Chapter 3

Using the Guide

3.1 Introduction

3.1.1 General purpose of the Guide

Section II of the Guide identifies categories of IIA obligations accompanied by a discussion of the purpose of each category, alternative approaches to formulating provisions in each category and a sample provision with a discussion of its specific features and rationale. This chapter provides a general introduction to using the Guide.

The main focus of the Guide is on provisions in bilateral investment treaties. The provisions discussed may also be used as the basis for the negotiation of other forms of international economic agreements that relate to investment. For example, many of the provisions could be used in regional investment agreements or in investment chapters in bilateral or regional free trade agreements. Investment provisions in these kinds of agreements often include the same kinds of obligations as those found in BITs, though the organisation of the investment provisions in these agreements may be different. For example, in some of these agreements, investment in services or in specific sectors, such as telecommunications and financial services, is dealt with separately from the general obligations applicable to investment.[1] Some of the provisions discussed in the Guide may be useful as a starting point for negotiations relating to investment provisions in economic partnership agreements, though the architecture of these agreements and their provisions on investment tend to be different from those in BITs.

3.1.2 Using the Guide in IIA negotiations

It is up to each state to decide what kinds of provisions it should seek when negotiating an IIA, in light of its own unique circumstances, including its domestic policy on foreign investment and its other international commitments affecting investment. There can be no guarantee that any particular sample provision in the Guide or any of the other options discussed will be optimal for a particular state. Indeed, a state may decide that certain provisions should be excluded altogether. Some states may even decide that it is better to refrain from concluding IIAs with any country on the basis that their costs outweigh their benefits, or they might conclude IIAs only with

1 C Fink and M Molinuevo (2008), 'East Asian Free Trade Agreements in Services: Key Architectural Elements,' 11 *Journal of International Economic Law* 263, at 279–286 (substantive obligations) and 300–303 (investor–state dispute settlement); A Mattoo and P Sauvé (2010), 'The Preferential Liberalization of Services Trade', NCCR Working Paper No. 2010/13, Bern, at 49–53.

selected states such as regional partners, states in a comparable economic position or states with which they have a special historical or economic relationship.

Once a state has decided to negotiate an IIA, it is unlikely that it will be successful in obtaining the agreement of its negotiating partner to include all the provisions that it desires in the final agreement. Each agreement will reflect the outcome of bargaining and the trade-offs that such bargaining entails. Consequently, each state must evaluate the cost and benefits of particular provisions, and make strategic decisions about which provisions it considers essential and which it is willing to change as a concession to the demands of the other party. To inform the choices that states must make when negotiating, the discussion that accompanies each category of provision explains the costs and benefits and the likely effects of alternative versions of the provision.

3.1.3 Using the Guide to better understand the relationship between IIA obligations and domestic law and other international obligations

Two overarching issues that states must consider in the context of IIA negotiations are: (i) the relationship between prospective IIA obligations and their other international obligations; and (ii) the relationship between prospective IIA obligations and their domestic law. These issues must be taken into account so that a state can ensure that its policies are coherent. Considering these issues will also help the state to avoid unintended consequences resulting from the interaction between various legal obligations. Some of the general challenges associated with the inter-relationships between IIA obligations and domestic law and between IIA obligations in different treaties are discussed in Sections 3.2 and 3.3, below.

3.1.4 Using the Guide to better understand existing IIA obligations

The Guide is intended not only to inform future IIA negotiations, but also to assist states in evaluating their existing commitments under IIAs already in force. States should carry out a comprehensive assessment of their existing IIAs because recent experience in investor–state arbitration has demonstrated that some kinds of provisions may carry significant and at times unforeseen risks. In the survey of IIA provisions, the Guide discusses these risks and how to address them. One aim of this discussion is to help states understand their existing obligations and how to avoid the risk of investor–state claims. In addition, a state may decide, based on its understanding of the impact of provisions in its existing agreements, to renegotiate or even withdraw from an IIA.

3.2 IIAs and domestic investment policy

3.2.1 General considerations

All treaty commitments constrain state sovereignty in some way. That is their purpose. The challenge for host states negotiating IIA commitments is to ensure that they understand the constraints and are satisfied that they contribute to the achievement of their domestic policy goals.

In the best case, the decision to enter into an IIA should be made only after the state has developed a broad policy on foreign investment, both inward and outward, having regard to its overall development strategy. In particular, states should ensure that their IIA commitments will be compatible with their current foreign investment policy. To avoid inappropriate commitments, states must review both their rules for foreign investment entry and their rules governing sectors in which foreign investment is permitted. Negotiating IIA commitments is especially challenging because IIA commitments tend to be of long duration. As a result, before accepting commitments, a state should also think through to what extent they may constrain future policy choices, perhaps in areas in which it has no developed policy at the moment. These preliminary steps should be taken prior to entering an IIA, because once a state has made IIA commitments, its freedom to make decisions on investment policies will be restricted by the obligations in the IIA.

Some states may welcome the way in which an IIA limits its sovereignty. For example, IIA commitments may be a way to secure a host state's market opening or market-based reforms, such as privatisation programmes.[2] Once IIA commitments have been entered into, it will be difficult for later governments to undo these reforms, because doing so may infringe the rights of investors under the IIA, thus giving rise to investor complaints.

The challenge of sorting out the implications of IIA commitments for domestic policy is particularly important in relation to investment treaties because they typically contain a distinctive form of enforcement mechanism: investor–state arbitration. This kind of dispute settlement mechanism permits private parties, through arbitration, to seek compensation from a state where its domestic measures breach its IIA obligations.[3]

3.2.2 Specific examples of the interaction between IIA commitments and domestic investment policy

Right of establishment

Each state negotiating an IIA must consider the commitments it proposes to undertake in the context of how open its domestic market is to foreign investment. Some countries have adopted a policy of opening most of their domestic economy to foreign investment. Others limit foreign investment in different ways. For many developing countries, controlling what foreign investments are permitted to enter is the most effective way for them to regulate foreign investment. Some capital-exporting states, however, seek an IIA commitment from another state (the host state) to allow its investors to enter the host state and carry on their businesses. An IIA provision that guarantees that foreign investors will be able to enter and operate in the host state is called a *right of establishment*. If a host state's policy is to allow foreign investors to

2 The interaction between IIAs and domestic policy is further discussed by JA VanDuzer (2008), 'Foreign Investment and Development: The Role of Domestic Policy and International Investment Agreements', in Commonwealth Secretariat (2008), *Commonwealth Finance Ministers Reference Report 2008*, Commonwealth Secretariat, London.

3 See Section 7.1 (Investor–state dispute settlement).

enter its market and carry on business, then granting a right of establishment would not require any change in government policy. However, such a provision would preclude a future return to a policy of excluding or limiting foreign investment. It is precisely this limitation on future policy change by the host state that is the mechanism by which IIA commitments encourage foreign investment. A right of establishment commitment provides certainty and predictability for foreign investors that they will be able to bring their capital into the domestic market. Granting a right of establishment may also represent a commitment by a state to remove existing restrictions on access to its market.

However, it may be inappropriate for a host state to agree to a right of establishment in several circumstances:[4]

- As a matter of domestic policy, the state does not permit foreign investment, either generally or in particular sectors. These kinds of policies would be inconsistent with a right of establishment commitment. An agreement to a right of establishment would be a commitment to liberalise the state's domestic regime.
- The state does not have a developed policy on the entry of foreign investment and lacks: (i) a robust system for making decisions about permitting particular foreign investments; or (ii) the capacity to regulate foreign investors who enter the country. If the state were to develop a policy limiting foreign investment into the country in the future, its implementation might be inconsistent with a right of establishment commitment.

No state grants unrestricted entry to foreign investors. At the very least, states will stop investments that pose national security concerns. Many states have sensitive sectors in which investment is prohibited for various policy reasons. If a state chooses to negotiate a right of establishment, the state must ensure that its commitments are consistent with its domestic regime, whatever it is, and that any commitment that it undertakes leaves it sufficient flexibility to control investment entry in accordance with its domestic policy. The various ways in which this may be done, such as through reservations and exceptions, are explored in the discussion of the sample provisions in the Guide.

The definition of 'investment'

Another issue related to the interaction of domestic policy and IIA obligations is the definition of investment in an IIA. This definition is critical to delimiting the scope of the host state's obligations under the agreement. It determines what kinds of interests held by investors of the other party state are entitled to claim the benefit of the investor protection obligations.

From a host state's point of view, another consideration is that the definition of investment should identify the kinds of investments that a state wants to attract as a matter of domestic policy. In addition, some forms of investment could be excluded

4 For a full discussion of this issue, see Section 5.2 (Right of establishment).

to ensure that host state policy-making flexibility in relation to these kinds of investments can be maintained. For instance, a state may not want to include bonds and other financial obligations that it issues within the definition of investment in order to preserve its flexibility to deal with these obligations in times of financial crisis. Sometimes policy concerns that arise in regard to the definition of investment can also be addressed in a more specific way through appropriate exceptions to the investor protection obligations in the agreement. For example, even if a state's financial obligations were included in the definition of investment, an exception might be included in the IIA to permit state actions to respond to a financial crisis.

Throughout the survey of categories of provisions in the Guide, an effort is made to identify domestic policy concerns. In particular, the Guide identifies certain provisions that may require the host state to maintain a level of openness to foreign investment or have a well-developed policy or regulatory capacity in relation to foreign investment. The Guide discusses alternative forms of provisions to address these concerns.

3.3 IIAs and other international obligations

As noted above, states may wish to use the Guide to conduct a risk assessment of their existing IIA commitments. This will allow them to determine how their commitments restrict their flexibility to make policies regarding foreign investment and other subjects that are related to investment such as financial policies, the regulation of economic sectors in which foreign investments exist and so on.

In addition, before negotiating a new IIA, states must consider how existing IIAs and their trade commitments interact with proposed new investment obligations. For example, if a state is a member of the World Trade Organization (WTO), it will have to consider the relationship between prospective IIA commitments and its obligations under the WTO's *General Agreement on Trade in Services* (*GATS*), which applies to some forms of investment. The possible interaction between IIAs and *GATS* is complex and will vary significantly from one country to the next.[5] While a full discussion of *GATS* is beyond the scope of the Guide, some of the main issues are identified in Box 3.1.[6] An overview of the *GATS* is set out in Appendix 2.

The challenge of identifying the impact of new IIA commitments on existing IIAs is significant because the inter-relationship between IIAs is complex and highly variable. In addition to the general challenge of trying to ensure that IIA commitments are consistent with domestic policy and each other, most favoured nation (MFN) clauses, which appear in some form in most IIAs and *GATS*, raise particular problems. Though they vary in scope, MFN clauses in IIAs generally oblige each party to treat investors

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5 The scholarly literature on this subject is just beginning to develop. See R Adlung and M Molinuevo (2008), 'Bilateralism in Services Trade: Is There Fire Behind the (Bit-)Smoke', 10 *Journal of International Economic Law* 1.

6 Negotiations are ongoing in the WTO with respect to, among other things, new services commitments under *GATS*. In this context it is equally important for countries to consider the impact of new *GATS* commitments on their IIA obligations.

from the other party no less favourably than investors from any other country. MFN clauses in existing agreements can have the effect of committing a state to extend the benefit of commitments undertaken in new IIAs to investors from the states that are party to its existing agreements. As a result, a country negotiating an IIA should review all their existing international trade and investment obligations so it understands to what extent MFN commitments in those agreements means that accepting new commitments in an IIA will grant new rights to investors from other countries with which they have IIAs. In addition, states may wish to consider restricting the scope of MFN provisions in new or renegotiated IIAs. By doing so, it may be possible to limit the extent to which the new or renegotiated IIA would incorporate commitments from existing or future treaties.

The MFN provision in *GATS* is discussed in Box 3.1. The challenges that MFN clauses in IIAs create and strategies to deal with them are discussed in more detail in the survey of particular kinds of provisions in the Guide.[7]

Box 3.1 Interaction between GATS and IIA commitments

Two interactions between IIAs and GATS

1. IIAs can expand the scope of *GATS* commitments: While IIAs and *GATS* may contain similarly worded commitments, an IIA protects far more forms of investment than *GATS*. Unlike *GATS*, IIA obligations are not limited to investors supplying services through a commercial presence as defined in *GATS*. Also IIA obligations may be the subject of investor–state arbitration under an IIA. *GATS* does not provide for this kind of dispute settlement.
2. *GATS* may extend IIA protections to WTO members: A host state may be required to extend certain IIA protections to service providers from WTO member states with which the host state does not have an investment agreement by virtue of the MFN provision in the *GATS*. This provision requires the state to treat service providers that are nationals of parties to the *GATS* no less favourably than those of parties to its IIAs.

The nature of these interactions between *GATS* and IIAs is described below following a general introduction to the *GATS* as it applies to investment.

How does GATS apply to investment?

Under *GATS*, each WTO member has two kinds of obligations. Some apply to its measures that relate to services trade in all sectors. Others apply only to measures that relate to services trade in sectors that the WTO member has agreed to list in a national schedule of commitments. Unlike WTO obligations relating

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7 See Section 5.4 (Most favoured nation).

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to goods trade, *GATS* obligations apply to services delivered through a '*commercial presence*', which includes certain types of investments. In general, a service supplier from one WTO member is supplying a service through a commercial presence in the territory of another WTO member if:

- The supplier has a subsidiary (usually a corporation) or an unincorporated branch of its operation within the territory of that other member for the purpose of supplying the service; and
- The subsidiary or branch is owned or controlled by natural persons that are nationals of the first member or legal persons (usually corporations) organised under the laws of the first member.

A bank incorporated in the UK that is supplying banking services through a locally incorporated subsidiary in South Africa that it controls is an example of a UK service supplier supplying services in South Africa through a commercial presence.

Commercial presence under *GATS* does not include all of the forms of investor and investment that are eligible for protection under existing IIAs. Most obviously, commercial presence for the purposes of *GATS* does not include investments that do not involve the supply of a service, such as an investment to operate a local manufacturing business. Even in relation to services businesses, such as accounting or construction services, commercial presence does not include many forms of investment protected under an IIA. For instance, it does not include investments that do not give the foreign investor control over the local business such as a minority shareholding in a business. This kind of investment is often protected in IIAs.

These differences between the kinds of investments covered by an IIA and *GATS* are the key to how an IIA can affect the scope of *GATS* obligations.

Overview of GATS *obligations*

The most important *GATS* obligation applying to all services sectors is the most favoured nation obligation. MFN requires each WTO member to treat services suppliers from any WTO member state no less favourably than it treats service suppliers from any other state. Each WTO member was permitted to file a list of specific exemptions from the MFN obligation when it joined the WTO and many did so.

Each WTO member has its own national schedule of commitments that identifies particular sectors with respect to which it has assumed additional obligations under *GATS*. For services sectors that a WTO member has listed in its national schedule of commitments, the member has an obligation to provide national treatment to foreign services suppliers from other WTO member states. This

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obligation means that the member may not treat such service suppliers any less favourably than its domestic suppliers. Also, for sectors they have listed, member states cannot impose certain kinds of barriers to market access, such as limitations on foreign ownership. These obligations apply to services suppliers operating through a commercial presence as well as through other modes of supply.

Both the national treatment and market access obligations for listed sectors can be circumscribed by limitations that the member has written into its schedule. In practice, the limitations in members' schedules typically carve out specific existing measures of the member that would otherwise be inconsistent with the national treatment or the market access obligation. Most states, other than those that have joined the WTO since it was formed in 1994, have made weak commitments in their services schedules that, at most, oblige them to maintain the degree of openness that they provided to their domestic markets when *GATS* came into force in 1995. Negotiations are ongoing, however, and it is possible that stronger liberalising commitments will be a feature of a successful conclusion of the current Doha round of negotiations.

GATS obligations and IIAs

A state's international commitments under *GATS* require careful consideration in the context of negotiating an IIA for a number of reasons. Two concerns are identified below.

Policy coherence

GATS raises a general policy coherence challenge when a WTO member is negotiating an IIA. To the extent that a state already has obligations under *GATS*, it must evaluate whether the obligations entered into under IIAs are consistent with them. If a state has already agreed to a certain obligation under *GATS*, a similar commitment in an IIA may not appear to represent a substantial additional commitment. For example, accepting an obligation to admit a foreign investor from another state in an IIA may seem to have only a marginal effect if the state has already committed through *GATS* to unlimited national treatment and market access in relation to that country's services suppliers operating through a commercial presence. Such a commitment would amount to an obligation to admit them to the domestic market.

Even if an IIA commitment seems identical to a state's prior *GATS* commitment, the IIA provision is broader in fact because it is not limited to investors supplying services through a commercial presence as defined in *GATS*. In addition, if the IIA contains investor–state dispute settlement procedures, the IIA commitment differs from the *GATS* obligation because, in most IIAs, an investor can claim compensation for its breach through investor–state arbitration.

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MFN obligation

The *GATS* MFN obligation may require that IIA commitments be extended to services suppliers from other WTO member states. A state's MFN obligation may apply in this way unless the state has included in its exemption list a sufficiently broad MFN exemption to exclude preferences under IIAs at the time it became a member of the WTO. Few countries did so. *GATS* also provides a general exception from MFN treatment for obligations undertaken in a broad-based economic integration agreement requiring the substantial liberalisation of services trade as defined in Article V of the *GATS*. Few existing IIAs will meet the requirements of *GATS* Article V, though free trade agreements with investment commitments will qualify in some cases.

The *GATS* MFN obligation will be a serious concern only to the extent that the commitments undertaken in an IIA exceed those made to other states through *GATS*. After all, only if higher obligations are assumed in an IIA will the *GATS* MFN obligation extend them to other WTO members' services suppliers. However, the commitments in IIAs are likely to exceed *GATS* and other international commitments in several ways. For example, as noted, under most IIAs an investor has a right to seek compensation for expropriation by a host state through investor–state arbitration. It is possible that the MFN clause in *GATS* would apply to require a state to give a right to initiate investor–state dispute settlement against the host state to some investors in a host state who are services suppliers from WTO member states that had not signed an IIA with the host state. Similarly, the MFN obligation in a state's IIAs may require that the commitments that the state has made under *GATS* be extended to investors from states protected under those IIAs, even if those states are not WTO members.