment Partnership (TTIP) under negotiation between the European Union and the United States.

The consultation, held between March 27 and July 13, 2014, asked whether the EU approach for TTIP would achieve the right balance between investor protection and safeguards on the European Union’s and member states’ right to regulate in the public interest. It also asked about transparency, ethical requirements for arbitrators, and appellate mechanisms in ISDS.

Of the 149,399 submissions received in the Commission’s largest consultation to date, 97 per cent express opposition ISDS in TTIP, or to TTIP in general. According to EU Trade Commissioner Cecilia Malmström, “the consultation clearly shows that there is a huge scepticism against the ISDS instrument.”

However, the Commission made it clear that the consultation was not a referendum. Given that the negotiating directives (the mandate) received from the EU member states foresee the inclusion of ISDS in TTIP, the Commission will only decide on the inclusion in the final phase of negotiations. Some NGOs criticized the consultation as a “mockery of democracy.”

The report indicates that there were around 145,000 collective replies, based on pre-defined answers provided by NGOs. The Commission affirmed it did not take “all the identical ones for one,” as controversially suggested in July 2014 by then–EU Trade Commissioner Karel De Gucht, but that it considered all of them as valid. Among individual replies, there were 3144 by EU citizens and 445 by NGOs.

Among the replies, numerous indicated that ISDS was “a threat to democracy and public finance or to public policies,” or unnecessary between the European Union and the United States, “in view of the perceived strength of the respective judicial systems.” Others expressed concerns that high-stake arbitrations would have a “chilling effect” on the right to regulate. There was also “a generic mistrust with regard to the independence and impartiality of the arbitrators” and a concern that “ISDS may create a possibility for investors to circumvent domestic courts, laws or regulations.”

Based on the submissions, the Commission identified four areas to be further developed: the protection of the right to regulate; the establishment and functioning of arbitral tribunals; the relationship between domestic judicial systems and ISDS; and the review of ISDS decisions for legal correctness through an appellate mechanism.

Before making any policy recommendations, the Commission will discuss the results with the European Parliament, EU member states and civil society, starting with a presentation to the Committee on International Trade of the European Parliament on January 22.

Singapore introduces a new court to settle international commercial disputes

This January Singapore launched a new international court to address commercial disputes. The Singapore International Commercial Court is designed to settle cases involving foreign parties and laws.

The court holds jurisdiction over cases that are international and commercial, where the parties have given written consent, and where they do not seek relief in the form of a prerogative order (an order for an arm of government to do or not to do something).

The Chief Justice of Singapore and twelve international jurists have been appointed as judges to the court. In contrast to the norm in arbitration, where the disputing parties typically choose the arbitrators, the court will assign judges to the cases.

The court’s judgements will be equivalent to those of the Singapore High Court, the lower division of the Supreme Court of Singapore (with the Court of Appeal sitting in the upper division).

According to Singapore’s Ministry of Law, subsidiary legislation will set out the circumstances in which foreign-qualified lawyers may appear before the court. These will be “cases with no substantial connection to Singapore, or to address the court on matters of foreign law,” said the ministry.

First announced in December 2014, the court forms part of Singapore’s efforts to establish itself as a hub for dispute resolution. The court is the first of its kind in Asia.

Venezuela: new and concluded arbitration cases, and a new foreign investment law

In addition to the 26 cases against Venezuela listed as pending on the ICSID website, U.S. energy firm Harvest Natural Resources announced on January 16 that its Dutch affiliates initiated ICSID arbitration against Venezuela under the Venezuela–Netherlands BIT. The company alleges that the state systematically thwarted the development of the company’s investment and its ability to sell its interests.

Two ICSID arbitrations against Venezuela were concluded in the last quarter of 2014. The Awards section of this issue of ITN presents summaries of the awards in the Exxon case, concluded on October 9, 2014, and in the Flughäfen and IDC case, concluded on November 18, 2014.

Also on November 18, in parallel to these developments in investment treaty arbitration, a reformed law on foreign investment entered into force in Venezuela.

The new law highlights that foreign investment is subject to the jurisdiction of Venezuelan courts or to dispute settlement mechanisms of which Venezuela may participate within the framework of economic integration in Latin America and the Caribbean. Among other provisions, it establishes the rights and obligations of foreign investors, and reserves to the state the right to develop strategic sectors.
Although finding largely in favour of Venezuela, ICSID tribunal awards US$1.4 billion to Exxon-Mobil for 2007 expropriations


Matthew Levine

An arbitration at the International Centre for Settlement of Investment Disputes (ICSID) brought by a group of Exxon-Mobil subsidiaries against the Bolivarian Republic of Venezuela has reached the award stage.

The claimants failed to convince the tribunal that Venezuela’s 2007 expropriation of two oil projects had been unlawful. The tribunal also sided with Venezuela in its quantification of compensation owing due to the nationalizations.

Nonetheless, the claimants were awarded US$1.4 billion (significantly less, though, than the initial ask of US$16.8 billion). The award is subject to being offset by an earlier award in a related, contract-based arbitration.

Background

The five claimants are all subsidiaries of Exxon-Mobil, the international oil major. In February 2006, Exxon-Mobil restructured its Venezuelan business under the Netherlands–Venezuela bilateral investment treaty (BIT). In its 2010 Decision on Jurisdiction, the tribunal affirmed jurisdiction only over disputes arising after the 2006 reorganization.

The claimants were investors in a joint venture in the Cerro Negro heavy oil project with Venezuela’s national oil company, PDVSA. They also entered into an income-sharing agreement with Venezuela in relation to the La Ceiba medium crude project.

In 2001 Venezuela amended its Hydrocarbon Law to expropriate foreign investors in the oil and gas industry, to the exception of Cerro Negro, La Ceiba and others. In August 2006, Venezuela amended its Income Tax Law such that Cerro Negro was no longer eligible for the general corporate rate and instead had to pay the higher rate applicable to the oil industry. From late 2006 through the first part of 2007, Venezuela imposed a series of production and export curtailments on Cerro Negro.

In January and February 2007, a series of public announcements, including by then President Hugo Chávez, made it clear that Venezuela would nationalize both projects. Venezuela did not dispute in the arbitration that it had ultimately expropriated the Cerro Negro and La Ceiba projects in June 2007. The arbitration dealt with the lawfulness of the takings and on the amount of compensation owing.

Claimants fail to establish that nationalization was unlawful

The claims submitted that, as the expropriation was unlawful, they were entitled to full reparation for damages caused under international law. By contrast, Venezuela contended that the expropriation was lawful and that the claimants were entitled only to the investments’ market value as of the date of expropriation, as provided for in Article 6 of the BIT.

The tribunal considered the three prongs of the claimants’ submission on the unlawful nature of the expropriation, namely, that the measures complained of did not follow due process of law, were contrary to Venezuela’s undertakings, and were not taken against any compensation, let alone just compensation.

In terms of due process, the tribunal considered that the expropriation was a result of laws enacted by the National Assembly and of decisions taken by the President of Venezuela, which prompted four months of negotiations with affected oil companies. Although the claimants characterized these negotiations as coercive, the tribunal noted that the negotiations had been successful with other companies, such as Chevron, Total, Statoil, Sinopec and BP. The tribunal ultimately found that this process, which enabled the claimants to weigh their interests and make decisions during a reasonable time, was compatible with the due process obligation of Article 6 of the BIT.

The tribunal found that the process of negotiations launched by Venezuela, which enabled the claimants to weigh their interests and make decisions during a reasonable time, was compatible with the country’s due process obligation under the BIT.

Moving on to the issue of the undertakings, the claimants alleged that the 2001 Hydrocarbon Law specifically provided that it would not apply to additional projects, such Cerro Negro or La Ceiba. However, the tribunal observed that regulatory approvals associated with the specific projects made clear that the 2001 Hydrocarbon Law neither imposed any obligations on Venezuela nor restricted its sovereign power. The tribunal found
no indication that Venezuela later committed not to exercise its sovereign right to expropriate; accordingly, the expropriation was not carried out contrary to undertakings given in this respect to the claimants. Finally, with regards to compensation, the tribunal observed that the mere fact that the investors had not received compensation could not in itself render the expropriation unlawful. Rather, an offer of compensation may have been made to the investors and, in such a case, the legality of the expropriation depended on the terms of that offer. As the burden of proof fell on the investors, the tribunal found that the evidence submitted failed to demonstrate that the proposals made by Venezuela were incompatible with the requirement of “just” compensation of Article 6(c) of the BIT.

**Ambitious expansion plans for largest asset fail to stick with tribunal in net cash flow determination**

The tribunal noted that Article 6 of the BIT requires that “just compensation” be paid to the claimants and that such compensation must “represent the market value of the investments affected immediately before the measures were taken or the impending measures became public knowledge, whichever is the earlier.” In the present case, the tribunal found that the market value must be determined immediately after the failure of the negotiations between the parties and before the expropriation, and that it must correspond to the amount that a willing buyer would have been ready to pay to a willing seller.

With respect to Cerro Negro, the parties agreed that the above evaluation must be made in accordance with a discounted cash flow (DCF) analysis. However, they diverged in their estimates of the appropriate net cash flow and discount rate. In terms of net cash flow, the tribunal rejected the claimants’ projection of expanded production on the basis that a prospective buyer in 2007 could not have taken for granted the required regulatory approval. As a result, the claimants’ estimates of production volume were divided by a factor of three, in a major reduction in the amount of compensation. The tribunal further deducted 50 per cent towards income taxes.

**Discount rate must include all aspects of country risk including confiscation**

The next step in the DCF analysis was the application of a discount rate to the present value. The tribunal agreed with Venezuela that the claimants’ proposed 8.7 per cent discount rate was too low. Instead, it was appropriate to factor in country risks and especially the risk of confiscation in the case of an international oil project. The tribunal was not sympathetic to the claimants’ position that the confiscation risk should not be a factor, as the BIT explicitly sets out a requirement for compensation in case of confiscation.

The tribunal observed that all of the models, including confiscation risk, produced a discount rate between 18 and 24 per cent. It further observed the discount rates adopted by other arbitral tribunals in comparable circumstances, ranging from 18 to 21 per cent. These included an International Chamber of Commerce (ICC) tribunal, which had decided a contractual dispute between related parties over Cerro Negro. The ICC tribunal had applied a discount rate of 18 per cent, which the ICSID tribunal decided to adopt.

**Parallel arbitration under contract means that double recovery must be avoided**

As noted above, prior to the conclusion of the ICSID arbitration, an ICC tribunal issued an award in relation to Cerro Negro. This tribunal found for Exxon-Mobil; as a result, PDVSA pledged to indemnify the relevant Exxon-Mobil subsidiary. The ICSID tribunal was at pains to ensure that there was no double-recovery, and stated for the record the claimants’ representation that, if they were awarded compensation in the ICSID case, they would reimburse the losing party in the ICC case.

“The tribunal was at pains to ensure that there was no double-recovery: if the claimants were awarded compensation in the ICSID case, they would reimburse the losing party in the ICC case.”

**In absence of discounted cash flow analysis, tribunal calculates compensation based on investment sunk in smaller project**

The tribunal also determined compensation for expropriation of La Cieba, which had not advanced to the production stage. Here, the parties agreed that a DCF analysis was inappropriate. The tribunal declined Venezuela’s suggestion that compensation be based on an earlier negotiated settlement with Exxon-Mobil’s former partner. As a result, it based its calculation on the total sunk investment of US$179 million made by the claimants.

**Pre-expropriation fair & equitable treatment claims fall flat**

Although the claimants sustained certain narrow breaches of the BIT’s fair and equitable treatment (FET) obligation, the tribunal dismissed most of those claims. Of particular interest, it found that the BIT’s FET provision does not protect foreign investors against tax measures.
Claimants fail to recoup costs

Finally, without giving reasons, the tribunal ordered each party to bear its own costs and fees. Interestingly, the ICC tribunal had adopted the same approach.

Notes: The tribunal was composed of Gilbert Guillaume (President appointed by the Chairman of the Administrative Council, French national), Gabrielle Kaufmann-Kohler (claimants’ appointee, Swiss national), and Ahmed Sadek El-Kosheri (respondent's appointee, Egyptian national). The award of October 9, 2014 is available at: http://italaw.com/sites/default/files/case-documents/italaw4011.pdf

ICSID tribunal orders Venezuela to pay damages and finds denial of justice by the country's highest court

Flughafen Zürich A.G. and Gestión e Ingeniería IDC S.A. v. Bolivarian Republic of Venezuela (ICSID Case No. ARB/10/19)

Martin Dietrich Brauch*

In an award dated November 18, 2014, an ICSID tribunal ordered Venezuela to pay damages for the expropriation of the General Santiago Mariño international airport, Venezuela’s second largest. The claimants were Swiss-based Flughafen Zürich A.G. (Flughafen) and Chile-based Gestión e Ingeniería IDC, S.A. (IDC).

The tribunal awarded damages of more than US$32 million, including interest, if paid by Venezuela by the end of 2014. Venezuela was also ordered to pay almost US$2.4 million in costs and legal expenses.

In comparison with recent investment treaty awards, the legal grounds in this case might be considered unsurprising, and the amount of compensation, unimpressive. Yet the award contains a particularly notable element: a majority finding of a denial of justice in a decision of the Tribunal Supremo, Venezuela’s highest court.

Factual background and claims

The Venezuelan state of Nueva Esparta and a consortium formed by Flughafen and IDC began discussing the privatization of the airport in 2001. Under the Venezuelan Constitution, to enter into a public interest contract with a foreign enterprise, Nueva Esparta was required to obtain approval from the national parliament. The state requested the approval, but time passed without a definitive response. Flughafen and IDC decided to establish offices in Venezuela. In February 2004, by both a strategic alliance contract and a state decree expressly authorizing the contract, Nueva Esparta awarded to the consortium the administration, control and operation of the airport.

The investors took over the airport in March 2004, and legal battles started already in November in the same year. The newly elect governor initiated several proceedings to invalidate or revoke the concession, ordered an intervention, and ultimately took control of the airport by force. The investors, in response, regained control through court injunctions that safeguarded their contractual rights. In mid-July 2006, the state changed its strategy. It revoked its previous acts and enacted Decree 806: invoking a contract clause, it took over the airport and terminated the contract for reasons of public interest, recognizing the investors’ right to compensation.

By effectively defending internal legality, the domestic administrative courts prevented Venezuela from committing an international illicit. Accordingly, the tribunal dismissed the claim of FET violation.

The Venezuelan Supreme Tribunal first came into play in 2005, when the investors sought relief from the court. It removed all cases between the investors and the state to its own docket, as it considered that the state acts had created a situation of legal insecurity affecting the public interest. It also created an intervention board to manage the airport while the cases were pending. In 2007, the investors asked the court to invalidate Decree 806, claiming that it was unconstitutional and illegal. While in 2008 the court had indicated that it would decide the challenge, in March 2009 it issued an order remanding the cases to a lower administrative court, extinguishing the intervention board, and handing the airport over to the federal administration.

The investors sought to clarify the Supreme Tribunal’s ruling, to determine whether the handover was interim or definitive. In its clarification, the tribunal stated that, given the circumstances of the dispute, the airport could not be given back to either of the parties. It indicated that the handover to the federal administration would last until the administrative proceedings before the administrative court were concluded, but highlighted that the federal administration could adopt other measures within its authority over airports. The tribunal had recognized federal authority over all airports just a few months earlier, in separate proceedings for the interpretation of a constitutional provision. Once the parliament enacted a law based on the tribunal’s decision on federal authority over the airport, the Santiago Mariño airport was consolidated in the hands of the federal administration.

The investors initiated arbitration against Venezuela in mid-2010, based on the Switzerland–Venezuela and the Venezuela–Chile bilateral investment treaties (BITs).
They claimed that Venezuela breached the BITs by expropriating their investment, failing to meet the fair and equitable treatment (FET) standard, and subjecting the investment to arbitrary and discriminatory measures. They also advanced a claim of denial of justice, in breach of customary international law. Flughafen and IDC asked for compensation of roughly US$40 million each, plus interest and legal costs. Venezuela requested that the tribunal declared its lack of jurisdiction or, in the alternative, denied all claims.

**Jurisdictional objections**

**Corruption.** Venezuela argued that the investors had obtained the airport concession by corrupting the governor of Nueva Esparta, and therefore failed to comply with the general requirement that investments, to be protected by the BITs, must be made in accordance with the law of the host state. Citing to *Plama v. Bulgaria*, *Phoenix v. Czech Republic* and *Saur v. Argentina*, the tribunal emphasized that, even if the requirement were not expressly mentioned in the BITs, it is an implicit condition in any BIT. Examining the evidence brought before it, the tribunal considered that Venezuela did not meet its burden of proving corruption.

**Noncompliance with Venezuelan law.** According to Venezuela, the concession contract did not comply with the federal and state constitutions and relevant statutes, in breach of the requirement that concessions must be granted in accordance with the public law of the host state in order to be considered covered investments. After analyzing the applicable laws, the tribunal found that the contract was not awarded in breach of any of them. In particular, it interpreted that Venezuelan law did not require legislative authorization for Nueva Esparta to enter into the contract, given that Flughafen and IDC had established offices in Venezuela. It also agreed with the investors that, since the Venezuelan courts had never invalidated the contract, it had to be considered valid.

**Breach of contract, not of international law.** Venezuela contended that the investors were merely attempting to "relabel" the dispute: rather than a dispute about internationally wrongful acts in breach of the BITs, Venezuela stated that it was a contract law dispute, concerning an alleged breach of the strategic alliance contract. It also stated that the investors could only bring the dispute before the tribunal if the BITs contained umbrella clauses. The tribunal, however, dismissed these objections, pointing out that the investors never claimed that Venezuela had breached the contract, but that it had breached its international obligations by expropriating their investment. Whether the BITs contained umbrella clauses was, therefore, irrelevant.

Venezuela objected to the tribunal’s jurisdiction on various other grounds—arguing that the investors did not make significant economic contributions nor assume investment risks; that Flughafen (as an enterprise partly owned by the Swiss Confederation) was a public instrumentality exercising governmental functions rather than a covered private investor; and that Venezuela had not consented to the consolidation of the claims. The tribunal, however, dismissed all objections and upheld its jurisdiction.

**Expropriation**

The tribunal held that the measures taken by Nueva Esparta and the Supreme Tribunal constituted a direct expropriation—specifically, a nationalization—of Flughafen and IDC’s investment in the airport, in breach of Venezuela’s obligation under the BITs. It also held that the expropriation was unlawful, given that it was not carried out in accordance with due process of law and that the investors did not receive the compensation to which they were entitled.

The majority characterized the Supreme Tribunal’s decision as a long document with “rather precarious” reasoning, and held that it consisted in a denial of justice. Arbitrator Raúl Emilio Vinuesa dissented.

**Fair and equitable treatment**

The investors asked the tribunal to declare that the same conduct characterized as an expropriation also constituted a breach of the FET standard, but claimed no additional compensation. While they stated that the acts of the new governor of Nueva Esparta were arbitrary and discriminatory, in violation of FET, Venezuela counterargued that the administrative proceedings were corrected by the courts of law, attesting to the proper functioning of the rule of law in the country. Here, the tribunal sided with Venezuela: it held that, by effectively defending internal legality, the administrative courts prevented Venezuela from committing an international illicit. Accordingly, the tribunal dismissed the claim of FET violation.

**Denial of justice**

The tribunal characterized the Supreme Tribunal’s decision of March 2009, which remanded the proceedings back to the lower court and handed the airport to the federal administration, as a long document with “rather precarious” reasoning. It stringently criticized the handover of the airport to the federal government. In this regard, and seeing no reasonable expectation
that the pending appeals could restore the investors as administrators of the airport, the majority tribunal held that the Supreme Tribunal's decision consisted in a denial of justice.

According to the majority, the Supreme Tribunal's decision was procedurally flawed, as it was delivered in the absence of a petition by any of the parties, and without giving them—either the investors deprived of their right of managing the airport or the federal government charged with running it—an opportunity to intervene. Furthermore, the tribunal affirmed that the decision lacked grounds and reasoning, in that it failed to refer to its supporting law, and contradictorily justified the handover of the airport to the federal executive power on the same grounds that had been earlier used to justify the creation of the intervention board. Finally, for the tribunal, the real reason behind the Supreme Tribunal's decision was “the objective of consolidating the policy of centralizing in the National [Executive] Power the authority over airports” (para. 692).

Arbitrator Raúl Emilio Vinuesa concurred in the finding of expropriation, but on different grounds, dissenting from his co-arbitrators with respect to the finding of denial of justice. According to him, an expropriation did occur when the airport was consolidated definitively in the hands of the national administration. However, he found that this happened not by force of the Supreme Tribunal's decision, but by a federal decree that, enacted twenty days later, established federal authority over the airport.

Notes: The ICSID tribunal was composed of Juan Fernández-Armesto (President appointed by the Chairman of the Administrative Council, Spanish national), Henri C. Álvarez (claimants’ appointee, Canadian national) and Raúl Emilio Vinuesa (respondent’s appointee, Spanish and Argentine national). The final award of the tribunal and the partial dissent by Raúl Emilio Vinuesa are both available in their Spanish originals at http://www.italaw.com/cases/1524.

Expropriation claims dismissed: Hungary terminated concession on good-faith contractual grounds Vigotop Limited v. Hungary (ICSID Case No. ARB/11/22) Martin Dietrich Brauch*

Expropriation claims against Hungary were dismissed in a case concerning the investment of Cyprus-based claimant Vigotop Limited (Vigotop) in King’s City (KC), a project to build a large tourist resort. In its award of October 1, 2014, the ICSID tribunal noted that the investor had breached the concession contract, and that Hungary terminated it on contractual grounds without abuse of right.

Factual background

Considering Hungary as a potential location for the KC Project, Vigotop first approached the Hungarian authorities in mid-2007. The investor owned plots of land in Albertirsia and Pilis, in Central Hungary, but identified a better site for the project in government-owned lands in Sukoró, on the shores of Lake Velence in the Central Transdanubian region. In mid-2008, the investor and the government concluded a land swap agreement: the investor exchanged its plots for the Sukoró site, and paid a difference in value, considering an assessment of a specialized valuation company retained by the government. The government justified the land swap without a public tender based on the public interest related to a road project affecting the Albertirsia and Pilis lands.

Noting that the violation of FET is “neither a necessary nor sufficient basis for finding an expropriation” (para. 310), the tribunal decided not to resort to other treaty standards in analyzing whether an expropriation had occurred.

As Hungary was required by law to retain ownership of a lakeshore strip of land, a “tract formation” process was needed for 4 of the 20 Sukoró plots. However, the process was never concluded. The land registry office and the county court rejected independent registration of the 16 unaffected plots, because the swap agreement did not provide for the possibility of partial fulfilment. Therefore, the investor was never able to register the title to Sukoró.

Hungary offered financial and tax incentives to support the KC Project, conditioned on performance requirements to be established in an incentive agreement. The offer was initially valid for three months, but Hungary extended its validity twice at Vigotop’s request. Recognizing the KC Project as one of special importance for the national economy, the government also granted it special project status, to reduce the administrative formalities for its implementation.

In 2009, the government published a call for tenders for a concession contract regarding a casino in the Central Transdanubian region. In parallel, however, the parliament and the media started to question the land swap transaction. Different investigations by government agencies suggested that the Albertirsia and Pilis had
a significantly lower value than initially appraised, and that the land swap agreement was “null and void,” as the public interest justification did not exist for the totality of the area exchanged. The tender committee accepted Vigotop’s application and recommended its announcement as the winner, but noted that investigations were underway. To address the uncertainty about the ownership status of Sukoró, the concession contract between Hungary and Vigotop, concluded on October 9, 2009, listed Sukoró along with 132 alternative sites where the KC Project could be located.

Soon after the concession contract was concluded, Hungary initiated judicial proceedings that culminated in establishing—by a county court decision confirmed by both the appellate court and Hungary’s highest court—that the land swap agreement was void due to a disproportionality of value, and restoring the initial status. It also postponed the signing of the incentive agreement and revoked the special project status that had been granted to the KC Project. In early 2011, Hungary terminated the concession contract with immediate effect, requesting payment of a cancellation penalty, on the grounds that the investor had breached three contractual provisions.

**Claims in the ICSID arbitration**

Vigotop initiated arbitration in mid-2011, arguing that Hungary—particularly after the election of the Fidesz government in 2010—had taken a series of unlawful measures, by preventing Vigotop from securing land for the project, withdrawing the incentives offered, revoking the special project status and, as a culmination, terminating the concession contract. For the investor, the measures amounted to an expropriation in breach of the Cyprus–Hungary bilateral investment treaty (BIT). It asked for compensation ranging from €278.3 million to €312.6 million, depending on the methodology.

**Direct or creeping expropriation?**

Vigotop advanced claims for both direct and indirect expropriation. Here the claimant argued that even if Hungary’s termination of the concession contract was not considered a direct expropriation, the cumulative effects of Hungary’s acts would amount to an indirect and creeping expropriation. The tribunal found that Vigotop could not establish that Hungary’s pre-termination actions had an expropriatory effect, but decided to take them into account as it focused its expropriation analysis on the termination.

**Is FET relevant for a finding of expropriation?**

The Cyprus–Hungary BIT limits jurisdiction to claims of expropriation. Even so, Vigotop argued that violations of other provisions, particularly the fair and equitable treatment (FET) standard, could inform the tribunal’s analysis of whether an unlawful expropriation occurred. By contrast, Hungary submitted that the FET and the expropriation provisions were and should be treated as “separate and independent” standards. Both parties cited to earlier cases in support of their views, but the tribunal found that there were no clear and relevant precedents. Noting that the violation of FET is “neither a necessary nor sufficient basis for finding an expropriation,” it decided not to resort to other treaty standards in analyzing whether an expropriation had occurred. Still, it would consider the principle of good faith in the analysis of Hungary’s conduct.

**Did Hungary have public policy reasons to terminate the concession?**

The tribunal’s analysis began by focusing on whether Hungary terminated the contract while acting in its sovereign capacity, to further a “hidden political agenda,” as Vigotop phrased. It found that the corruption allegations regarding the land swap—even though never proven—constituted legitimate public policy reasons for the government to oppose the KC Project at Sukoró. It also found that policies to support environmental ecotourism in the Lake Velence region after the conclusion of the concession contract also constituted a public policy reason behind its termination.

**Did Hungary have contractual grounds to terminate the concession?**

The tribunal went on to analyze whether, in addition to the public policy reasons, Hungary had contractual grounds for termination. In its termination letter to Vigotop, Hungary had specified three grounds: the investor’s non-compliance with the obligation to establish headquarters in the area where the concession activity would be exercised; the investor’s failure to secure rights to the land for establishing the project; and temporal and pecuniary limitations of the guarantee offered by Ronald Lauder, one of the investors in Vigotop. According to the tribunal, the failure to secure land for the project was Hungary’s main ground for termination,
while the others were “additional, more formalistic grounds” (para. 515). After an analysis of the latter, the tribunal concluded that neither justified the immediate termination.

The tribunal analyzed the land swap agreement independently of the analysis of the Hungarian courts, but ultimately agreed with the courts’ conclusion that the land swap was not necessary for the state, the public interest requirement was not fulfilled, and the land agreement was indeed invalid. Therefore, the tribunal found that Vigotop had not secured possession and the right to build on the land for the project by the established deadline, thus giving Hungary contractual grounds for termination.

Did Hungary act in good faith or did it abuse its contractual rights?

Having found that Hungary had parallel causes (both public policy reasons and contractual grounds) for termination, the tribunal examined whether the contractual grounds were exercised in a manner consistent with the principle of good faith, or in an abuse of Hungary’s contractual right.

In its analysis, the tribunal considered that Vigotop, when signing the concession, “must have known” that the lack of a resolution for the issue of the Sukoró lands would lead to court proceedings, and that “it must have been clear” to the investors that these proceedings would concern both the disproportionality of the values and the potential invalidity of the land swap (para. 611). The tribunal also considered that Hungary did not frustrate Vigotop’s search for an alternative site (para. 615), and that the investor had “a realistic opportunity to secure an alternative site within the contractual deadline” (para. 624). In view of these circumstances, the tribunal held that Hungary did neither demonstrate a lack of good faith nor abuse its rights by terminating the contract or by refusing to extend the deadline.

Tribunal dismisses expropriation claims—but denies declaring that no expropriation occurred

Considering that Hungary terminated the concession on contractual grounds and acted in good faith, the tribunal held that the termination did not amount to an expropriation, and therefore dismissed all of Vigotop’s claims. Interestingly, the tribunal “denied” Hungary’s request to declare that it did not expropriate Vigotop’s investment “as being unnecessary in that such declaration is implicit in the Tribunal’s decision to reject Claimant’s claims in their entirety” (para. 632).

Vigotop’s claims dismissed—but each party bears its own costs

For the tribunal, it was “fair and appropriate” that the parties shared arbitration costs in equal parts, and that each party bore its own costs and legal fees. In reaching this conclusion, the tribunal considered that, although Vigotop did not prevail in its claims, it “raised reasonable issues in good faith and presented an arguable case” (para. 639).

Notes: The tribunal was composed of Klaus Sachs (President appointed by the parties, German national), Doak Bishop (claimant’s appointee, U.S. national) and Veijo Heiskanen (respondent’s appointee, Finnish national). The award is available at http://www.italaw.com/sites/default/files/case-documents/italaw4047.pdf.

* Martin Dietrich Brauch is an international lawyer and associate of the International Institute for Sustainable Development’s program on foreign investment and sustainable development, based in Brazil.
The paper surveys the types of performance requirements (PRs) in use around the world, and briefly describes the WTO’s Agreement on Trade-Related Investment Measures (TRIMs). The study focuses on the meaning and scope of PR-related clauses in bilateral investment treaties (BITs) and the interpretation of such clauses by investment tribunals. If well-formulated and applied, PRs can be effective tools to maximize the economic, environmental and social benefits of foreign investments. However, it is important for states, particularly developing countries, to retain the possibility of using them when circumstances warrant it. In this context, the growing trend of prohibiting most PRs in some investment treaties, combined with the investor–state dispute settlement mechanism, seriously impairs the ability of developing states to use these development policy tools. Notably, these restrictions and prohibitions on PRs often go beyond WTO TRIMs prohibitions—and, when available, exceptions in BITs are not always effective before tribunals. Finally, the paper provides some options to help states preserve their policy space in BITs for imposing, if needed, PRs on foreign direct investment in their territory. Available here: http://www.iisd.org/publications/best-practices-series-performance-requirements-investment-treaties

Do Investment Treaties Unduly Constrain Regulatory Space? By Lorenzo Cotula, Published by the International Institute for Environment and Development, December 2014 International investment law (IIL) is at a crossroads. A large number of investor–state arbitrations, and rapidly expanding scholarly writing, have made IIL one of the most dynamic branches of international law. However, the proliferation of treaties and arbitrations has also made IIL a contested field, with campaigners and some experts questioning substantive standards and dispute settlement mechanisms, and commentators warning of a ‘legitimacy crisis’. Controversy about the interface between investment promotion and regulatory space has been central to these developments.

This article argues that investment treaties, even of the ‘recalibrated’ type, can have far-reaching implications for regulatory space, requiring careful thinking through. This is particularly the case in low and middle-income countries, where room for tightening regulatory frameworks may be greater, constraints on public finances harder, and capacity gaps more challenging. Ultimately, choices on the boundaries between investment promotion and regulatory space are eminently political, and a key challenge ahead is increasing democratic participation in the making of these political choices. Available here: http://pubs.iied.org/X00128.html

Investment Protection in TTIP: Three Feasible Proposals By Jan Kleinheisterkamp and Lauge Poulsen, published by the Global Economic Governance Programme, Oxford University, December 2014 investor–state dispute settlement (ISDS) through international arbitration has become a major stumbling block in negotiations of the Transatlantic Trade and Investment Partnership (TTIP). In agreements with Canada (CETA) and Singapore, the European Commission has included several modifications to the ‘traditional’ investment provisions found in the bilateral investment treaties of European capital exporting countries, so as to address some of the shortcomings of the traditional ISDS system. Yet, a large number of stakeholders remain unconvinced that the changes will sufficiently safeguard policy space in Europe. Broader political support for TTIP may be difficult unless these concerns are addressed. To contribute to this debate, this brief proposes three pragmatic solutions for the investment protection chapter in TTIP, which could be politically acceptable in Europe while still offering meaningful investment protections. The European Commission and the Member States should:

- Insert and make applicable the fundamental principle framing the mandates on both sides of the Atlantic that TTIP will not include greater substantive investor rights than those enshrined in domestic laws;
- Consider limiting dispute settlement to state-to-state consultations and arbitration, as this is standard in investment treaties among countries with developed legal systems;
- If ISDS is included: condition it to a local litigation requirement; allow the parties to filter out disputes from arbitration; allow the parties to make binding interpretations; and implement an efficient appeal mechanism.


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