



Business and Industry Advisory Committee to the **OECD**

Comité Consultatif Economique et Industriel Auprès de l' **OCDE**

Paris, 6 April 2004

## **BIAC Contribution**

### **Aspects of Investment Protection: Indirect Expropriation and Fair and Equitable Treatment**

#### **1. Introduction**

In the last couple of months business had to face for the second time during a couple of years the breakdown of negotiations of a multilateral agreement on investment. After the recent failure to establish such an agreement in the WTO the international community of investors is still waiting for a signal from governments to further develop and strengthen international investment law.

**BIAC would like to ask CIME what consequences investors should draw from this recurrent failures and what other ways could be explored to strengthen the global investment environment motivating OECD investors to engage in projects in the developing world.**

At the same time we note that CIME is dealing with a range of issues related to investment clauses. We would appreciate being closer involved and consulted on these very important subjects. As a first step, all documents produced by the OECD Secretariat should be classified "For Official Use", so that we can comment on them.

#### **2. Protection against Indirect Expropriation**

##### **2.1 General Remarks**

BIAC supports initiatives to improve investment law in order to strengthen investment protection. The paper "Indirect Expropriation and the Right to Regulate in International Investment Law" (**DAFFE/IME(2003)5/REV2**) gives a useful overview on cases, but suffers from some misperceptions:

- The exercise should not seek to establish a bright line or quasi test/criteria to delineate more clearly an indirect expropriation from a bona fide regulation. Given the case specific facts and circumstances, we do not believe this would be feasible or desirable. If it were carried out there would be unintended adverse consequences for investor protection and for investors both foreign and domestic in developing countries where risks are high and regulation overly abundant.
- Cases of expropriation, be it direct or indirect, are harmful not only for the investor, but also for the economy in which the investor operates. This is the main reason why many

governments have a policy to include mechanisms to protect foreign investors from indirect expropriation.

- Such policy has to be seen in a broader context: The smaller the risks associated with foreign direct investment in a specific country, the better its investment climate. Fact is that a country with bilateral or regional investment treaties including compensation clauses for cases of indirect expropriation has a policy to improve the investment climate on a long term basis.
- The OECD paper starts with the notion that there exists a conflict between the compensation for indirect expropriation in specific cases and the “right of governments to regulate”. This notion is not appropriate because it is addressed to the wrong level of policy decision making: Any government that uses actively the international investment law by agreeing to investor protection exerts its “right to regulate” every time when it signs an international agreement. All compensation cases that might arise later are a consistent part of this policy.
- Therefore, compensation mechanisms in cases of indirect expropriation do not conflict with the “right to regulate” but are a classic instrument of international investment law to solve negative side effects from other policy areas, thus contributing to overall policy consistency. This has to be the starting point for analysing indirect expropriation and compensation mechanisms.
- We see a risk that given the political debates surrounding some of the more recent cases involving indirect expropriation, recognised investment protection standards might be watered-down without giving due regard to legitimate expectations of investors in the stability and predictability of the regulatory environment in a host state. CIME members should not give in to policy pressures which may calm the political debate in the short-term but will have detrimental effects on investors in the long-run. This is all the more true, given the fact that any guidance on the issue would have some effect also on the protection standards to be applied in non-OECD countries (Framework for Investment).
- BIAC sees merit of this CIME project if it is designed to increase investor protection in cases of indirect expropriation. In fact, any possible guidance given by CIME must include the highest investor protection standard in any OECD country as a starting point.

**BIAC supports any initiative to improve the investment climate by increasing investor protection. In a rapidly globalising world economy, investor protection is a cornerstone for sustainable long term foreign direct investment.**

## **2.2 Overview on Literature and Cases in the Paper**

- The paper gives a useful overview on important cases and literature on the subject. However, the text does not sufficiently distinguish between existing conventions and agreements on the one hand and draft norms on the other hand.
- Recent cases and existing conventions (World Bank Guidelines 1992) emphasize the effect on the owner, whereas the cited literature and in particular some draft norms also elaborate on the “right to regulate” criteria.

- The paper indicates that the owner effect has been applied in some of the most recent cases. However, the paper does not stress that the owner effect is also the main criteria for the most recent guidelines and agreements.
- It is true that the current case-by-case approach of international tribunals will not guarantee convergence of the result of compensation mechanisms. Different scopes and contents in the fast growing population of international investment agreements, the wide range of policies leading to situations of indirect expropriation and the different dispute settlement procedures are the main reason for this situation. Different notions on the “right to regulate” play a less significant role in arbitration practice.
- The paper makes a well-written overview on the most prominent cases, identifying four main criteria determining whether an indirect expropriation has occurred (paper, p. 11): Degree of interference, duration of regulation, effect on the owner and purpose and context of the government measure in addition to the effect on the owner. BIAC is convinced that the degree of interference should be assessed on a static or a dynamic basis. The static basis reflects the interference on an asset in the current situation, whereas a dynamic basis includes future prospects that can be expected if the investor would continue using the asset without the regulatory change. In many cases, the dynamic basis is more relevant.
- The effects of duration is difficult to assess. In highly competitive markets or in the bidding for large one-time contracts (e.g. public utilities), even a relatively short and temporary regulation leading to tantamount expropriation can lead to enormous losses for the investor.
- As the degree of interference and duration are both factors that, at the end, determine the effect on the investor they have to be considered as sub-criteria: E.g. even a very short and temporary governmental measure is a reason for compensation if it leads to a significant negative effect on the owner which is covered by the relevant investment agreement.

**BIAC is convinced that in addition to other the "effect on the owner" is the central criteria to determine an incident of indirect expropriation which can be found not only in international law, but also in the administration laws of OECD members.**

### **2.3 Economic implications of indirect expropriation**

Where CIME definitely could give guidance is about the economic implications of indirect expropriations on investors. BIAC stresses the following economic effects:

- **Large swings vs. stable policies**

Large swings of regulatory regimes tend to create large windfall gains and thus distort the efficiency of markets. This is true for specific markets as well as for the economy of a country. In policy terms, the requirement to compensate tantamount expropriation substantially increases incentives for governments to apply stable and prudent policies.

- **Distortion of capital growth**

Where indirect expropriation destroys capital it leads to a slower expansion of the capital stock in an economy.

- **Predictability and adjustment costs**

The predictability of regulatory changes is an important criteria to assess policy in general. This is also true in cases of indirect expropriation. The negative impacts of large regulatory changes can be softened if market participants are informed as early as possible. Unless there is a national emergency, the mitigation of adjustment costs requires that policy changes are predictable.

- **Compensation procedures**

Although the right to receive compensation exists, there are many cases where enforcement problems after lengthy legal procedures occur. Problems arise identifying expropriated assets, the measurement of impairments and losses.

#### **2.4. How to avoid Indirect Expropriation: Policy Guidance by CIME**

- As the legal complexities of the existing bilateral and regional agreements within the context of the principles of international law will not be overcome by a single CIME undertaking, CIME might explore additional ways to contribute to this field which will become more important in future years.
- Even if the compensation mechanisms would be complied with in every case of indirect expropriation, there would still remain substantial deadweight losses to the investors and the capital building process in the affected country.
- Thus, CIME would definitely make an important contribution with a guidance on how governments could avoid policy decisions that lead to indirect expropriation. In market economies there is a wide range of possibilities on how to make the best use of the “right to regulate” without destroying capital of an economy.

### **3. Fair and equitable Treatment as a Principle of Bona Fide and of Good Governance**

The draft paper “Fair and equitable Treatment Standard in International Investment Law” (DAFFE/IME(2003)4/REV2, 31.10.2003) has to be seen in a wider context: In general, the principle of fair and equitable treatment expresses bona fide between governments as regards to investors that invest in the partner country. The fair and equitable treatment clause constitutes an important cornerstone in international investment law if it contributes to the investment environment by establishing a reliable basis for foreign direct investors.

Whereas it is difficult to find a “positive” definition of the term, as shown in the OECD draft paper, a “negative” definition will be clearer. Thus

- International investment legislation and regulations,

- all governmental activities as regards to foreign investors, and
- the treatment of domestic investors

should not have effects on foreign investors that conflict with fair and equitable treatment.

In practice, fair and equitable treatment is to be seen as a minimum of international investment law with the function to protect foreign investors from unfair and discriminating treatment by governments.

**BIAC supports the notion that the principle “fair and equitable” treatment has to be seen as an important part of investor protection policy. The principle is part of good governance in a policy area that is prone to unfair and unequitable practices. Thus, it encompasses elements of transparency, predictability, rule of law, non-discrimination, prudence, proportionality and cooperation.**