
recursos naturales e infraestructura

Revisiting privatization,
foreign investment, international
arbitration, and water

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NACIONES UNIDAS



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Abstract

A subject relevant to the governance of water resources and public services is the effect that international trade and investment agreements may have on national capacities to manage natural resources and to regulate public services. As a consequence of globalization, many public services are provided and water rights held by companies within foreign investment protection systems or special conflict resolution regimes, which means that external jurisdictions can intervene in local matters. These agreements, which override national laws, restrict the power of governments to act in the public interest and in that of local communities. The region has yet to assess the consequences that international investment agreements may have on the economic, social and environmental sustainability and efficiency of natural resources utilization and provision of public services. Such an assessment is necessary when formulating public policies, adopting natural resources legislation and regulatory frameworks for public services, granting water rights and wastewater discharge permits, and entering into contracts related to economic activities in which water is an input or end product. This paper is a first step in this direction. It summarizes the main issues raised by Mann (2006a), Hantke-Domas (2005) and Barraguirre (2005), and at the same time expands on some of them. This study also draws on the research done by Agua Sustentable of Bolivia, the International Institute for Sustainable Development (IISD) and the International Development Research Centre (IDRC) of Canada, the Water Law and Indigenous Rights (WALIR) project (ECLAC/The Netherlands, University of Wageningen), and the Forum for Democracy and Trade of the United States.

Introduction

The principal factors that determine the level of foreign investment in a country are the policies that have been adopted towards direct foreign investment, the overall economic situation, and the business environment (Rosales, 2007). Within the context of policies towards foreign direct investment, the most important considerations are general policies creating political and economic stability, the rules governing access and operations, and regulatory policies, especially those related to the overall functioning of markets. General commercial policies are also significant, particularly as these determine the market size. Obviously, tax policies can have a determining influence and need to be stable, equitable, and transparent. Also, there are advantages in location and of access to natural resources, the availability of a skilled labour force, advanced technology, and the possession of adequate and competitive infrastructure. The business environment is a further factor determining the extent of foreign investment both in terms of the promotion and the facilitating of investments.

Countries that adhere more to international agreements on investments, treaties on double taxation, and that are signatories to global organizations, such as the World Trade Organization (WTO), are viewed more favourably (Rosales, 2007). Investors tend to give importance to the extent of State interference in the markets, particularly if it affects competition and the general environment for operating in a given market. For these reasons, developed and developing countries have realized the crucial importance of, and the need for, international mechanisms to facilitate and protect international trade and investment, since both are important for

development. On the other hand, Bolivia has recently denounced the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (the ICSID convention) (see Box 1).¹ The Government of Brazil, when withdrawing six bilateral investment treaties from Congress on 13 December 2002, expressed the view that foreign investors were given a too broad set of rights, at the expense of national jurisdiction and society, and that the stability of the national legal framework and the strength of the national economy explained the important position of Brazil as a recipient of direct foreign investment.² Also, the empirical basis for the claim that bilateral investment treaties stimulate foreign direct investment remains weak and recent studies have come to conflicting conclusions (see Box 2) (Tobin and Rose-Ackerman, 2006).

Many developing countries have signed, sometimes without due consideration of the implications,³ numerous agreements for the protection of foreign investment over the last two decades. In many cases, investment has been addressed as part of wider international trade agreements, such as the North American Free Trade Agreement (NAFTA), the United States-Central American Free Trade Agreement (CAFTA) and Canada-Chile Free Trade Agreement, which include chapters on investment. However, the major source of international investment law is found in bilateral investment treaties and, increasingly, similar regional investment agreements. By the end of 2005, the total number of bilateral investment treaties had reached 2,495, and double taxation treaties 2,758, along with 232 other international agreements containing investment provisions (UNCTAD, 2006a). Unlike trade law, this diverse universe of agreements has no institutional home such as the WTO, and it lacks a comprehensive, consistent, standing dispute settlement process (Mann, 2006a).

Arbitrators sitting on investor-State panels have often focused on the rights of the foreign investors, as expressed in the text of the agreements, and limited their recourse to other sources of international law that may be relevant in any particular case. This approach has been based, at least in part, on reference to the stated object and purpose of the international investment agreements, which is to protect the foreign investor. It has tended to lead to an expansive interpretation of

¹ The following arguments were presented in support of Bolivia's decision to denounce the ICSID convention: (i) the ICSID was established to favour the interests of foreign investors over States; (ii) ICSID tribunals misapply investment treaty obligations and expand protections such as that of fair and equitable treatment in favour of multinational corporations; (iii) some arbitrators serving on ICSID tribunals, or their law firms, act at the same time as lawyers for other investors in similar disputes, thus raising doubts as to their capacity to interpret investment treaty provisions in an impartial manner; (iv) the confidentiality of arbitration hearings charged with resolving matters of public interest; and (v) the lack of a substantive appeals mechanism for arbitration rulings, capable of ensuring consistent outcomes from one case to the next (Cabrera, 2007a). Bolivia also intends to pursue revisions to its bilateral investment treaties (see page 9) (Vis-Dunbar, Peterson and Cabrera, 2007). These revisions would be sought in three areas: the definition of investment, performance requirements, and dispute resolution. As far as the first issue is concerned, Bolivia reportedly wants to limit the definition of an investment to those that "truly generate a value to the country". For rules on performance requirements, Bolivia wants greater scope to set requirements for the use of domestic inputs and establish rules for technology transfer. Finally, in the area of dispute resolution, Bolivia is aiming to limit investor-State arbitrations to domestic fora, rather than international venues such as the ICSID. Bolivia intends to pursue these changes one at a time, as these existing bilateral investment treaties are set to expire. Notably, most of Bolivia's bilateral investment treaties contain a so-called survival clause, which ensures that most of the protections offered in these treaties will continue to apply to investments made prior to the termination of the treaty, for 10 to 20 years after that termination date.

² Although Brazil negotiated various investment treaties during the mid-1990s, none of these have gone into effect: "Despite growing pressure from developed countries ..., for Brazil to ratify these agreements, they remain held up by concerns about their constitutional implications. Brazil ... had long resisted offering foreign investors greater rights than those accorded to domestic firms ... Brazil remains wary of permitting investment disputes to go to international investor-state arbitration" (Peterson, 2003).

³ The Attorney General of Pakistan, Makhdoom Ali Khan, speaking at a colloquium hosted by the International Centre for Settlement of Investment Disputes (ICSID), cautioned States to scrutinize closely any international investment treaties which they conclude with other governments (Peterson, 2006c). Speaking of his own country's experience, he noted that Pakistan long treated such treaties as "photo-op" agreements, which could be signed hastily, with little consideration of their concrete legal consequences: "Because someone is going visiting someplace and wants to sign an 'unimportant' document; or someone is coming over for a visit and an 'unimportant' document has to be signed. And a ... [bilateral investment treaty] until very recently was regarded as one such (unimportant) document ... These are signed without any knowledge of their implications. And when you are hit by the first investor-state arbitration you realize what these words mean" (Khan, 2006). In Pakistan's case, the first arbitration to arise under one of its investment treaties was filed by a Swiss multinational, Société Générale de Surveillance (SGS) in 2001. When this case was filed, the Pakistani Government was taken by surprise: "SGS having lost before the Swiss Supreme Court, having lost in Pakistan, how could it start a third round?" (Khan, 2006c).

Box 1

IMPLICATIONS OF BOLIVIA'S WITHDRAWAL FROM ICSID CONVENTION

Bolivia has become the first State to denounce the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (the ICSID convention). The World Bank received Bolivia's written notice of denunciation on 2 May 2007. Under the terms of the convention, Bolivia's denunciation will take effect six months after the receipt of the notice, i.e., on 3 November 2007. Since becoming an ICSID contracting State on 23 July 1995, Bolivia has been a party to one concluded ICSID arbitration proceeding (Aguas del Tunari) and to a further proceeding which is still pending (Química e Industrial del Bórax). It has also been threatened with international arbitration from time to time.

The ICSID convention has a mechanism by which certain rights and obligations survive after a State's withdrawal. Article 72 of the convention provides: "Notice ... [of denunciation] shall not affect the rights or obligations under this Convention of that State or of any of its constituent subdivisions or agencies or of any national of that State arising out of consent to the jurisdiction of the Centre given by one of them before such notice was received by the depositary". The critical question is whether there is a certain date by which rights and obligations must have arisen — from Bolivia's consent to the ICSID jurisdiction — for them to be preserved through the operation of article 72. Bolivia currently has some 24 bilateral investment treaties in place offering such consent. However, this consent varies from treaty to treaty, depending on the specific terminology employed. Three different scenarios may be plausible on the basis of the text of article 72 and other provisions of the convention.

One interpretation would require consent to be perfected (i.e., for Bolivia's consent to have been accepted by an investor) before 2 May 2007 in order for any rights and obligations under the convention to survive Bolivia's denunciation. The advantages of this view would include: (i) that it is consistent with what may reasonably be understood as the "consent of the parties" referred to in other provisions of the convention; and (ii) that it provides certainty and control to the denouncing State regarding exposure to the centre's jurisdiction. Its disadvantages would include: (i) that it provides uncertainty for investors who may have invested in reliance on Bolivia's ICSID membership and references to ICSID convention arbitration in Bolivia's treaty commitments; (ii) that it would leave certain of Bolivia's investment treaties with no investor-State dispute settlement procedures (and possibly expose Bolivia to an allegation that it has breached those or other treaties); and (iii) that it would mean that Bolivia's consent to convention arbitration in the six-month period after denunciation, while it is still a contracting State, would have no legal effect.

A second interpretation would require consent to be perfected at any time while Bolivia remains an ICSID contracting State, i.e., until 3 November 2007. The advantages of this view would include: (i) that it is consistent with the possibility that parties may have given their consent at different times; and (ii) that it is consistent with a contracting State's exercise of its rights up until the time that its denunciation takes effect. Its disadvantages would include: (i) that there may be some uncertainty as to the effect of consent if by 3 November 2007 no dispute has arisen between the parties; and (ii) that there may be some uncertainty as to the effect of any consent given by a denouncing State after (as opposed to before) receipt of its notice of denunciation by the depositary.

A third interpretation would allow consent to be perfected as long as the consent "given by" Bolivia has not been withdrawn. The advantages of this view would include: (i) that it would avoid any exposure to an allegation that Bolivia is acting in violation of its investment treaty commitments; and (ii) that it would preserve the expectations of investors on the basis of which they may have invested in Bolivia. Its disadvantages would include: (i) that it would tie in the effect of the ICSID convention, as regards the consent to the jurisdiction of the ICSID centre, for many years beyond the date of denunciation (and Bolivia's consent would be available even to investors who invested after that date); and (ii) that it would create some uncertainty if Bolivia were to declare its various treaty consents to be withdrawn despite the continuing force of the relevant treaties.

In any event, Bolivia's withdrawal may not affect future arbitrations because many of Bolivia's bilateral investment treaties provide for the use of other arbitration rules, such as the United Nations Commission on International Trade Law (UNCITRAL) Arbitration Rules.

DO BILATERAL INVESTMENT TREATIES INCREASE FOREIGN DIRECT INVESTMENT?

Elkins, Guzman and Simmons (2007) argue that the spread of bilateral investment treaties is driven by international competition among potential host countries — typically developing countries — for foreign direct investment. The results suggest that potential hosts are more likely to sign bilateral investment treaties when their competitors have done so. Elkins, Guzman and Simmons find some evidence that coercion and learning play a role, but less support for cultural explanations based on emulation. Their main finding is that diffusion in this case is associated with competitive economic pressures among developing countries to capture a share of foreign investment. They have doubts about the benefits of this competition for development.

Gallagher and Birch (2006) analyze the determinants of foreign investment in Latin America. They find that signing a bilateral investment treaty with the United States does not have an independent effect on attracting foreign direct investment from that country. The most significant determinants of foreign investment are the degree to which a nation has a large or growing economy, and whether it has achieved macroeconomic and political stability. In an interesting development, Gallagher and Birch find that there is a correlation between the number of total bilateral investment treaties signed and the amount of foreign investment that flows to Latin American countries. In other words, countries that are signing bilateral investment treaties with countries besides the United States are attracting more foreign investment. The findings of this study suggest that investment treaties with the United States may stimulate little investment, but carry costs, most notably limitations on the policy instruments governments can use to promote national development.

Tobin and Rose-Ackerman (2006) show both theoretically and empirically that bilateral investment treaties cannot be judged in isolation. Their impact on host country foreign direct investment flows must be studied within the context of the political, economic and institutional features of the host country that is signing the bilateral investment treaty and in the light of the worldwide bilateral investment treaties regime. Tobin and Rose-Ackerman find that bilateral investment treaties indeed have a positive impact on foreign direct investment flows to developing countries. Importantly, however, they show that this general positive impact is highly dependent on the political and economic environment surrounding both foreign direct investment and bilateral investment treaties. Their results demonstrate that, as the coverage of bilateral investment treaties increases, overall foreign direct investment flows to developing countries may increase, but the marginal effect of a country's own bilateral investment treaties on its foreign direct investment will fall. Additionally, a stronger political environment for investment and a better local economic environment are complements to bilateral investment treaties.

Neumayer and Spess (2005) provide quantitative evidence that a higher number of bilateral investment treaties raises the foreign direct investment that flows to a developing country. This result is very robust to changes in model specification, estimation technique, and sample size. There is also some limited evidence that bilateral investment treaties might function as substitutes for good domestic institutional quality, but this result is not robust to different specifications of institutional quality.

Hallward-Driemeier (2003) shows that, while half of the Organisation for Economic Co-operation and Development (OECD) foreign direct investment into developing countries was covered by a bilateral investment treaty, this increase is accounted for by additional country pairs entering into agreements rather than signatory hosts gaining significant additional bilateral investment treaties. The results also indicate that such treaties act more as complements than as substitutes for good institutional quality and local property rights. The relevance of these findings is heightened not only by the proliferation of such treaties, but by recent high profile legal cases that demonstrate that the rights given to foreign investors not only exceed those enjoyed by domestic investors, but expose public policy makers to potentially large scale liabilities and curtail the feasibility of different reform options. Formalizing relationships and protecting against dynamic inconsistency problems are still important, but the results should caution public policy makers to look closely at the terms of agreements.

Source: Elkins, Guzman and Simmons (2007); Gallagher and Birch (2006); Hallward-Driemeier (2003); Neumayer and Spess (2005); Tobin and Rose-Ackerman (2006).

foreign investor rights and a commensurate reduction of public policy space for host States. The approach has often led to a minimization of the sources of, and hence the scope of, the substantive law considered in any given international arbitration compared with what would likely be considered in a balancing of public and private welfare in a domestic court case (Mann, 2006a).

The criteria applied by international investment law for conflict adjudication are biased towards the protection of a particular group: foreign investors. They are not the value-oriented criteria typical of domestic law and regulation, such as justice, equity, efficiency, public interest (see Box 3), and the like. It is, therefore, not surprising that arbitrators tend to take a rigid look at contracts, since their only mandate is to protect the foreign investor. Yet, even in the fictional courts of *The Merchant of Venice*, the judges went through complex machinations to avoid rigid compliance with the infamous “pound of flesh” contract, because of the inequitable and shocking effects that rigid compliance would cause (Wells and Ahmed, 2007).

There are also elements of moral hazard, and wrong design and incentives, that may affect the system, particularly in the context of corruption. Wells and Ahmed (2007) name a number of failed foreign-owned projects where local partners were powerful political figures, their relatives or associates; in such situations, some governments have specifically instructed their lawyers not to invoke the corruption argument.

Current international trade and investment law can affect water resources and water-related public services. Concern with the way in which water has been brought into trade and investment agreements — and the way in which such agreements curtail the regulatory powers of governments — has been expressed by a number of authors. “There is not just one relation among free trade agreements and water, but multiple and crisscrossing relationships which complement each other, regarding consumptive and non-consumptive water uses” (Solón, 2005).

Countries with weak regulatory systems may find that they are faulted for trying to improve their regulatory and natural resources and environmental management frameworks by adopting measures that in the European Union, the United States and other advanced countries are considered essential for environmental sustainability, efficient public utility services provision, and social harmony. In fact, many international arbitrators have found that measures objectively affecting the “legitimate expectations” of foreign investors (having a negative impact on profit — although not necessarily eliminating it) engender liability, regardless of purpose and motivation, context of economic crisis, or extent of effective economic loss.

Such decisions may in fact be affecting the political governance, economic stability and environmental sustainability of the host countries. This system of “state-authorized private justice”, deals with issues relevant to general well-being, without the context, process, and balancing considerations that a domestic court would apply, and so “often fails to settle disputes satisfactorily” (Wells and Ahmed, 2007). The reach of the new system would be an equivalent of cases on public interest and impartial justice in the United Kingdom, French and German post First World War cases, and cases related to economic depression, monopoly and public utilities in the United States, being adjudicated by private justice, to protect investors, without a balancing act. Therefore, “global investment rules lack mechanisms to generate a socially and politically responsive body of international civil or common law” (Wells and Ahmed, 2007).

The interface between investment and regulatory needs for efficiency and control of externalities creates tensions between such regulatory needs and foreign investor rights. The same happens with the interface between the general economic situation, for example an economic and social crisis, and foreign investor rights. It can also occur when improvements in regulatory or management systems affect investment contracts entered into under poor or deficient regulation and management.

IMPLICATIONS OF INVESTOR-STATE ARBITRATIONS FOR THE PUBLIC INTEREST

The needs of investor-State arbitrations differ very significantly from those of commercial arbitrations. Most critically, the latter refer to purely private interests, while the investor-State process inevitably involves weighing the private interest versus the public interest. Five different, but frequently overlapping, public interest concerns can be identified:

- The disputes often arise in public service sectors such as drinking water supply and sanitation, oil and gas, electricity, transport, waste disposal and telecommunications. The public clearly has an interest in seeing that disputes in these critical sectors are resolved in a way that ensures that their rights to these public services are not impaired.
- Investor-State arbitrations may challenge regulatory measures intended by States to protect the public welfare, if the measure directly or indirectly affects the value of the investment. Such measures might include legislation directed to human rights, health and safety, labour laws, or environmental protection. The international arbitration may thus impact the rights and welfare of those individuals and communities where an investment is located.
- The threat of investor-State arbitration has an informal “chilling effect” on States adopting public welfare regulations in the first place. Like the sword of Damocles, investors have been known to use the spectre of arbitration proceedings to discourage governments from pursuing regulations in their citizens’ interest.
- Every investor-State arbitration, regardless of sector or regulatory measure involved, has implications for the public purse. The costs involved in defending an international arbitration are considerable, and consume funds that could otherwise be used for a public purpose.⁹ Furthermore, should a tribunal find against a State, the sums awarded may be significant. There has been an increasing number of awards over US\$ 100 million in the last couple of years.
- International investment law has now become an important part of the international law relating to globalization. The agreements that this law is based on — bilateral and regional investment agreements and free trade agreements with chapters on investment — are widely recognized as being often vague or general in their terms. This gives tribunals an enormously important role in how the law is developed. Investor-State case law is now central to the future direction of international investment law. While tribunal decisions are not binding on future tribunals, tribunals nevertheless refer to the decisions of their predecessors. This places a higher level of importance on the process of interpreting and applying the law in the investor-State context. As a result, the arbitration process may be as important to the development of international investment law as the negotiation of the investment agreements themselves.

These kinds of public interest concerns place a much higher premium on the qualities of the investor-State process than that for strictly private commercial arbitration. A process is not legitimate simply because it is legally constituted or has roots in the practices of past decades. Legitimacy in international law is achieved through good governance practices that apply the rule of law and the best practices of democratic institutions today, not those of decades ago. Ensuring the legitimacy of the rules governing investor-State relations is all the more imperative given the dependence of developing countries on foreign capital to help meet their development needs. However, the legitimacy of investor-State arbitration is imperilled by the procedures’ failure to bring the most basic democratic principles of good governance and the rule of law to bear in the investor-State process. That is, the procedures fail to ensure transparency, impartiality, accountability, and consistency.

Transparency

In private commercial disputes the interests at stake are only those of the parties themselves. Money is usually the issue. Public goods are almost never involved. The need for transparency is thus confined to the needs of the parties for the substantive and

Box 3 (Concluded)

procedural details of the proceedings. By contrast, it is today understood that transparency is an essential component of democratic governance when private versus public interests are at stake. The lack of transparency in the investor-State arbitration process precludes the democratic checks and balances which good governance and the rule of law require in any balancing of private and public welfare. It also gives foreign investors a privileged position in an international legal process to negotiate with governments out of sight on issues of significant public interest. It is not credible to argue that such preferential access corresponds to the foreign investor's special interest in the issue. By definition, public welfare regulation denotes that other stakeholders also have significant interests in it. Ensuring transparency in investor-State arbitrations is vital to the legitimacy of the international arbitration process. Finally, transparency is fundamental to the broader role of international investment law as part of the international law on globalization. It is axiomatic that this part of international law, as any other, should be based on justice and equity for all stakeholders. Yet, because of the secrecy imposed in many instances, there is no way to know if this basic goal is being met. Democratic countries have long held to the principle that for justice to be done it must be seen to be done.

Impartiality

The impartiality of a process flows from the independence of its decision-makers. Only a system fully and functionally independent of external pressures and relationships meets the requirements of legitimacy in a democratic context. Conflict of interest is not simply a matter of declarations by arbitrators, but of ensuring that independence both is met and is perceived to be met at every stage of the process. There is still a long way to go to achieve the rule of law in the governance of investor-State dispute settlement processes. Chief among the issues that are cause for concern are: (i) the conflict of interest inherent in lawyers acting as arbitrators in other cases, a frequent occurrence today; (ii) repeated designations by counsel of the same arbitrators; (iii) counsel selecting an arbitrator who, the next time around when the arbitrator is counsel, selects the previous counsel as arbitrator; and (iv) the problem of arbitrators acting on investor-State cases when they come from law firms that represent foreign investors who might some day benefit from expanded interpretations of investor-protection rules (see page 55).

Accountability

In allowing foreign investors to commence proceedings against States, international investment treaties have bestowed rights and remedies not available to domestic investors. Moreover, these rights accrue in an international process that is largely devoid of the safeguards that exist in domestic courts. Whereas proceedings in domestic courts are a matter of public record, the public can have access to the pleadings, judges are neutrally rostered and parties have the right to appeal, investor-State arbitrations lack such basic accountability mechanisms. In any legitimate process making decisions that weigh private against public interest, tribunals must be accountable for what they do.

Consistency

Inconsistent arbitral awards, i.e., when tribunals make disparate findings on claims with similar facts, make it difficult for other investors and States to predict where their own rights or obligations lie. It is a basic principle of commerce to know what one is bargaining for. The better that foreign investors and States understand their rights and obligations from the outset, the more efficient the outcome for all concerned. In particular, less time and expense would be wasted on international arbitrations that either should never have been brought or never have been defended. Even at the entry and establishment phase, foreign investors and governments should be appraised of their potential rights and liabilities should the relationship go awry. Moreover, governments considering regulations or policies that may impact on foreign investors have added need to know where they stand.

Source: Marshall and Mann (2006).

^a For example, the United Nations Conference on Trade and Development (UNCTAD) (2005) estimates that the average legal costs incurred by governments are between US\$ 1 million and US\$ 2 million. This does not include arbitrators' fees or the final award if the tribunal finds against the State.

I. Water, trade and investment

A. Trading water

Bottled water is covered by trade law and restrictions on its exports are significantly limited (Mann, 2006a). On the other hand, it is generally believed that a State cannot be compelled to export water through canals, or make other bulk transfers.⁴ However, an initial export of bulk water, unaccompanied by adequate environmental and regulatory controls, reservation of regulatory powers for the future, protection of water supplies from damages, and preservation of local uses and ecosystems, could lead to requests for non-discriminatory treatment of future water exports. The above issues do not have direct relation to transboundary water agreements (see Box 4).

B. Investment rights under trade law

Trade law affects water mainly through the liberalization of water-related services. Trade services are broadly defined in the General Agreement on Trade in Services (GATS),⁵ allowing the

⁴ For example, in a 1993 statement, the governments of Canada, Mexico and the United States declared that “The NAFTA creates no rights to the natural water resources of any Party to the Agreement. Unless water, in any form, has entered into commerce and become a good or product, it is not covered by the provisions of any trade agreement including the NAFTA. And nothing in the NAFTA would oblige any NAFTA Party to either exploit its water for commercial use, or to begin exporting water in any form. Water in its natural state in lakes, rivers, reservoirs, aquifers, water basins and the like is not a good or product, is not traded, and therefore is not and never has been subject to the terms of any trade agreement. International rights and obligations respecting water in its natural state are contained in separate treaties and agreements negotiated for that purpose”.

⁵ GATS is a treaty of the WTO. Its objective is to extend the multilateral trading system to services, in the same way the General Agreement on Tariffs and Trade (GATT) provides such a system for merchandise trade.

NAFTA TRIBUNAL LACKS JURISDICTION IN A TRANSBOUNDARY WATER DISPUTE

A group of United States-based water rights holders has brought a claim under the North American Free Trade Agreement (NAFTA) Chapter 11 asserting that Mexico diverted water from the Rio Grande River for the use of its own citizens, in a manner contrary to its obligations under the 1944 water treaty, resulting in as much as a billion dollars worth of losses to the affected Texas counties. A period of drought in Mexico gave rise to this dispute. Mexico has been unable or — according to the claimants — unwilling to allow adequate amounts of water to flow to farms on the Texas side. Claimants charge that they hold “legally-adjudicated rights” to water from that source, that water is being “wrongfully withheld and diverted from the Rio Grande by Mexico”, and that their water rights “are a valuable investment, the expropriation and diversion of which has severely damaged the ability of claimants and the farmers they represent to produce crops”. The claimants allege that Mexico has violated protections accorded to foreign investors and foreign investments under the NAFTA Chapter 11.

The Mexican Government has objected to the NAFTA tribunal's jurisdiction on several grounds. Mexico points out that the 1944 water treaty has its own dispute resolution mechanism that may be invoked only by a State party to that agreement. As such, Mexico argues that even if a breach of the 1944 water treaty could be construed as a breach of the NAFTA, it would be outside the competence of a tribunal formed under the NAFTA to decide whether such a breach had in fact occurred. However, Mexico's primary argument against the tribunal's jurisdiction is that none of the claimants has investments in Mexico and therefore cannot take advantage of the NAFTA's Chapter 11. Mexico argues that Chapter 11 “only applies to investments of investors of a Party in the territory of another Party, and to the investors of another Party insofar and they have made such investments”.

The claimants counter that Article 1101(1) (a) on the Scope and Coverage of Chapter 11 gives the Tribunal jurisdiction to hear the dispute because that provision states that the chapter applies to measures adopted by a party relating to investors of another party, without mentioning any requirement for an actual cross-border investment. Similarly, according to the claimants, Articles 1102 on national treatment and 1105 on fair and equitable treatment do not require cross-border investments. The claimants also insist that they do indeed have a cross-border investment covered by NAFTA — namely property rights in certain Rio Grande waters located in Mexico. For its part, Mexico strongly disputes this assertion; insisting that the United States-granted rights to waters drawn from the Rio Grande River do not constitute property rights or investments in Mexico.

In its June 19, 2007 ruling the tribunal essentially agreed with Mexico on both jurisdictional arguments. On the first argument, the tribunal held that while Chapter 11 was titled simply “Investment” and not “Foreign Investment”, it deals with the latter. “The ordinary meaning of the text of the relevant provisions of Chapter 11 is that they are concerned with foreign investment, not domestic investment,” held the tribunal. The tribunal further reasoned that had Chapter 11 been intended to diverge from the approach of other international investment agreements and to accord protection to investors of a Party who had made wholly domestic investments, one would find clear indications of this in the preparatory documents of the treaty — which one does not. The tribunal concluded: “In the opinion of the Tribunal, it is quite plain that NAFTA Chapter Eleven was not intended to provide substantive protections or rights of action to investors whose investments are wholly confined to their own national States, in circumstances where those investments may be affected by measures taken by another NAFTA State Party”.

The tribunal also rejected the claimants' second argument, that they owned water rights in Mexico. On this point, the tribunal held that: “One owns the water in a bottle of mineral water, as one owns a can of paint. If another person take it without permission, that is theft of one's property. But the holder of a right granted by the State of Texas to take a certain amount of water from the Rio Bravo/Rio Grande does not ‘own’, does not ‘posses property rights in’, a particular volume of water as it descends through Mexican streams and rivers towards the Rio Bravo/Rio Grande and finds its way into the right-holders irrigation pipes. While the water is in Mexico it belongs to Mexico even though Mexico may be obliged to deliver a certain amount of it into the Rio Bravo/Rio Grande for the taking by US nationals”.

Source: Cabrera (2007b); Cabrera and Peterson (2006); Peterson (2004a).

liberalization of water-related services, and limiting the scope of future regulations. Yet, the primitive state of regulation in most developing countries, the constraints to sustainable service financing in emerging economies, the regulatory gaps between developed and developing countries, the strategic behaviour and commercial requirements of water-related services, the moral hazard element created by investor's protection agreements, all lead to perverse decisions and to investments that are risky for both countries and foreign investors: "If managers really believe that the new international property rights will secure their investments, they have little reason to worry much about risks. If unfortunate events occur, the 'insured' investors will be compensated anyway. It is much like someone who decides to build in a flood zone under the assumption that government flood insurance will compensate him if his property is damaged" (Wells and Ahmed, 2007). The cases of Argentina, Bolivia and Tanzania are highly illustrative of such situations.

The risks of reckless privatizations are compounded by "list-out" agreements,⁶ where only services specifically excluded are left out of liberalization. Under present arrangements and the current status of international investment law, failure to permit the entrance of foreign investors in non-listed-out services and changes in regulatory systems significantly affecting foreign investors can lead to State liability. In the case of CAFTA, only Costa Rica listed out water services, meaning that all other Central American countries are now committed to allow for foreign investment in the water services sector if any privatization of ownership or service provision is authorized (i.e., as soon as it is not a fully public sector utility) (Mann, 2006a). The United States, however, has undertaken no such liberalization commitments, as it has excluded those areas subject to state jurisdiction from mandatory coverage, and water is a State-regulated service sector.

C. Water and investment law

Water can be subjected to international investment law in several ways. For example, a foreign investor may invest in water utilities. Drinking water supply and sanitation services may be subjected to different forms of investor participation. This has happened in a number of countries including, *inter alia*, England and Wales, the United States, Chile, Argentina, Brazil, Indonesia, The Philippines, and Tanzania. The structural and regulatory differences among these countries determined varying degrees of success (and failure) in foreign investment associated with drinking water supply and sanitation services. A foreign investor may also invest in agricultural, industrial, energy, mining, or oil activities for which water is important or where water is an input, or an essential element. The investor may also participate in an activity which pollutes or deteriorates the environment associated with water.

It is actually difficult to conceive of an economic activity that is independent of the use of water. Foreign investors will enter every sector under the same terms and conditions as domestic investors. Thereafter, future measures intended, among other goals, to balance water rights, to control water pollution, to protect environmental values, to formally acknowledge prior but non-formalized customary water rights, to protect watersheds and water sources, or to charge for environmental services, wastewater discharges or water abstraction, may be challenged under property protection provisions or fair and equitable treatment principles.

⁶ There are two approaches to liberalization of services in trade law agreements as it relates to services and to investment in services (Mann, 2004). One is a bottom up approach ("list-in"), where only sectors listed by a State are covered. The second is a top down approach ("list-out"), where all sectors are considered covered by an agreement except those specifically excluded in a schedule. The bottom up approach is used in the GATS. The top down approach is used in the NAFTA chapter on services and on investment, and replicated in several other bilateral or regional agreements.

D. Investment law and privatization

A number of Latin American and Caribbean countries privatized their water supply and sanitation services during the 1990s. Argentina, Bolivia and Chile embarked on intensive privatization programmes with greatly varying degrees of success. Many other countries have isolated examples of private participation, but these seem to be more the exception than the rule.

Chilean privatizations were successful (Valenzuela and Jouravlev, 2007), while those in Argentina (Ordoqui, 2007) and Bolivia (Bustamante, 2004) can be described as failures, ending up at international arbitration forums, specifically at the International Centre for Settlement of Investment Disputes (ICSID).⁷ There were important structural and procedural differences between the privatizations in Argentina and Bolivia, on the one hand, and the Chilean process, on the other. Chilean privatizations were the result of a national consensus. They took place several years after the Argentinean privatizations, and were part of a national long-term strategy based on sound macroeconomic policies, efficient sector management, development of local capital markets, and appropriate regulation. In contrast, the Argentinean (Santoro, 2003) and Bolivian (Bustamante, 2004) privatizations were strongly encouraged by international financial organizations. They were elements of the programmes of conditionalities requested of highly indebted countries as part of the renegotiation of external debts. Privatizations elsewhere, such as Manila, The Philippines (Landingin, 2003), and Jakarta, Indonesia (Harsono, 2003), were also endorsed by international financial organizations. The Washington Consensus provided their philosophical underpinnings (Bohoslavsky, 2007).⁸ Its *vademecum* included the privatization of state-owned companies and the deregulation of new investment, as well as the reduction of public subsidies.

Thus, some countries decided on privatization without reaching a national consensus, in contexts of economic crisis and social problems, with light regulation, rushed programmes and without national sources of financing. At the same time, they were signing agreements for the protection of international investments. The cocktail of speedy and ill-prepared privatizations, light-handed regulation, and investment protection treaties has proved risky when dealing with public interest issues and public utilities. The processes in the cases of Buenos Aires, Argentina (see page 25), Cochabamba, Bolivia (see Box 5), Jakarta (see Box 6) and Manila (see Box 7), provide a fair sample of the risks posed when privatizing inefficient and under-financed companies, under the umbrella of investment protection agreements, with light-handed regulation, and without due consideration of the macroeconomic context.

1. Light-handed regulation

The years of the privatizations were a period of unlimited trust in free markets and deep distrust of governments. As a result, the regulatory frameworks adopted by many developing

⁷ ICSID was established under the Convention on the Settlement of Investment Disputes between States and Nationals of Other States which came into force on October 14, 1966 (ICSID, 2006). ICSID is an autonomous international organization. However, it has close links with the World Bank. Provisions on ICSID arbitration are commonly found in investment contracts between governments of member countries and investors from other member countries. Advance consents by governments to submit investment disputes to ICSID arbitration can also be found in about twenty investment laws and in over 900 bilateral investment treaties. Arbitration under the auspices of ICSID is similarly one of the main mechanisms for the settlement of investment disputes under four recent multilateral trade and investment treaties (NAFTA, the Energy Charter Treaty, the Cartagena Free Trade Agreement and the Colonia Investment Protocol of Mercosur).

⁸ The “Washington Consensus” is a term initially coined by John Williamson to refer to the lowest common denominator of policy advice being addressed by the Washington-based institutions, such as the International Monetary Fund (IMF) and the World Bank, to Latin American countries as of late eighties (Williamson, 2000). Williamson (1990) summarized these policies in 10 propositions: fiscal discipline, a redirection of public expenditure priorities toward fields offering both high economic returns and the potential to improve income distribution, such as primary health care and infrastructure, tax reform (to lower marginal rates and broaden the tax base), interest rate liberalization, a competitive exchange rate, trade liberalization, liberalization of inflows of foreign direct investment, privatization, deregulation (to abolish barriers to entry and exit), and secure property rights.

Box 5

COCHABAMBA, BOLIVIA, WATER SUPPLY AND SEWERAGE PRIVATIZATION

In September 1999, the Aguas del Tunari consortium was awarded a 40-year concession contract to provide drinking water supply and sanitation services in the city of Cochabamba, Bolivia. This award was made by negotiation, as the tender process was declared void. In October of the same year, Parliament adopted (despite a lack of consensus) Law N° 2029 (drinking water and sewerage services law) to provide the legal framework for sector regulation. In addition to dealing with sectoral matters, the Law N° 2029 also included provisions on water resources management. In Bolivia, water legislation is based on the 1906 water law, whose provisions “are mainly irrelevant” (Mattos and Crespo, 2000). The Law N° 2029 gave broad powers to allocate water rights to the sectoral drinking water supply and sanitation authority. In addition, despite the advanced nature of discussions and analyses concerning the recognition of the rights of indigenous peoples and farmers in the formulation of a new legislation, Law N° 2029 included no such provisions. The contract and the law, combined with alleged irregularities in the tender process, brought about a strong reaction among the public in the form of protests against rate increases in urban areas without any prior improvement of services, foreign-currency indexation and the new legislation’s effects on traditional rights in rural communities. Social unrest broke out in February 2000 and again in April that year, when there were several days of violent clashes between police and protestors followed by the declaration of a national state of emergency.

The economic factors that played a role in the conflict include: (i) the concession was linked to the implementation of a costly, long-delayed and possibly unviable Misicuni project, which had a significant effect on rates; (ii) the concession involved taking on considerable debt from previous administrations, which also pushed up the project costs; (iii) shortcomings in the public consultation and participation process and poor media management; and (iv) lack of confidence in the financial and institutional capacity of the consortium, aggravated by suspicions of corruption.

Social discontent was such that it was only quelled when the contract signed with Aguas del Tunari was terminated and over 30 articles (almost half) of Law N° 2029 were amended to subsequently become Law N° 2066. Aguas del Tunari applied to the World Bank’s International Centre for Settlement of Investment Disputes (ICSID) for US\$ 25 million in compensation for the breaking of the contract, under the terms of the Netherlands-Bolivia bilateral investment treaty.

During hearings on jurisdiction, Bolivia had argued that Aguas del Tunari was ineligible to sue under the Netherlands-Bolivia bilateral investment treaty claiming that the consortium was “controlled” by the United States-based Bechtel, which held a 55% stake in it. The Netherlands companies used to hold Bechtel’s shares in Aguas del Tunari were mere “shell” companies, argued Bolivia, which did not exert any real “control” over consortium’s corporate destiny. Indeed, Bolivia alleged that the Dutch companies had been set up in the autumn of 1999 in a *post-facto* attempt by Bechtel to bring its investments in Bolivia under the cover of a treaty umbrella (in 1999 there was no bilateral investment treaty in force between Bolivia and the United States), at a time when there was growing public opposition to the water concession in Cochabamba. Bolivia asked the tribunal to request documents from Aguas del Tunari so as to prove the company’s assertions that it was “controlled” in actual fact by the Dutch companies.

However, in a decision handed down in 2005, the tribunal affirmed its jurisdiction. A majority of the tribunal expressed the view that control is a quality that flows from ownership, so there was no need for a test to determine if the owners exercised “actual” control. Indeed, the tribunal expressed doubts as to whether there was even a viable test which could determine when such “actual” control was being exercised by an owner. What is more, the tribunal added that the purpose of the Bolivia-Netherlands bilateral investment treaty — to stimulate investment — might be thwarted if such uncertain standards were to be required.

Finally, in January 2006, Bechtel agreed to withdraw the claim from the ICSID; in return, Bolivia has absolved the foreign investors of any potential liability.

Source: Bustamante (2002) and (2004); Crespo (2000); Vis-Dunbar and Peterson (2006); Peterson (2005a).

JAKARTA, INDONESIA, WATER SUPPLY AND SEWERAGE PRIVATIZATION

The Jakarta Water Supply Enterprise (Pam Jaya), a government corporation established in 1977, was responsible for drinking water supply and sewerage services in Jakarta until early 1998, when two multinational private companies started operating Jakarta's water supply systems under separate 25-year concession contracts. The concessions were awarded without public consultation or bidding. The privatization process began following loans from the World Bank and the Overseas Economic Cooperation Fund of Japan. Both organizations were encouraging Indonesia at the time to privatize its utilities. The World Bank also appointed consultants to advise PAM Jaya on the privatization.

The concessionaires offered to modernize and expand the Jakarta drinking water supply and sewerage system. PAM Jaya was nominally responsible for overseeing the privatized system, but it had no right to see the private companies' financial reports and there was no clear sanction for failure to meet targets specified in the contracts. Furthermore, it was not clear what authority PAM Jaya or any other government agency had to monitor the private firms. The contracts also gave the companies enormous leeway in hiring contractors; they were required to go to public bidding only on contracts worth more than US\$ 5 million. PAM Jaya also agreed to force water users to shut down private wells and buy their water from the concessionaires. At the time, about 70% of the water drunk in Jakarta came from private wells. In exchange, the private companies agreed to pay PAM Jaya's foreign debts; the payments would come out of revenues. Rate increases had to be approved by the local parliament, but the contract required PAM Jaya to pay any shortfall arising from a delay in a rate increase caused by protracted debates. Shortly after the contracts were signed, a World Bank report declared the Jakarta privatization a "likely success" and described how the country could privatize the rest of its water companies. Another report, issued a year later, stated that a World Bank loan had "facilitated" the privatization and predicted that the two companies would be "more successful" in lobbying for more money for management of the waterworks in the future.

The Asian economic crisis hit Indonesia a few weeks after the contracts were signed and in the ensuing civil unrest executives of the concessionaires left the country. In May 1997, the water operation was turned back to PAM Jaya. The companies threatened to sue the government if PAM Jaya did not honour the contract. The government was also concerned that this conflict would scare off foreign investment. Negotiations for a new contract were protracted, in part because the companies were happy to continue to operate under the generous terms of the old contract. Finally, in October 2001, a new contract was signed between PAM Jaya and the two consortia. Under the new contract, the companies agreed to give PAM Jaya joint control of the bank account; and instead of using the accounts to pay off their operating expenses, the companies first had to pay off PAM Jaya debts. They also accepted the establishment of a regulatory body that would independently recommend new water rates, monitor the Jakarta waterworks and mediate disputes between PAM Jaya and the consortia.

The companies claim that they have fulfilled a large part of their original commitments. Some critics say that the two consortia have not met many of the projections outlined in the original contracts, and that most of their financial problems are of their own making and result from excessively high operating costs, such as rents and salaries.^a They add that, in any case, there is no way to verify the companies' claims, since they still do not supply enough information to allow regulators to assess their performance. The companies blame missed connection targets on the currency devaluation resulting from the economic crisis, which raised the costs of imported equipment. Other explanations include a lack of cooperation by local employees and government's refusal to grant the extent of rate increases needed to finance improvements to the system.

Source: Harsono (2003).

^a It is illustrative to compare this situation with the regulatory practice in the United States: "Conflicts do arise over whether certain expenditures should be charged to operating expenses or paid for by owners out of earnings. Management might vote itself high salaries and pensions. Payments to affiliated companies for fuel and services might be excessive. Expenses for advertising, rate investigations, litigation and public relations should be closely scrutinized by the commissions to determine if they are extravagant or if they represent an abuse of discretion. In all cases, moreover, the commissions should require proof as to the reasonableness of a utility's charges to operating expenses" (Phillips, 1993).

Box 7

MANILA, THE PHILIPPINES, WATER SUPPLY AND SEWERAGE PRIVATIZATION

In the mid-1990s, water supply coverage in the Manila metropolitan area was one of the lowest among major Asian cities. Only two-thirds of residents were connected to the intermittent, low-pressure water system and less than 10% were connected to the sewerage system. The financial situation was also weak. Non-revenue water was at 55% due to leakages, faulty meters, illegal connections and an inefficient billing system. The Metropolitan Waterworks and Sewerage System (MWSS), the public utility serving the capital, was very heavily indebted. It was also heavily overstaffed and had a history of labour troubles.

With the population of Manila expected to double over the next 30 years, it was clearly an unsustainable state of affairs. In 1995, the government enacted the Water Crisis Act, which set the legal framework for radical reforms in the sector. One of the country's leading papers, *The Manila Standard*, wrote that consumers "had grown convinced that no other arrangement could be worse than the present situation".

The heavy debt load of the MWSS was a key reason for privatization. From 1993 to 1995, the utility's net income plunged by 62% because of rising costs and interest payments. It needed about US\$ 253 million for a major pipe replacement plan, but the funds could come only from international financial institutions. Creditors, such as the World Bank and the Asian Development Bank (ADB), encouraged the privatization of the Manila system. The MWSS debt problems added a sense of urgency to the privatization. MWSS had to be transferred prior to September 1997, when a US\$ 17 million payment was due.

The World Bank financed a mission to Buenos Aires to study that city's privatization. The team, which included top MWSS officials, labour union leaders and politicians, "met with numerous Argentine officials, all of them happy with the privatization". The French government gave a grant to hire a French company as a consultant. The International Finance Corporation (IFC) contracted with the Philippines government to draft the concession agreement and designed the bidding process for selecting two private operators for the western and eastern sections of the Manila metropolitan area. It had a vested interest in assuring the privatization process was successful. It had a clause in its contract that awarded it at least US\$ 1 million if the privatization bidding was successful.

The MWSS was allowed to increase water rates by 38% shortly before the bidding. The bidding rules favoured companies that offered the largest rate reductions. A government official promised the public no rate increases during the first 10 years of the contracts. Manila Water Company was awarded the East Zone with a 74% tariff reduction, while the West Zone went to Maynilad Water Services which proposed a tariff reduction of 43%. Dividing the city into two service areas was considered to offer the advantage of promoting competition, providing scope for performance benchmarking, and of allowing one concessionaire to take over if the other failed to meet its obligations. Under the terms of the contracts, water pressure and availability were to meet international standards within three years, universal water coverage was to be assured within ten years and more than 80% of the population was to have sewerage and sanitation services within the concession period.

Six years after they took over from the MWSS, the private water utilities have performed well below targets. Even where the companies appear to meet or exceed targets, critics claim the figures are overstated. The companies say that the data submitted at the bidding were defective. Water losses have not been reduced as originally promised. However, the IFC did not make water loss reduction a performance target and water losses are passed onto the customers, even though the ADB had made water loss reduction a condition of its loans to the former public authority.

It is claimed that the companies have not spent what they promised on upgrading infrastructure. Money had to be diverted to pay MWSS debts, which ballooned after the Asian Crisis. The concessionaires were unable to secure long-term loans from independent creditors. Some critics allege that the companies have steered capital spending, consultancy services and management fees to affiliated companies. The regulator, created under the concession agreement rather than by law, is weak. In addition, sharp increases in rates have brought charges that it favours the companies.

Source: Landingin (2003); Rosenthal (2001); Joseph (1997).

countries for the water supply and sanitation sector are generally weak, especially compared with the regulatory practices of countries with a long tradition of public utility services being provided by the private sector.⁹ There are various structural reasons that help explain this situation:

- A prejudiced view of governments as inevitably inefficient and corrupt and whose powers must be limited, whereas private participation is perceived as an end in itself to be achieved at any cost (Solanes, 2002). Furthermore, there are reasons to believe that the design of regulatory frameworks may have been influenced by ideological factors.¹⁰
- Regulatory frameworks were often designed at a time when, for various reasons, the need to ensure efficient regulation was not high on the list of governments' priorities. In Argentina, for instance, "the policy of asset divestiture was more a macroeconomic tool to stabilize the economy than part of a structural reform policy aimed at increasing economic productivity in the long term" (Gerchunoff and Cánovas, 1993).
- Third, the formulation of regulatory frameworks and the incorporation of the private sector in many countries have taken place in a context of weak or poor institutions and problematic State finances. This "has limited the bargaining power of government structures in their dealings with transnational economic groups ... Institutional weakness, sometimes aggravated by corruption, encourages a waterfall effect in which large economic groups, often supported by the government in their countries of origin, press government structures and limit the independence and impartiality of regulatory bodies" (Lentini, 2004).
- The fourth aspect worth mentioning is the belief — often related with the strict and inflexible application of ideological models — that regulators in modern systems such as price-cap regulation, benchmarking and yardstick competition, can use relatively limited and simple information on costs and demand and have no need to measure the rate base or rate of return or to allocate common costs.¹¹ There is therefore thought to be no need to develop information access methods (such as regulatory accounting and controlling transfer pricing in transactions with associated companies) that are usually applied in traditional regulation (particularly rate-of-return regulation in the United States).
- Another factor worth mentioning is the belief, mainly created by ideological visions, that competition (whether competition for the market through tendering contracts as in many Argentine provinces, direct market competition or contestable markets)¹² reduces the need

⁹ According to ECLAC (2000), "The region has received much international guidance on economic issues and for developing specially designed manuals on how to approach different problems; but little information has been forthcoming on the dynamics of regulation and the existing jurisprudence in mature systems, such as the United States, the United Kingdom and France".

¹⁰ Sappington (1993) suggested that, in order to overcome the commitment problem, it might be advisable to make it more difficult to measure the true level of profits, for example, by developing accounting systems that reduce the visibility of profits or encouraging vertical integration of regulated companies so that "creative" transfer prices may be used for reducing observable profits.

¹¹ "The main thrust of Littlechild's case for the ... [the price cap method] was its assumed advantage over the fair rate of return approach. If maintaining a clear distinction between the two systems proved to be a false hope, so also did the expectation that the price cap method would be 'easy to understand' ... there is an unresolved debate as to whether the allocatively efficient level has been attained. As regards productive efficiency, it is impossible to disentangle the effects of price control from other changes ... the institutional structure in Britain has been criticized for the weakness of its accountability and for the lack of procedural safeguards. This problem, the reliance of regulators on information provided by firms, and the history of bargaining between them all suggest that the system may not be as resistant to the influence of private interests as its proponents hoped" (Ogus, 1994).

¹² The theory of contestable markets is often strongly criticised because of its unrealistic assumptions on costless entry and exit, because it assumes an unnatural sequence of events when entry occurs, and because it ignores the entrenched dominant position of the incumbent utilities: "Implausible assumptions have been applied on an abstract plane to reach ... emphatic conclusions and wide policy lessons. The system hangs in the air, lacking a foundation or even plausibility. If the adjacent technical analysis of multiproduct conditions were less formidable and the authors less famous, these ideas and claims would seem naive and premature ... their analysis only treats a specialized, extreme set of conditions, which are probably found in no real markets which have significant ... market power ... model rests on assumptions which are contradictory ... and which reverse reality" (Shepherd, 1984). According to Ogus (1994), although as "an abstract construct, the theory has gained considerable currency ... [its] ... impact on

for regulation and therefore does away with the need to develop conventional regulation procedures. In many cases, that assumption has turned out to be excessively optimistic and lacking any empirical basis, while other attempts to implement that system have been plagued by serious difficulties.

It is curious to note that many of the theories that have been the most influential in the formulation of regulatory frameworks in the region (the supposed superiority of price cap regulation, the convenience of contract regulation, bidding on the basis of lower rates, scant concern for the need to create and strengthen a regulatory agency prior to privatization, etc.) have generated constant renegotiations and regulatory conflicts (see Table 1).

Table 1

LATIN AMERICA AND THE CARIBBEAN: CONCESSION RENEGOTIATIONS AND CHARACTERISTICS OF THE REGULATORY FRAMEWORKS
(Renegotiated concessions as a percentage of the category)

	All infrastructure sectors	Drinking water and sanitation
All concessions	29	75
Award criterion		
• Lowest rate	60	82
• Highest payment to government	11	67
• Multiple	34	0
Regulatory framework		
• In law	17	56
• In decree	28	84
• In contract	40	71
Regulatory entity		
• In place at the time of privatization	17	41
• Not in place at the time of privatization	61	88
Rate regulation		
• Price cap	38	89
• Rate-of-return	13	14
• Hybrid regime	24	40
Regulatory obligations		
• Regulating by means (investment obligations)	51	85
• Regulating by objectives (performance indicators)	24	25

Source: Estache, Guasch and Trujillo (2003).

2. Franchising and concessions¹³

Almost 90% of water supply and sanitation privatizations in Latin America and the Caribbean during the 1990s were concessions: “The popularity of concessions is easily explained by the fact that they allowed a relatively easy handling of constitutional, legal or political constraints on privatizations. With concessions, governments could, for instance, argue that they were not selling the assets of the country and hence bypass legal or constitutional constraints and reduce the criticisms of reforms by anti-privatization segments of civil society. These concession

regulatory policy in relation to natural monopolies has been much less significant, simply because the assumptions of ‘perfect contestability’ on which it is based, notably that the entrant can costlessly leave the market when it is no longer profitable to remain, are rarely encountered in practice”.

¹³ This section is based on Jouravlev (2000).

contracts ... became the main regulatory instrument” (Estache, Guasch and Trujillo, 2003). Unfortunately, there are major practical problems with this approach in the water supply and sanitation industry as well as in most other public utility sectors: “franchising is prone to a number of difficulties in some circumstances, and unfortunately the industries where regulatory problems are greatest ... are especially prone to such problems” (Kay and Vickers, 1988).

Bidding for the concession contract may fail to be competitive. There may be very few competitors due to scarcity of requisite skills or resources. There is also a danger of collusion between bidders, especially if they are few in number: “Auctions presume noncooperative behavior ... This assumption is somewhat naïve once it is realized that an auction is a *deus ex machina* aimed at extracting a maximal surplus from firms. A natural reaction of those firms is to protect themselves by collusion” (Laffont, 1994). An additional limitation is the fact that an incumbent franchisee is likely to enjoy such strategic advantages (for example, arising from the experience gained from the operation of the system or from reluctance on the part of the franchiser to accept the disruption associated with a change of operator) that could deter potential competitors.

Lack of competition in the awarding of concession contracts is a common problem in the water supply and sanitation industry, especially in the case of relatively large projects, where only a very small group of major companies is currently involved in the concession business: from one to five depending on the region in question (Silva, Tynan and Yilmaz, 1998): “In electricity, hundreds of western firms ... are scrambling to win contracts to build ... power plants; in the process they have bid down the returns these contracts are likely to generate. In water, though, there are only a handful of firms in the international market, and competition is less fierce” (The Economist, 1998). In addition, the companies belonging to this small group often operate jointly.

Short-term contracts may encourage greater competition, but are also likely to considerably reduce incentives for maintenance and investment, especially in long-lived industry-specific assets, which are very important in the drinking water supply and sanitation sector. The organization of auctions involves major costs and considerable time. Furthermore, short-term contracts reduce incentives for cost reduction, thus increasing the risk of mediocre performance, and imply that the sector would constantly be in a state of turmoil and that the problems of asset valuation and handover occur more often.

For these and other reasons, most water supply and sanitation concessions are typically long-term (25 to 30 years). However, the longer a contract lasts, the less effect the terms determined in the initial auction will have on the terms of the service provision over the full life of the contract. In the early part of the twentieth century, in the United States, in “a few cities, a degree of competition for franchises to build and operate waterworks ... did occur at the outset, but since substantial investments in fixed facilities ... were required, contracts were typically of long — or even indefinite — duration and recurrent bidding almost never took place” (Jacobson and Tarr, 1995).

Problems associated with asset valuation and handover in the event of an incumbent franchisee being displaced by a rival may distort incentives to invest and the nature of competition for the concession (Bishop and Kay, 1989). In the water supply and sanitation sector, assets generally have a longer useful life and a higher component of sunk costs than in most other industries. With a substantial portion of assets underground, it tends to be difficult and expensive to assess their value. It is important to ask, for example, whether the equipment was originally purchased on competitive terms and whether there was adequate maintenance; what method of depreciation should be used; and how appropriate were past investment decisions. This in turn has a bearing on incentives to invest in new assets and maintain existing ones: if the incumbent anticipates that investments carried out over the life of the contract will be undervalued (overvalued), incentives to invest in new assets and maintain existing ones will be correspondingly low (high). In any case, since it is difficult to evaluate the state of underground assets, as the

franchising contract nears the end, the franchisee normally has an incentive to stop any maintenance work or even strip the assets.

Underbidding or post-contract opportunism.¹⁴ Once the contract is awarded, any move to replace the successful bidder would be disruptive and expensive and, as a general rule, governments are understandably reluctant to terminate a contract. In view of this, participating firms would have an incentive to put in speculative bids and to try to renegotiate them at a later stage. Therefore, efforts to secure private sector participation would tend in the main to attract those entrepreneurs who have greater lobbying power or who are more inclined to take risks.

Problems of contract specification, monitoring and enforcement (Train, 1991). Perhaps one of the most important limitations of the franchising approach arises when it is acknowledged that in a constantly changing world, the optimal price and other contractual conditions change over the course of time. Given that costs and demand conditions change, locking the franchisee into a price or other contractual conditions that were optimal at a given point in time is likely either to force it into bankruptcy or to allow it to make windfall profits: “Under the best of circumstances, the assumptions behind the expectations in a concession contract will be quickly outdated. Economic factors change, as do political needs. In circumstances where the condition of the water system is not well known to either party and information on consumption and bill collections is absent, invariably one or both of the parties is likely to want to revisit the contract within a short time period” (Lee, 1998). Lastly, it is worth mentioning that reliance upon auctions and contract-based regulation entails serious risks, especially if the government lacks the skills and bargaining leverage to ensure that the contract fairly balances public and private interests.

These and other difficulties pose serious problems which are known to have affected the franchising of public utilities in many countries. For example, from the end of the nineteenth century through to about 1920s, public utility regulation relied on franchising in the United States: “While use of the well-drawn franchise had some merit, in the main the franchise, as actually used, proved a defective instrument for ... regulation ... little regard was paid to the interest of the public ... franchises ... tended to be poorly drafted ... And even when they were well-drawn, the company often benefited, since it was common for the utility’s lawyers to draft the franchise and then present it to the city council for approval. Changes in the prescribed rates or in the service standards were made with great difficulty ... As expected, the companies resisted downward rate changes, and the city councils, upward adjustments ... Service often became poor as the termination date on the franchise drew near. The company would try to keep its investment as small as possible to avoid loss if the contract was not renewed. The agreements also failed to provide for administrative machinery to keep check on the company to see it met the terms of its franchise ... It was often impossible ... for franchise ... provisions to be changed ... Detailed requirements were unsatisfactory under changing conditions” (Phillips, 1993).

3. The water supply and sanitation concession in the Buenos Aires Metropolitan Area¹⁵

a) The privatization context

From 1912 to the 1980s, the provision of water supply and sewerage services was undertaken by a national company, the National Sanitation Works (OSN). Central authorities enacted regulations, designed rates, and planned the expansion of service. Capital investment in service expansion had the highest priority; the national treasury funded the system and guaranteed financing. Efficiency, economic and financial considerations were disregarded, and tariff setting

¹⁴ See, generally, Guasch (2004), Guasch, Laffont and Straub (2003), and Guasch and Straub (2006).

¹⁵ This section is based on Solanes (2006).

was politically based (FIEL, 1999). However, a policy of cross-subsidies allowed expansion to the less developed and populated areas of the country (Azpiazu and Forcinito, 2004).

The system broke down as a result of recurrent fiscal crises, which severely limited budget allocations. From 1976 to 1982, Argentina maintained an artificial exchange rate. Resources for other activities were reduced, including OSN. Service expansion was halted, and maintenance and rehabilitation deteriorated. In 1982, following a debt crisis due to the financing of the artificial rate of exchange, public financing became even more limited. The responsibility for the provision of water supply and sanitation services was decentralized to the provinces. This process was sudden and in some cases traumatic, due to scanty institution-building in the provinces, and the poverty of the population (ECLAC, 1995). At first, the provinces tried to maintain the original national philosophy, but no alternatives to previous national subsidies were provided (Azpiazu and Forcinito, 2004). The original company with nationwide coverage remained in existence, but only to service the federal capital and thirteen districts of Buenos Aires province.

Water supply and sanitation services were no longer a priority either for the national government or for the provinces. Between 1970 and 1979 investment in the sector represented 0.31% of the gross domestic product (Ordoqui, 2007). It decreased to 0.15% between 1980 and 1989, and to 0.07% between 1990 and 1991. The lack of funds was compounded by inefficient operation and declining real water tariffs (Alcázar, Abdala and Shirley, 2000). Investment could not keep pace with population growth and was not even sufficient to maintain existing assets. The deterioration of the systems led to water shortages and deficient service quality. There were no independent regulators to monitor state-owned public utilities, their practices, and standards. All aspects of service provision were affected.

It was clear that OSN was unable to meet investment and maintenance needs. In addition to the problems created by the debt crisis, there were company-specific problems related to the bad management practices of an overmanned public company with strong, highly politicized labour unions, and a short-term view of the social aspects of water supply and sanitation services. However, the supply of raw water was ample throughout the year and transport costs were low (Alcázar, Abdala and Shirley, 2000). It was deemed that favourable physical conditions, the professional type of management afforded by the private sector, and undertaking the postponed investments would improve service conditions (FIEL, 1999). Therefore, a private concession was launched with a sense of urgency (Alcázar, Abdala and Shirley, 2000). The concession contract was granted to Aguas Argentinas, a consortium of private companies, both foreign and national. The urgency of the situation was to affect the outcome.

Throughout almost the whole period of the Buenos Aires privatization (until 2001) the exchange rate was kept artificially low to preserve currency stability (much as in 1976-1982, and with even more disastrous results). The State intervened heavily in the exchange market, borrowing and buying foreign currencies and selling them on the local market. Local production declined and fiscal revenues fell. By 2001, the year of the crisis, the external debt was unmanageable. Unemployment became rampant and shops were looted by hungry mobs. Such events had an important effect on the sustainability of the concession.

Although the few available empirical studies provide conflicting evidence on the effect of type of ownership (public or private) on efficiency and ability to expand service coverage in the water supply and sanitation sector,¹⁶ in the case of the Buenos Aires Metropolitan Area,

¹⁶ “Theoretical arguments that draw on property rights, public choice and principal agent models emphasise the difficulty that governments have in monitoring and providing proper incentives for utility managers. These models predict that privately owned water utilities will outperform public ones. However, these models are not without their limitations and critics ... These studies [empirical evidence from the United States, the United Kingdom and France] reveal that there is no compelling evidence to date of private utilities outperforming public utilities or that privatising water utilities leads to unambiguous improvements in performance”

privatization did in fact improve efficiency. During the first year of private management the number of employees was halved. Employment reduction, together with the increase in coverage and production, resulted in large productivity increases.

Thus, although the goals and conditions of the contract were not fully achieved, the company succeeded in improving efficiency, measured as total factor productivity (Ordoqui, 2007). Efficiency gains were, however, concentrated in the first years of private management, and increases were slower thereafter. The reasons for the slowdown are uncertain, but two main causes have been suggested: a lack of incentives and accounting practices designed to hide efficiency gains through transfer prices.

Improvements in the levels of efficiency were accompanied by significant increases in rates and profitability (Lentini, 2004). The average bill paid by residential customers increased between May 1993 and January 2002 by 88%, which is far above the retail price inflation rate of 7.3% for the same period. This increase was primarily the result of contractual renegotiations that, for the most part, were favourable to the concessionaire. In terms of accounting profitability, rate hikes have resulted in highly satisfactory figures for a company operating in a regulated market with a guaranteed average demand for services. This is evident if the company's profitability is measured in terms of sales (annual average of 13% during 1994-2001) and its net assets (21%).

b) The aftermath of the concession

The clues to understanding the problems of the Buenos Aires concession lie in its structural and regulatory roots. First, there was a defective structural assessment of the economic and financial sustainability of both the national economy and the concession. Second, regulatory framework did not properly address neither the conflicts between equity and efficiency in the relationship between society and the company, nor the complexities of capital structure (debt-equity ratio) or the needs of the poor. Regulation and control were weak, with the result that political authorities routinely by-passed the regulator.

The process of regulation and the negotiation of the contract failed in terms of a key technical tool for enhancing social equity: ensuring that the level of equity contributed by stockholders was commensurate with the magnitude of the operation. Public utilities may finance their investment through equity or through debt. If debt is too high, fixed charges are high and have to be paid by consumers; likewise, the cost of capital increases financial risks and therefore costs: "It is now generally recognized that abuses of capitalization can prevent effective regulation. In extreme cases, overcapitalization has resulted in higher rates charged by a company or in deteriorating quality and quantity of service offered" (Phillips, 1993). That is why the debt-capital ratio is closely controlled. For example, in the United Kingdom, the water supply and sanitation regulator's approach to capital structure has been to apply a standardized assumption for the capital structure in the industry; the value applied was around 1, or 50% debt and 50% equity (OXERA Consulting, 2002). Aguas Argentinas opted for a capital structure with a level of indebtedness that is high (a ratio of debt to net assets equivalent to 2.4) in relation to levels acceptable in advanced regulatory systems (Lentini, 2004). Although this structure minimized the cost of capital for the company, it resulted in a structure different to what had been offered in the original contract, and also led to a critical debt situation following the devaluation in 2002.

(Renzetti and Dupont, 2003). According to Clarke, Kosec and Wallsten (2004), "The household surveys [in Argentina, Bolivia, and Brazil], ... allow us to compile data before and after the introduction of ... [private sector participation] as well as from similar (control) regions that never privatized at all ... in general, connection rates to piped water and sewerage improved following the introduction of [private sector participation] ... We also find, however, that connection rates similarly improved in the control regions, suggesting that ... [private sector participation], *per se*, may not have been responsible for those improvements".

Transfer pricing also affects efficiency. Companies may buy their inputs from associates, eventually increasing costs and therefore tariffs. Again, social equity is affected.¹⁷ In addition, the regulatory framework did not originally provide for subsidies for the low-income groups, and the tariff system did not encourage expansion to poor areas. Equity was not properly embedded in the concession design.

Effective regulation requires an independent, autonomous, objective and impartial regulatory agency, endowed with necessary resources and appropriate legal capacities, and subject to rules of good conduct and ethics. In the case of the Buenos Aires concession, the “regulator’s inexperience was natural since the agency was created quickly as part of the general rush to privatize, and set up without a clear regulatory framework or established procedures. Prior to the concession there was no independent regulatory body for water” (Alcázar, Abdala and Shirley, 2000). In addition, it was often bypassed by political authorities in both rate regulation processes and contract renegotiations.

With the collapse of the Argentinean economy at the end of 2001, and default on the external debt in 2002, the law on “Public Emergency and Exchange Regime Reform” abolished the “dollarization” of utility tariffs and their periodic adjustment to foreign inflation and currencies. The law also provided for the renegotiation of the contracts with the privatized utilities according to a number of criteria, including: (i) the impact of tariffs on the competitiveness of the economy and the distribution of income; (ii) service quality and investment plans; (iii) the consumers’ interests and the accessibility to the services; (iv) the security of the systems; and (v) the profits of the firms. This has created a continuing conflict between the government and Aguas Argentinas. The management of Aguas Argentinas informed the government of the unilateral suspension of a number of contractual obligations, including investment plans, and insisted that the Central Bank should sell dollars to Aguas Argentinas at the parity one peso equals one dollar to guarantee the payment of debt services (Hall, 2002).

Elsewhere, in similar (previous) cases where a national economic crisis was of the magnitude of Argentina’s, it has been consistently ruled that the investment climate of the host country should be considered in tariff-setting (see page 38). Otherwise, two types of economic actors would be created: those having all manner of guarantees, whatever the fluctuations in the economy, and those, usually ordinary citizens and national investors, who do not have any. It can be argued that differential protection is not equitable.

The practice of guaranteeing exchange rates has been put in question (see Box 8). Such guarantees can wipe out the benefits of privatization by dampening incentives to select, manage and finance programmes and projects efficiently. Chile does not resort to exchange rate guarantees. As a result, companies search for financing in local capital markets to avoid the risk of currency fluctuations (Valenzuela and Jouravlev, 2007).

Although the provision of services has improved compared to the former level under government management, targets set in the concession contract have not been fulfilled (Lentini, 2004). Water supply services are available to 79% of residents within the concession area compared to the target of 88% stipulated in the original contract (a difference of 800,000 residents).¹⁸ The lag in sewerage services is around 1 million residents, as 63% receive sewerage services compared to 74% set out in the original contract. The lag in provision of sewage treatment is even more serious. According to the original contract, primary wastewater treatment should by now cover 74% of the population, but the level achieved is only 7%. Investments in infrastructure

¹⁷ In the case of Aguas Argentinas, an audit carried out by Halcrow in 1997 concluded that many works were directly contracted with related companies, and that prices could have been lower if contracts had been grouped (Ordoqui, 2007; Jouravlev, 2003).

¹⁸ Only data up to 2001 was used, given that data from subsequent years would result in distorted interpretations owing to the devaluation of the exchange rate and relative prices.

Box 8

WHO SHOULD BEAR EXCHANGE RATE RISK IN INFRASTRUCTURE PROJECTS?

Until January 2002 the Argentine peso was pegged to the dollar, and utility tariffs were effectively indexed to the foreign exchange rate, thus protecting investors with foreign currency debt from the risk of currency depreciation. Between January 2002 and January 2003, the peso lost 70 percent of its value following the removal of the peg. The government initially banned implementation of tariff indexation mechanisms for utilities, freezing tariffs at their January 2002 peso levels (with the intention of reducing inflationary pressures and protecting consumers amid a sharp economic downturn). For project sponsors and lenders to infrastructure projects, this case has provided a particularly instructive lesson in the interplay of currency risk and regulatory risk. The conclusion is that, whatever benefits fixed exchange rates may have, because they have not proven sustainable, they represent perhaps the worst choice of exchange rate regime for the successful financing of infrastructure projects. The consequences of the collapse of fixed exchange-rate regimes are likely to be severe because of the magnitude of ensuing depreciation. So, who should bear exchange rate risk in infrastructure projects?

Three parties can bear the risk of exchange rate movements: the private investors (whether foreign or local equity-holders or creditors), the host country government (ultimately, its taxpayers), and customers of the service. The principle of optimal risk allocation can be defined as follows: exchange rate risk should be allocated according to the parties' ability and incentives to influence the exchange rate, change the sensitivity of the value of the project to the exchange rate, and hedge or diversify away the risk.

The government's influence over the exchange rate is one factor that, other things equal, argues in favour of allocating project and financing-related exchange rate risk to the government. But this argument should not carry too much weight. Allocating the risk to the government is unlikely to improve the quality of its decisions affecting the exchange rate, both because the relationship between the exchange rate and the government's financial position is affected in complex ways by many factors unrelated to the project and because governments do not respond to financial incentives in the same way as firms and individuals do. It is important to add that governments typically carry a lot of foreign exchange risk (for example, foreign debt) and in a currency crisis foreign currency obligations to infrastructure projects may fall due at a time when the government is least able to manage them.

Customers are in a poor position to manage the risk because they have no influence over the sensitivity of the value of shareholders' interest in the project to the exchange rate (they have no control over whether the investors decide to use financing that creates exchange rate risk). Moreover, most customers have no good natural hedges against the risk of currency fluctuations and in most developing countries no realistic opportunities to acquire hedges or diversify away the risk. Indeed, because exchange rates tend to fall during macroeconomic crises, their ability to pay higher tariffs is likely to be lowest just when the exchange rate has fallen.

Investors choose financing and thus control the extent of financing-related exchange rate risk. And their ultimate shareholders are well placed to diversify away much of the risk they choose to take on. So, there are strong grounds to argue that investors should: (i) share with customers project exchange rate risk, according to their ability to respond in value-enhancing ways to changes in the exchange rate, but erring toward investors; and (ii) take on all financing-related exchange rate risk, even though this may mean higher tariffs for consumers as a premium for bearing that risk.

The problem with many deals is the mix of foreign capital: many projects have too much dollar-denominated debt, which drives the demand for allocating exchange rate risk to governments and consumers. While allocating the risk this way keeps the initial financing costs low, it risks a blow-up in the longer term. Reducing reliance on foreign debt may mean that the volumes of private finance will be lower and that the initial costs of finance will be higher. But the benefits may be longer-lived and more robust investments that can weather the vagaries of emerging markets.

Source: Gray and Irwin (2003); Matsukawa, Sheppard and Wright (2003).

rehabilitation and renovation have not been effective in reducing losses. This inefficiency has resulted in problems of low water pressure for almost 70% of the drinking water network.

The contract did not provide for incentives to reach the goals. Tariffs were globally estimated on the basis of long-term average costs. Thus, tariffs were supposed to generate enough demand-related income to recover, within 30 years, operation, maintenance and investment costs. This is tantamount to an incentive to delay investments since, once the company has collected the tariffs, it profits from delaying investment. In the absence of adequate supervision, control and penalties, there was a perverse incentive not to comply with the investment plan. If penalties for non-compliance are lower than its benefits, a company has no incentive to invest. Chile has a different system: rate increases are allowed only after investments are made and works are operational. This is similar to the approach adopted in the United States, where assets must be considered “used and useful” before being allowed in the rate base; used and useful means that the asset is actually being used to provide service and that it is needed to do this.

There were other disincentives: the rates paid in poorer areas were based on lower indexes than the rates paid in other areas, since the rates were based not on consumption but on property valuation; supply to such areas represents a higher investment in infrastructure, as well as relatively higher operating costs; poorer areas represent higher commercial and collection risks; the high cost of connections discouraged users, who were accustomed to using septic tanks; infrastructure charges were too high to be paid by the poorest sectors of the population; and the problems associated with a non-performing economy were not taken into account. The situation was aggravated by the lack of an active government policy with effective measures to alleviate the problems faced by low-income segments of the population in accessing services (Lentini, 2004).

The rigid design of the contract posed a barrier to implementation of reforms and regulations to solve problems: “The contract ... assumed that, given that the provision targets had been established in the tender ..., the function of the regulator merely consisted of checking that the operation was run in accordance with the contract ... with the assistance of ... auditors ... From 1995 ... many questions were asked about: the current value of ... not implemented projects; resulting savings in operational costs; lost income from bills that would have been received from new customers ...; and since operational costs, future investments, and income not received were included in the equation for determining rates, this led to the question of whether rates should remain the same, decrease or increase and by how much. This process has shown itself to be extremely confusing, laborious and lacking in transparency ... The fixed technical bid failed to avoid what it was intended to, and turned out to be the worst option owing to the changes that had to be made to the original bid on the basis of the reality of the situation” (Dupré and Lentini, 2000).

4. Summing up the experience

The years of the Buenos Aires, Cochabamba, Jakarta and Manila privatizations were a period of infinite trust in private markets and deep distrust of governments. It was assumed that market disputability, competition for the market, rate regulation according to price-cap mechanisms, light-handed regulation, and information substitutes, would make up for both the information asymmetries and the market, State, and system failures well researched in economic theory. The four concessions have many common features:

- They were encouraged by international financial organizations.
- Their information requirements were weak.
- The concessionaires often claimed that the initial information provided by governments was defective.

- Their regulatory regimes were weak.
- They were affected by transfer prices in transactions with associated companies.
- All of them were affected by improperly assessed macroeconomic situations.
- The contracts were all renegotiated.
- None of them had established a transparent and objective system to account for the connections made and works undertaken.
- None of them seems to have benefited from the accumulated regulatory experience of advanced systems, such as that in the United States.
- They were all initially pronounced to be a success by their promoters.
- The systems privatized were in critical conditions, inefficient, underfinanced, with large deficits in coverage and low service quality.
- The concessionaires were international companies.

Recent World Bank publications acknowledge the shortcomings of the privatization processes of the 1980s and 1990s: “As developing and transition economies began restructuring and privatizing their infrastructure ... Under pressure from international agencies, investment banks, and financial advisers, many of these countries have hastily adopted regulatory templates from industrial countries, especially the United Kingdom and the United States. But these models have rarely been adapted to the political and institutional features common to poorer countries, including lack of checks and balances, low credibility, widespread corruption and regulatory capture, limited technical expertise, and weak auditing, accounting, and tax systems ... As a result such efforts have had limited success — or been outright failures” (Kessides, 2004).

While it is true that the ideological underpinnings of the United Kingdom privatizations were transferred to developing countries, it is not true that the full extent of regulatory experience in the United Kingdom and the United States was also transferred. Had it been transferred, better regulatory principles would have been applied. The result is that regulation was inadequate. Moreover, “An inadequate focus on sector economics has been a serious weakness of privatization in many developing and transition economies. It has also been a weakness of technical assistance provided by their international advisers, including the World Bank” (Kessides, 2004).

At the end of the day, we have a group of developing countries saddled with defective privatizations and regulations, plus inadequate economic assessments, and recognition of inappropriate advice. Yet, while negligence or lack of expertise may be shared among governments, advisors, international financial organizations, and companies, it is the governments that are being sued to fulfil contracts that were wrongly designed, assessed, and instrumented. And if the governments lose, the people of the country sued, will, in the end, be the payers.

The process of structuring privatizations and formulating regulatory frameworks would have been more effective if the following issues had been addressed:

- Governments, international financial organizations, and service providers must carefully analyze the socioeconomic context, the quality of governance and macroeconomic policies, national priorities, and the economic, financial, social and environmental sustainability of expansion programmes before embarking on public or private development of water supply and sanitation services. Services are costly and stagnating economies may be unable to afford them.

- Governments striving to expand and improve water supply and sanitation services, including control of environmental externalities, will not be successful unless high priority is given to the sector, the resources assigned are adequate, and subsidies are provided for the poor.
- Rushed decisions should be resisted. Adequate physical, economic, and social data are crucial to good decision-making and to the sustainability of services, state-owned or privatized.
- Public utility services are not independent of the socioeconomic characteristics of their environment. Their sustainability is affected by overall socioeconomic performance and political stability. Privatization is a formal procedure that does not, in itself, ensure sustainability, since success depends on the quality of overall economic policies, appropriate institutional design, public priorities, and economic growth.
- Regulatory design should establish the basic instruments necessary for good regulation, based on relevant experience, enacted separately from the concession contract through regulatory law.¹⁹
- Regulatory frameworks should rely less on theory and more on experience, and so be prepared for proper management of critical issues.
- Countries with a tradition of private provision of utility services, such as the United States and the United Kingdom, have developed such principles. They include reasonable returns, linking rates and tariffs to growth and performance of national economies, controlling transfer prices, requiring expenses to be reasonable, controlling company debt, setting regulatory accounting, having independent regulators, connecting returns to actual investment, providing subsidies and protection to the poor, requiring companies to be efficient and to periodically transfer cost reductions to customers, providing regulators with broad information powers, penalizing improvidence and non-compliance, etc.
- Governments and international financial organizations should carefully consider the effects of providing special guarantees (rates of returns, exchange rates, etc.) on the generation of contingent liabilities for the State and on the efficiency and sustainability of service providers.
- Bidding mechanisms, contestability and other measures are no substitute for adequate regulation. There is a need to refine competition mechanisms for awarding monopolies to avoid bid offers with predatory tariffs (to win now and negotiate later) and to provide for a capital contribution from the successful bidder that represents a level of commitment commensurate with the venture undertaken.
- Initiating a privatization process with faulty data and inadequate public information is a prescription for conflict.

¹⁹ See for example, Phillips (1993) for the United States experience, Cour des Comptes (1997), for the French experience, and Ogus (1994) for the United Kingdom experience.

II. Protection of foreign investment²⁰

There are five key protections for foreign investors that are relevant to the effects of international investment agreements on water-related services and on water management, particularly in developing countries: national treatment, most favoured nation treatment, minimum international standards of fair and equitable treatment, protection from expropriation without compensation, and freedom from the imposition of performance requirements.

These protections are simultaneously rights of foreign investors and obligations of their host States, and apply to the full life of an investment, not just its initial establishment phase. Further, they apply to all actual foreign investments subject to an agreement, whether made before or after the agreement enters into force, and whether the investment is made pursuant to specific rights of establishment or to the simple application of domestic laws on establishing a foreign investment. Thus, foreign investor rights can be very broad and should be understood as applying to the full lifespan of the investment.

The breadth of the rights has also been expanded in some interpretive constructs due to the absence of express obligations on foreign investors or rights of States in relation to the investments. The implications of each type of foreign investor right for governments thus extend not just to the immediate decision on allowing an investment, but throughout its lifespan. This imposes a large burden on setting the right domestic law framework for the initial decisions on

²⁰ This section is based on Mann (2006a).

foreign investments, as well as ensuring that the host State has the economic capacity to support the potential success of the foreign investment.

A. National treatment

This requires the host government to treat the foreign investor no less favourably than it treats its own domestic investors. Thus, higher labour, environmental, health or other standards, or taxes, cannot be imposed on a foreign investor unless the government has expressly excluded any specific standard or tax from the scope of the agreement. In water-related terms, a foreign investor could not, for example, have higher rates of water charges imposed upon it, or tougher environmental standards applied to it than to other investors in similar circumstances.

B. Most-favoured-nation treatment

This requires any foreign investor to be treated no less favourably than a domestic investor or any other investor from a third country. It therefore extends the comparative net of the national treatment requirement to cover all other foreign investors as well. Both the national treatment and most-favoured-nation treatment provisions of agreements can be expressly excluded from application to certain sectors or certain laws and regulations through annexes that usually accompany international investment agreements. However, this must be expressly done, usually when the treaty is first negotiated.

C. Minimum international standards of fair and equitable treatment

Unlike the national treatment and most-favoured-nation treatment provisions, this is an absolute standard defined by international law, not on a comparative basis with the treatment of domestic or other foreign investors. However, while it is not a comparative standard, it is intended to be a contextualized standard requiring fair and equitable treatment to be determined in the light of all the facts and circumstances. This implies that the fair and equitable standard must also be seen in a relational manner, requiring treatment that is fair and equitable as between the different rights, obligations, and interests of all the stakeholders, not just the foreign investor.²¹

The precise nature of this standard is far from clear. Increasingly, it is emerging as a form of administrative law standard, invoking elements of transparency in decision-making, due process, and the right to be heard, access to administrative or judicial review of decisions, plus a certain level of fairness and equity in treatment. Patent abuses of administrative decision-making functions will fail this test, but lesser types of abuses, such as a failure to allow an appeal of a decision to be heard, may also fail it. There is some evidence that the test will be “scaled” by arbitrators to the level of development of the government in question, but there is no conclusive legal view on the matter. These tests may also be applied to decisions taken without any abuse of process. In particular, decisions that run counter to explicit or even implicit assurances given by a government official may also fail to meet the standard (see page 63). An increasingly applied test in this regard is whether the government action or decision is consistent with the “legitimate expectations of the investor”, a subjective standard that provides considerable scope for the arbitrator to determine.

²¹ A broader review of this issue is found in Mann (2006b).

In the water sector, some examples of the potential breach of this standard could include an increase in water tariffs if none is foreseen in a license or the legislation underpinning a license, increased pollution controls that affect the profitability of a business and that are not clearly provided for in legislation underpinning an investment, reductions in water allocation levels for a water-intensive investment not foreseen in the initial operating decisions, or changes in water service provision contracts that impose increased service requirements, such as universal service. Where express assurances have been given that operating conditions will be maintained for a given number of years, changes to those conditions will form a basis for a claim. The absence of an express assurance will not, however, preclude a claim on this basis, if there is no pre-existing regulatory base that foretells the right of government decision-makers to make later changes. In all cases, the presence or absence of a transparent decision-making process, founded on sound administrative practice, will be a very significant factor. Thus, following a pre-designed decision-making process will reduce chances for investor challenges of the result, while ignoring pre-designed procedures, or not having any transparent procedures in place, will increase them.

1. The standard of fair and equitable treatment and national law

This standard is not free from discussion. Sometimes it is argued that the standard has been designed as a residual rule when all other norms of international liability do not apply. Therefore the standard would be *ad hoc* justice, or justice based on equity (Dolzer, 2005; Barraguirre, 2005).

The sources of the standard, on the other hand, have been questioned. The minimum standard of treatment has always had a highly indeterminate content. The standard — and its minimum and equitable treatment component — is the focus of significant controversy, due to its emergence as the most frequently invoked standard of protection in investor-State arbitral disputes (Porterfield, 2006). It is argued that the standard is not a legitimate norm of international law, as it lacks a clearly defined content. This defect cannot be cured by conferring the authority to define the contents of the standard to *ad hoc* arbitral tribunals or to appellate bodies.

Many experts in the United States argue that non-delegation principles would be violated if international decision-makers were able to create a continuously evolving international common law of foreign investor rights discretionally (Porterfield, 2006). This lacks the legitimacy of State consent. Furthermore it is not rooted in customary practice, but in decisions of international investment tribunals that are creating their own law, whereas the binding sources of international law are treaties and custom, not the jurisprudence of tribunals. In addition, it lacks the specificity required regarding binding customary international law.²² It also collides with domestic interpretations of substantive due process, since it affords a more aggressive review of economic legislation (requirement of a stable business environment) than present domestic legislation (which allows changes, as circumstances change, within certain limits).

2. Investor conduct

Parts of the doctrine worry that the role the conduct of foreign investors may play in the evolution and application of the standard has not been examined in much detail. Such examination is necessary in view of the fact that the standard is beginning to cover a wider range of government

²² In the United States, the federal courts have recognized the need for international rules to have a well-defined content by declining to give domestic legal effect to vague international legal standards (Porterfield, 2006). In *Sosa v. Alvarez-Machain*, the Supreme Court rejected a claim brought against the United States based on an alleged violation of customary international law, on the grounds that the purported customary standard lacked sufficient “specificity” to be enforceable in the United States courts: “Whatever may be said for his broad principle, it expresses an aspiration exceeding any binding customary rule with the specificity this Court requires ... we think courts should require any claim based on the present-day law of nations to rest on a norm of international character accepted by the civilized world and defined with a specificity comparable to the features of the 18th-century paradigms we have recognized. This requirement is fatal to Alvarez’s claim” (United States Supreme Court, 2004).

administrative and judicial actions (Muchlinski, 2006). Examination of foreign investor behaviour is also necessary in the light of the findings of new research on their conduct.²³ In addition, new international rules securing foreign investor rights give them little reason to worry much about risk, fostering moral hazard: “Excessive awards not only impose direct costs on host countries, but they also can lead to perverse behavior by investors, discouraging renegotiations that might lead to assets being put to productive use. If such awards become common, they will encourage corporations to seek out risky investments and even to encourage governments to breach contracts. In sum, they pose moral hazards similar to those that often accompany other kinds of insurance coverage” (Wells and Ahmed, 2007).²⁴

There are also cases of aggressive, opportunistic, or strategic biddings. Bidders make low bids to win public utility contracts, with a view to renegotiate them later without competition and taking advantage of both their incumbent position and the pressures faced by governments pressed to provide public utilities services (see page 25). Moreover, the protection afforded by international investment treaties, and the possibility to collect not just compensatory damages for investments actually made, but also expected profits from investment not yet incurred, further aggravates the moral hazard problem (see Box 9). These factors may also discourage foreign investors from renegotiation and compromise, and induce them to resort to litigation.²⁵ Although international arbitration tribunals have entered into traditional domestic law areas, they seem to prefer to ignore relevant precedent and create new *ad hoc* law, rather than resort to principles of national comparative law, to cope with the specific problems of public utilities.

There seem to be grounds for concern about the issue of foreign investor behaviour. Yet, the current status of investor discipline does not emphasize the behaviour and duties of foreign investors, stressing only the duties of States, as if assuming ethical and rational behaviour on the side of investors. For this reason, part of the ongoing debate is how to create and to organize a coherent set of duties for foreign investors. Although there is no actual coherent set of investor disciplines, there are a number of cases that have relied on the behaviour of foreign investors to either reject their claims or limit the responsibilities of countries. Most of them have dealt with regulatory takings, but foreign investor conduct should be relevant to all the different claims they make (Muchlinski, 2006). It is therefore suggested that foreign investors should obey the following three major commandments: refrain from unconscionable conduct (i.e., unfair or unreasonable conduct in business transactions that goes against good conscience), engage in investment in the light of adequate knowledge of its risks, and conduct business in a reasonable manner.

²³ Enron, for example, reportedly paid managers 10% of the net current value of the Dabohl (India) power renegotiations (Wells and Ahmed, 2007). The bonus was to be kept, even if the agreement later collapsed. With this type of incentive there is little reason for managers to pay much attention to risk.

²⁴ “The returns expected of power plants in the Third World must have seemed quite extraordinary to American utilities in the 1990s ... Investment money was cheap and plentiful, and managers were desperate for growth. Word of golden opportunities in the developing countries surely tempted otherwise cautious managers ... Moreover, as competitors rushed in to grab the riches, any managers who hesitated faced another kind of risk: to their careers. If the newly popular investments turned out to be the bonanzas that they were made out to be and a manager had failed to join competitors, the hesitant manager might in the end look very bad indeed. On the other hand, if the projects failed after a manager had invested in them, he or she could always point out that no one could have known better because all the smart competitors had done the same thing ... There is no doubt that this kind of bandwagon effect caused banks and investment funds to take on huge risks abroad. Almost certainly a similar phenomenon drove foreign investors in infrastructure” (Wells and Ahmed, 2007).

²⁵ “Indonesians ... claimed that KBC could not have raised the funds to go ahead with the project once the currency crisis had struck, and therefore they should not be awarded profits from a project that they could not have finished. KBC countered that FP&L would have supplied the funds itself ... A skeptic might wonder whether FP&L would, in the end, have put up large sums of money at a time when it appeared to be losing its enthusiasm for developing-country markets. Indonesians also ... argued that some of the expenditures were ‘wasteful’ and that payments made to the Indonesian partner were ‘undocumented and unwarranted’ and thus questionable. The tribunal concluded that even if some expenditures were wasteful, they were spent by the firm to accomplish its task and that payments to the local partner were not ‘questionable’ because they were ‘openly declared’. In short, payments that are public cannot be corrupt” (Wells and Ahmed, 2007).

Box 9

CALCULATING DAMAGE AWARDS

Lawyers disagree on how to calculate awards to an investor when a contract is breached or a project is expropriated.

In both the Karaha Bodas Company (KBC) and CalEnergy cases arbitral panels drew on a principle of Roman law and modern civil codes, *damnum emergens* and *lucrum cessans*, investment and profits. This may be appropriate for some trade cases, as it was originally applied, but its use for investment cases is debatable. If Indonesia entered a contract to buy a customized airplane from Boeing, for example, and then suddenly cancelled it, Boeing might be granted the “investment” made thus far to build the plane (more accurately, costs incurred) and anticipated profits. The profits would have been earned over a short period, could be forecast with some degree of confidence, and might have been genuinely foregone. But even in this case, Boeing would be expected to mitigate damages by seeking another customer for the airplane; its award would be reduced by its likely recovery.

To understand why the same principle should not be applied to long-term investments such as the power arrangements, consider a parallel example: an individual saver whose bank account is covered by deposit insurance. Say the saver’s bank fails, and deposit insurance pays both the amount of the deposit and foregone interest for 30 years into the future. The award leaves the saver better off if the bank fails than if it does not, because the saver can now “invest” the principal and the compensation for foregone interest in another bank and earn interest again. Of course, for good reason the United States Federal Depository Insurance Corporation does not pay future interest when a bank fails: “Why, therefore, should the private claimant expect the tribunal to award him loss of profits under the terminated contract for the same period during which the same capital is earning a second set of profits? On the assumption that he has put his returned capital to good use, the claimant, in effect, is claiming a double recovery for loss of profits. Such a claim seems both illogical and unethical” (Stauffer, 1996).

In describing the KBC award, an angry Indonesian provided a more colourful analogy: “Driving down a very bumpy road you unexpectedly hit a chicken and it is killed. The farmer comes out and you apologize and offer to pay him for the chicken. But he says the chicken might have lived for 5 or 6 years, could have laid an egg every day, half of which could have become other chickens which could have laid more eggs and so on. So he wants a million dollars compensation”. Presumably such an award would encourage a wise farmer to spread feed corn across a nearby highway.

In the CalEnergy case, the arbitrators handled the issue of future profits by drawing on the concept of “abuse of rights”, arguing that it “would be intolerable in the present case to uphold claims for lost profits from investment not yet incurred ... as though the claimant had an unfettered right to create ever-increasing losses for the State of Indonesia (and its people) by generating energy without any regard to whether or not PLN had any use for it”.

Excess awards in investment disputes can have similarly serious implications. First, the host country has to pay more than it should. Moreover, the expectation of such awards would create incentives for inappropriate corporate behaviour. Large awards are likely to lead firms to resist renegotiation and mediation. Indeed, why should investors agree to a new deal, if they could recapture their investment plus future profit without risk and work? A clever investor would even seek projects with the greatest political risk, and perhaps behave in ways that increase the likelihood of government takeover. Finally and perhaps most importantly, excessive awards discourage governments from ending contracts when such action is economically efficient or from introducing desirable regulations: “Notice how careful the law must be not to exceed compensatory damages if it doesn’t want to deter efficient breaches” (Posner, 1986).

Source: Wells and Ahmed (2007).

a) Refrain from unconscionable conduct

“Equitable” conduct means a balancing process which applies principles of justice to correct or to supplement the law, and where the person “who comes to equity must come with clean hands”, with a duty to do equity, to have equity. That is why unconscionable claims are set aside. The behaviour of foreign investors is of public interest to the host country, particularly when such investors develop important oil, mineral, or forestry resources, or when they provide public utility services (Muchlinski, 2006). That’s why — however unorganized — a number of decisions have stressed the duties and responsibilities of foreign investors. Fraud (see Box 10), misrepresentation, undue influence, or abuse of power on the part of an investor may vitiate its claims. Contracts would also be vitiated by sufficient evidence of unlawful conduct on the part of the investor.

The conduct of the foreign investor may be weighted against the conduct of the host country authorities in determining whether the latter had indeed acted wrongly. Yet, that conduct must reach a threshold level of unconscionability to negate the improper conduct of the host authorities (Muchlinski, 2006).

The foreign investor has an obligation to behave with candour and transparency in dealings with the host country authorities. For example, the investor in *Alex Genin and others v. Estonia* should have provided information to financial authorities, cooperating prudentially, something that it failed to do (Muchlinski, 2006). The country was coming to grips with the realities of modern financing and banking practices, and the foreign investor knowingly chose to invest there. The greater the inexperience of the host State the greater the investor’s duty to act with candour and transparency, in order not to abuse the inexperience of the host country. Transitional and developing economies are inexperienced. Such inexperience should not be taken advantage of.

There is also the possibility that foreign investors abuse superior bargaining position, to extract financial benefits from it unduly (Muchlinski, 2006). In the field of public utilities this would be the case of an investor coming into public utilities sectors with strategic biddings, intending to renegotiate later.

b) Engage in investment in the light of adequate knowledge of its risks

Investment agreements are not insurance policies against bad business judgment (Muchlinski, 2006). Corporate social responsibility requires that investment agreements do not foster moral hazard problems by encouraging reckless or speculative adventures. This was the decision in *Waste Management, Inc. v. Mexico*: “It is clear that the arrangement was not commercially viable, taking into account both the lower than expected proportion of customers serviced and the additional costs incurred” (Crawford, Civiletti and Gómez, 2004). Investors should not fail to do proper feasibility studies. Similar reasoning was applied in *MTD Equity Sdn. & MTD Chile v. Chile* (see Box 11). In *Alex Genin and others v. Estonia*, the tribunal found that the officers of the claimant had acted unprofessionally and carelessly, failing to make a proper assessment, when they should have been particularly careful, knowing that the parent company was at the verge of bankruptcy. The responsibility for the loss was the claimant’s alone (Muchlinski, 2006).

The foreign investor should also consider the investment climate of the host country. Serious economic crisis, as well as the situation of transitional economies, and the profits and returns of the claimant, are also important considerations. The *LG&E v. Argentina* decision is in keeping with national decisions on rates and tariffs at times of crisis (see Box 12). Thus, during “the depression years of the 1930s, the [United States Supreme] Court recognized the decline in interest rates and

Box 10

TRIBUNAL DECLINES JURISDICTION OVER FRAUDULENTLY MADE INVESTMENT

A tribunal at the International Centre for Settlement of Investment Disputes (ICSID) declined jurisdiction over the case of *Inceysa Vallisoletana v. Republic of El Salvador*. The claimant turned to arbitration in 2003, alleging that El Salvador had breached the terms of a contract which entitled the Spanish firm to establish motor vehicle inspection facilities throughout El Salvador and to conduct physical inspections and emissions-control testing. In addition to its contractual claim, the Spanish firm also charged that El Salvador had breached the terms of a bilateral investment treaty in place between the two countries.

The Government of El Salvador countered that the investor had made various misrepresentations in the course of securing a contract from the Ministry of the Environment. As a consequence of this, El Salvador argued that Inceysa's investment had been made illegally, and could not be arbitrated pursuant to the bilateral investment treaty. In an effort to reinforce its argument, El Salvador pointed to a provision of the investment treaty which stipulates that covered investments must have been made in accordance with El Salvador's laws. El Salvador also insisted that the non-treaty claims (for example, for breach of contract) were also outside of the jurisdiction of the tribunal, because the government had not consented to ICSID arbitration of disputes arising out of investments obtained through fraudulent means.

Much depended, therefore, upon the tribunal's finding as to whether the Spanish investor had secured its investment through fraudulent means. Ultimately, the tribunal would concur with El Salvador in finding that Inceysa had submitted false financial statements and forged documents to El Salvador authorities. Moreover, the tribunal found that Inceysa had misrepresented its experience in the field of vehicle inspections — having embellished its own record during the public bidding process, when, in fact, the company's previous expertise had been the selling of women's underwear and shoes. Concluding that the Spanish firm had engaged in "deceit" and misrepresentation in order to procure its contract with El Salvador, the ICSID tribunal was asked by El Salvador to determine whether this ought to be fatal to the investor's arbitration bid. For its part, El Salvador argued that its consent to arbitration in the bilateral investment treaty was limited to disputes which had been made in accordance with the laws of El Salvador. The tribunal turned to examine the provisions of the relevant investment treaty, including two separate references to the need for covered investments to have been made in accordance with the laws of the host country. The tribunal also consulted the written records of the treaty negotiation between Spain and El Salvador, which shed further light on the intentions of the two countries. Ultimately, the arbitrators took the view that "any investment made against the laws of El Salvador is outside the protection of the Agreement and, therefore, from the competence of the arbitral tribunal".

Thus, the tribunal turned to examine whether the misrepresentations by the Spanish investor were sufficient to render those investments illegal, and, as such, outside the coverage of the bilateral investment treaty. The tribunal began by looking at the investment treaty itself, which was, according to El Salvador's Constitution, considered part of that country's domestic law. However, the treaty itself was silent as to what would or would not constitute an investment made in accordance with the law. The next step, therefore, was to turn to the "generally recognized rules and principles of international law" which had been referred to in the Spain-El Salvador treaty. Ultimately, the tribunal would identify a number of such general principles, including good faith, "international public policy", the prohibition of unlawful enrichment, and a series of maxims which stipulated that no one should profit from their own fraud.

In each instance, the tribunal would hold that Inceysa's actions clearly ran counter to these general principles, leading to the conclusion that an illegally-made investment could not benefit from the protections of the bilateral investment treaty. Inceysa's effort to convince the tribunal to take jurisdiction over alleged contractual (rather than treaty) breaches would prove no more successful. The tribunal examined a series of legal instruments, including El Salvador's Foreign Investment Law, and in each instance concluded that these instruments did not provide for jurisdiction over disputes involving an illegally-obtained investment.

Source: Peterson (2006b).

MTD EQUITY SDN. & MTD CHILE V. CHILE

The case of MTD Equity Sdn. & MTD Chile v. Chile arose out of claimant's investment in a sprawling parcel of undeveloped land in metropolitan Santiago which the firm hoped to develop into a mixed-use "planned community". After having secured a contract with Chile's Foreign Investment Commission, and invested more than US\$ 17 million into a joint-venture, the Malaysian firm learned that it could not re-zone the property — which had been earmarked for agricultural use — on the grounds that a change would be contrary to Chile's urban development and environmental policies.

Frustrated in its investment, MTD turned to international arbitration in June of 2001, under the Malaysia-Chile investment treaty, in an effort to obtain compensation. The firm alleged that it was subject to an indirect form of expropriation and a denial of fair and equitable treatment. MTD also contended that the latter guarantee extended — thanks to its right to most-favoured-nation treatment — also to two other bilateral investment treaties concluded by Chile with Denmark and Croatia, and which contained more detailed treaty language on fair and equitable treatment, including obligations to award permits subsequent to the approval of an investment and to fulfil contractual obligations, respectively.

In determining whether MTD could invoke such protection, the tribunal began by indicating that "the fair and equitable standard of treatment has to be interpreted in the manner most conducive to fulfil the objective of the ... [treaty] to protect investments and create conditions favourable to investments". Accordingly, it had little difficulty in incorporating the provisions of the Croatian and Danish treaties into the Malaysian treaty by virtue of the "wide scope" of the latter's most-favoured-nation clause — and deeming this importation to be "in consonance with" the purpose of the Malaysia-Chile investment treaty.

The tribunal then turned to the question of how fair and equitable treatment applied to the present case. In particular, the tribunal turned to the definition expounded by an ICSID tribunal, in an arbitration between the Técnicas Medioambientales TECMED and Mexico States (see page 28), in which fair and equitable treatment had been interpreted so as to require States "to provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment".

The parties differed substantially as to the extent to which certain officials had cautioned MTD about the possibility that its application for re-zoning of the investment property might be viewed unfavourably by the land-planning authorities. The parties to the dispute also disagreed as to the proper role of Chile's Foreign Investment Commission — with Chile insisting that the body's remit was limited to approval of inflows of capital, rather than to assess the viability of the project as a whole and guarantee future safe-passage to the foreign investor. Ultimately, however, the tribunal decided that it was unreasonable — and, hence, unfair and inequitable — for Chile to have approved an investment which was clearly against its own urban development policy, and as such likely to be frustrated.

Nevertheless, the tribunal held that, while the provisions of the Chile-Croatia bilateral investment treaty (which obliged a State to award permits after approval of an investment) could be invoked by MTD, the firm was wrong to believe that these provisions entitled it to anything more than the ability to apply for permits and for those applications to be considered in accordance with the law. The tribunal noted that the obligation "does not entitle an investor to a change of the normative framework of the country where it invests. All that an investor may expect is that the law be applied". And, given that MTD's investment would have required "a change in the norms that regulate the urban sector in Chile", the investor could not assert that it was entitled to such a change in Chile's policy.

Thus, MTD was found to have been the victim of an "unreasonable" approval by Chile of a project which could not be implemented because it was counter to the country's urban development policies, but the investor could not claim that it deserved to see those policies changed to suit its needs. Nor did the tribunal believe that MTD's treatment could be characterized as an indirect form of expropriation. In the end, the tribunal elected to award only a portion of the compensation claimed by the Malaysian firm, noting that the firm was not blameless for its losses and "had made decisions that increased their risks in the transaction and for which they bear responsibility".

Source: Peterson (2004b).

Box 12

LG&E V. ARGENTINA

On January 31, 2002, the International Centre for Settlement of Investment Disputes (ICSID) registered a request for arbitration brought by three United States companies providing services in the natural gas sector, LG&E Energy Corp., LG&E Capital Corp., and LG&E International Inc., against Argentina. The claimants invoked the provisions of the November 14, 1991 Treaty between the United States and Argentina for the Encouragement and Reciprocal Protection of Investment, which entered into force on October 20, 1994. According to the claimants, certain measures taken by Argentina, in particular the adoption of the Public Emergency and Exchange Regime Reform Law of January 7, 2002, modified the regulatory environment under which the claimants invested in three natural gas distribution enterprises in Argentina. The claimants contended that these measures constituted a breach of Argentina's undertakings under the bilateral investment treaty: (i) to accord foreign investors a fair and equitable treatment; (ii) not to impair, by arbitrary or discriminatory measures, the use and enjoyment of these investments; (iii) to observe any obligation Argentina may have entered into with regard to investments (the "umbrella clause"); and (iv) not to expropriate, directly or indirectly, claimants' investment.

In a ruling dated October 3, 2006, a tribunal at the ICSID held that Argentina violated certain provisions of the bilateral investment treaty, but accepted Argentina's argument that the country was in a state of necessity at least for a certain period for which reason it should be (at least partially) exempted from responsibility. The tribunal held that the evidence put before it showed that from December 21, 2001 until April 26, 2003, Argentina was in a period of crisis "during which it was necessary to enact measures to maintain public order and protect its essential security interest". The tribunal concluded that during this period the protections afforded by Article XI of the bilateral investment treaty were triggered to maintain order and control civil unrest ("This Treaty shall not preclude the application by either Party of measures necessary for the maintenance of public order, ..., or the protection of its own essential security interests"). The tribunal also found that Argentina had not contributed to its financial crisis (and could therefore remain eligible to make a defence of necessity). Although the tribunal considered the protections afforded by Article XI as sufficient to excuse Argentina from liability, it noted that the state of necessity defence under international law (Article 25 of the International Law Commission's Draft Articles on State Responsibility) also supported the tribunal's conclusion. At the same time, the tribunal held that Argentina is liable for damages related to violations occurring outside of that 17 month span. It is important to note that, in two other cases — CMS Gas Transmission Company (2005) and Enron (2007) — ICSID tribunals determined that Argentina was not entitled to a defence of "necessity" under international law in relation to its actions during the financial crisis (see Box 13).

Regarding the other allegations raised by the claimants, the tribunal rejected the argument that Argentina's measures amounted to an expropriation in breach of the bilateral investment treaty. In doing so, the tribunal considered the economic impact of the measures, the degree of interference with claimants' use and enjoyment of their investment and the duration of the measures. The tribunal found, however, that Argentina breached its obligations to accord claimants a fair and equitable treatment and its obligations under the umbrella clause. The tribunal also concluded that while Argentina's measures may not have been arbitrary, they were discriminatory in nature and thus, in breach of the treaty.

The claimants had initially proposed a methodology for calculating their compensation which would have compared the fair market value of their Argentine share-holdings in August of 2000 with the depressed share prices in October 2002. The tribunal rejected such a method, noting that it was better suited to those cases where investors had suffered a clear expropriation, or when there had been interference with property rights equivalent to the total loss of the investment. In this case, the tribunal noted that the claimants continued to hold stakes in three Argentine gas distribution firms. The tribunal also added that they had not sold their Argentine assets when their value was depressed, and that the assets had since bounced back in value. Accordingly, the tribunal held that the appropriate method of compensation for the treaty breaches would be one based on the "actual loss" incurred as a result of those breaches. The tribunal also noted that it could only award compensation for loss that is certain, and so declined to provide compensation for future lost profits.

Source: Frutos-Peterson (2007); Peterson (2006a), (2007a) and (2007c); Cabrera and Peterson (2007).

CMS V. ARGENTINA

In May of 2005, an International Centre for Settlement of Investment Disputes (ICSID) tribunal issued its award in the arbitration between United States-based CMS Gas Transmission Company, a 29% shareholder in Argentine natural gas transporter TGN, and Argentina. The tribunal found Argentina liable for violations of the United States-Argentina bilateral investment treaty, as well as of its contractual commitments, as a result of measures taken by the Argentine Government in response to that country's financial crisis, including a freeze on public utility rates.

Argentina had argued that it had acted out of a state of emergency or a state of necessity during its financial crisis, thus precluding the country's liability for breach of the United States-Argentina bilateral investment treaty's provisions. This defence was ultimately rejected by the CMS tribunal, which ruled that Argentina had not met the stringent tests imposed by customary international law, nor was it excused from liability thanks to the terms of Article XI of the treaty (see page 42). The tribunal ultimately held Argentina to have breached the fair and equitable treatment obligation in the bilateral investment treaty, as well as a so-called umbrella clause which was deemed to require Argentina to "respect any obligation it may have entered into with regard to investments".

Following the adverse outcome in the CMS case, Argentina applied to the ICSID in an effort to annul the award — a limited form of post-award review available under the ICSID system. Hearings in that case were held in May of 2007, and a final decision was rendered by an *ad hoc* committee in September. The committee has annulled the portion of the 2005 award relating to the so-called umbrella clause. That portion of the award had generated doubts in some observers, as it was not entirely clear how CMS could have suffered a breach of contractual stabilization undertakings given that the company was not itself party to any of those contracts (rather subsidiaries of this firm were party to those legal agreements). Indeed, a different ICSID tribunal in another arbitration against Argentina, had held that the United States water services company Azurix could not claim for alleged breach of the supposed umbrella clause in the United States-Argentina treaty, because Azurix was not itself party to any of the contracts which it alleged Argentina to have breached (rather other corporate subsidiaries had concluded those contracts with the Argentine province of Buenos Aires).

At the same time, the annulment committee held that it was powerless to annul other portions of the award, including certain portions which it identified as containing errors of legal reasoning which may have had a "decisive impact on the operative part of the award". The committee levelled a sharp critique at the tribunal's handling of Argentina's "necessity" defence. In particular, it said that the tribunal had failed to examine whether conditions laid down by Article XI had been fulfilled, and thus whether it was even possible for Argentina to have been in violation of any of the substantive obligations in the treaty. Instead, the tribunal appeared to have conflated the interpretation of Article XI with the approach under customary international law used to assess states of necessity. That is, the annulment committee maintained that the tribunal failed to interpret Article XI on its own merits, perhaps precluding Argentina from taking advantage of one of several general exceptions provided under the treaty (for example, measures related to maintenance of public order or protecting its own essential security interests). The annulment committee noted that if it were "acting as a court of appeal, it would have to reconsider the Award on this ground". As it was, however, the committee was impotent to overturn this error of law, given the very narrow authority enjoyed by ICSID annulment committees. On the committee's view, the original tribunal had applied the relevant law — albeit in a defective manner — and this meant that the annulment committee could not annul the erroneous award.

The holdings of the CMS annulment committee could provide further arguments for the long-running debate as to whether there is a need for an appellate mechanism which might review investment treaty arbitration awards so as to ensure greater consistency. It is worth noting that a discussion paper prepared by the ICSID Secretariat in 2004 had called for an exploration of such an appellate review mechanism; however that proposal was ultimately discarded following a round of consultations by ICSID with its member-states and other stakeholders.

Source: Peterson (2005b), (2007f) and (2007g).

in business earnings throughout the country, and was willing to accept lower rates of return” (Phillips, 1993).²⁶

Voluntary assumption of risks, by foreign investors, may be a relevant factor in determining whether State conduct is equitable or inequitable. A closely related consideration is that of the extent to which legal assurances that are not backed by objective and diligent analysis of relevant economic, financial and social data, amount to a waiver of the duty of due diligence, or whether such a waiver is a full realization of moral hazard risks.

c) Conduct business in a reasonable manner

When foreign investor’s losses can be attributed to bad management of the business or investment rather than to regulatory actions by the host country, compensatory claims should not be accepted (Muchlinski, 2006). Investments should be managed in a manner that ensures their economic viability and foreign investors must be aware of regulatory environment.²⁷ Thus, in *Webb’s Fabulous Pharmacies, Inc. v. Beckwith*, United States Supreme Court asserted that “a mere unilateral expectation or an abstract need is not a property interest entitled to protection” (United States Supreme Court, 1980).²⁸ The court also held that an investment-backed expectation was unreasonable if constructive notice of regulation was previously known (United States Supreme Court, 1984 y 1987). The constructive notice accounts for information available to the public, even the existence of a general regulatory scheme, necessary to be considered at the time of taking a decision of buying or investing in property. In *Methanex Corporation v. United States*, foreign investors were told that the political economy of environmental regulation implied a continuous process of monitoring and control.²⁹ Foreign investors must comply with local regulations (*Emilio Agustín Maffezini v. Spain*) and take relevant professional advice (*Marvin Feldman v. Mexico* and *ADF Group Inc. v. United States*), and also assume a corporate responsibility to act in the best interests of the host country and its economic development. Foreign investors must take reasonable care in the conduct of investments, so that, as far as possible, the interests of stakeholders can be realized, within the corporate responsibility to act in the best interests of the host country and its economic development (Muchlinski, 2006).

On 20 March 2007, the Organisation for Economic Co-operation and Development (OECD) Council approved the “OECD Principles for Private Sector Participation in Infrastructure” to help governments work with private sector partners to finance and bring to fruition projects in areas of vital economic importance, such as transport, water and power supply and telecommunications. Principle 21 includes the investors duty to participate in infrastructure projects in good faith and with a commitment to fulfil their obligations (see Box 14).

²⁶ In the *Federal Power Commission v. Natural Gas Pipeline Co.* case of 1942, the United States Supreme Court argued that “The evidence shows that profits earned by individual industrial corporations declined from 11.3% on invested capital in 1929 to 5.1% in 1938. The profits of utility corporations declined during the same period from 7.2% to 5.1%. For railroad corporations the decline was from 6.4% to 2.3%. Interest rates were at a low level on all forms of investment and among the lowest that have ... ever existed. The securities of natural gas companies were sold at rates of return of from 3% to 6% with yields on most of their bond issues between 3% and 4%. The interest on large loans ranged from 2% to 3.25%. The regulated business here seems exceptionally free from hazards which might otherwise call for special consideration in determining the fair rate of return” (United States Supreme Court, 1942).

²⁷ In modern regulatory and public utilities law, at the national level, investors providing public utility services have an obligation of efficiency, on behalf of consumers, which has the objective to prevent overcapitalisation, excessive operational costs, transfer pricing, excessive debt, etc.

²⁸ “A ... reasonable investment-backed expectation ... must be more than a ... unilateral expectation or an abstract need” (United States Supreme Court, 1984).

²⁹ “Methanex entered a political economy in which it was widely known, if not notorious, that governmental environmental and health protection institutions at the federal and state level, operating under the vigilant eyes of the media, interested corporations, non-governmental organizations and a politically active electorate, continuously monitored the use and impact of chemical compounds and commonly prohibited or restricted the use of some of those compounds for environmental and/or health reasons” (Rowley, Reisman and Veeder, 2005).

OECD PRINCIPLES FOR PRIVATE SECTOR PARTICIPATION IN INFRASTRUCTURE

- The choice by public authorities between public and private provision should be based on cost-benefit analysis taking into account all alternative modes of delivery, the full system of infrastructure provision, and the projected financial and non-financial costs and benefits over the project lifecycle.
- No infrastructure project — regardless of the degree of private involvement — should be embarked upon without assessing the degree to which its costs can be recovered from end-users and, in case of shortfalls, what other sources of finance can be mobilized.
- The allocation of risk between private parties and the public sector will be largely determined by the chosen model of private sector involvement, including the allocation of responsibilities. The selection of a particular model and an associated allocation of risk should be based upon an assessment of the public interest.
- Fiscal discipline and transparency must be safeguarded, and the potential public finance implications of sharing responsibilities for infrastructure with the private sector fully understood.
- A sound enabling environment for infrastructure investment, which implies high standards of public and corporate governance, transparency and the rule of law, including protection of property and contractual rights, is essential to attract the participation of the private sector.
- Infrastructure projects should be free from corruption at all levels and in all project phases. Public authorities should take effective measures to ensure public and private sector integrity and accountability and establish appropriate procedures to deter, detect and sanction corruption.
- The benefits of private sector participation in infrastructure are enhanced by efforts to create a competitive environment, including by subjecting activities to appropriate commercial pressures, dismantling unnecessary barriers to entry and implementing and enforcing adequate competition laws.
- Access to capital markets to fund operations is essential to private sector participants. Restrictions in access to local markets and obstacles to international capital movements should, taking into account macroeconomic policy considerations, be phased out.
- Public authorities should ensure adequate consultation with end-users and other stakeholders including prior to the initiation of an infrastructure project.
- Authorities responsible for privately-operated infrastructure projects should have the capacity to manage the commercial processes involved and to partner on an equal basis with their private sector counterparts.
- Strategies for private sector participation in infrastructure need to be understood, and objectives shared, throughout all levels of government and in all relevant parts of the public administration.
- Mechanisms for cross-jurisdictional co-operation, including at the regional level, may have to be established.
- To optimize the involvement of the private sector, public authorities should communicate clearly the objectives of their infrastructure policies and they should put in place mechanisms for consultations between the public and private partners regarding these objectives as well as individual projects.
- There should be full disclosure of all project-relevant information between public authorities and their private partners, including the state of pre-existing infrastructure, performance standards and penalties in the case of non-compliance. The principle of due diligence must be upheld.

Box 14 (Concluded)

- The awarding of infrastructure contracts or concessions should be designed to guarantee procedural fairness, non-discrimination and transparency.
- The formal agreement between authorities and private sector participants should be specified in terms of verifiable infrastructure services to be provided to the public on the basis of output or performance based specifications. It should contain provisions regarding responsibilities and risk allocation in the case of unforeseen events.
- Regulation of infrastructure services needs to be entrusted to specialized public authorities that are competent, well-resourced and shielded from undue influence by the parties to infrastructure contracts. Activities with a monopolistic element must be subjected to regulation in the public interest. National authorities will wish to take advice from commonly accepted good practices, including as regards the duty of efficiency on behalf of the public, transfers of efficiency, transparency, constructive notice, control of transfer pricing, regulatory accounting and users' participation.
- Occasional renegotiations are inevitable in long-term partnerships, but they should be conducted in good faith, in a transparent and non-discriminatory manner.
- Dispute resolution mechanisms should be in place through which disputes arising at any point in the lifetime of an infrastructure project can be handled in a timely and impartial manner.
- Private sector participants in infrastructure should observe commonly agreed principles and standards for responsible business conduct.
- Private enterprises should participate in infrastructure projects in good faith and with a commitment to fulfil their commitments. The difficulty in disengaging from infrastructure projects provides both the public sector and private contractual parties with leverage to improve their financial position following the awards. From the perspective of the private side this may be done by means of insisting on renegotiations of contracts, or by raising profitability by renegeing on service agreements and other commitments. However, it is in the interest of private sector participants to uphold the "sanctity of contracts", even where this may lead to short-term losses. If there is evidence that investors have acted in bad faith — for instance signing contracts that they knew, or should have known, they could not realistically honour — they are at risk of legal suits, and of souring the working relationship with their public partners, antagonizing affected communities and sparking international criticism. The principle of due diligence implies that private sector participants should engage in a process of investigation and evaluation into the details of a potential investment, such as an examination of operations and management and the verification of material facts, drawing on all available sources before embarking on a project. The board members of private enterprises should be particularly mindful of the responsibilities, including contractual obligations and due diligence, when engaging in infrastructure projects. Such instruments as the OECD Principles of Corporate Governance provide guidance regarding board responsibility.
- Private sector participants, their subcontractors and representatives should not resort to bribery and other irregular practices to obtain contracts, gain control over assets or win favours, nor should they accept to be party to such practices in the course of their infrastructure operations.
- Private sector participants should contribute to strategies for communicating and consulting with the general public, including vis-à-vis consumers, affected communities and corporate stakeholders, with a view to developing mutual acceptance and understanding of the objectives of the parties involved.
- Private sector participants in the provision of vital services to communities need to be mindful of the consequences of their actions for those communities and work, together with public authorities, to avoid and mitigate socially unacceptable outcomes.

Source: OECD (2007).

The duties of efficiency, good faith, and due diligence are an essential part of the obligations of public utility operators in a number of countries. Thus, in the European Union, law aims for efficiency and an undertaker cannot abuse its exclusivity rights (Hantke-Domas, 2005). In the United Kingdom, under the Water Act of 2003, the Water Services Regulation Authority must exercise and perform its powers and duties in the manner which it considers is best calculated to promote economy and efficiency on the part of companies providing water supply and sanitation services. In the United States, a number of regulatory principles — used and useful investment, prudence review, control of transfer prices and of capital structure, supervision of operating expenses, particularly those not controlled by competitive forces — are based on the notion of efficiency. Investments and expenses violating the duty of efficiency are closely controlled and eventually disallowed.

D. Protection from expropriation without compensation

Protection against expropriation is also an absolute standard and not based on treatment of domestic investors. This protection is not a barrier against an expropriation taking place for a public purpose, but it does require fair market value compensation to be promptly paid for any expropriation. This is not a new concept from international law, but is widely applied in almost all domestic legal systems. What is new, however, is the potential extension of the notion of expropriation to government regulations that have an effect on foreign investors. It has been argued, with some success to date, that a normal regulatory measure that has a significant financial effect on an investor qualifies as an indirect or “regulatory expropriation”. While this is alleged by some observers to come from the United States legal principles on regulatory takings, it is worth noting that no compensation to United States investors appears ever to have been paid following the adoption of measures under the Clean Air Act, Clean Water Act, and similar pieces of classical environmental protection at the Federal or State levels.

1. Expropriation and national law

The elastic notions of expropriation sustained by some international arbitration courts collide with concepts of expropriation in the domestic law of the United States and other countries. In the United States, there are also national regulatory principles that may eventually conflict with expanding international expropriation notions.

In the United States, the substantive standard for establishing a regulatory taking is high. The takings clause applies only to real property and to other specific property interests and does not extend to more generalized interests, such as the expectation of future profits (Porterfield, 2004). Property owners must show that a measure has destroyed all or almost all value of the property. Also, the degree of destruction of value must be weighted against the value of the entire property, rather than only the portion affected by the government measure. Some forms of property, such as contract rights and chattel, will usually not be compensated, even if regulation destroys all economic value.

In this conception, in deciding whether there is a regulatory taking, it is important to determine whether the investment can earn reasonable returns. In *Penn Central Transportation Co. v. New York City*, the United States Supreme Court decided that there was no taking, considering that the objected regulation resulted in widespread public benefit, was applied to all similarly placed property and there was reasonable return to investment (United States Supreme Court, 1978). In *Pennsylvania Coal Co. v. Mahon*, the Court asserted that: “Government hardly could go on if to some extent values incident to property could not be diminished without paying for every such change in the general law” (United States Supreme Court, 1922).

Most countries in the world accept private property regulation, as long as it is reasonable, non-discriminatory, and does not result in a fundamental destruction of economic use. When dealing with public utilities, United States regulatory law looks for a balance of interests and consideration of context. According to Troxel (1947), “The Supreme Court’s concept of a reasonable return is really a notion of a zone of reasonableness. Confiscation of the property of a private company is the lower limit of the zone; exploitation of buyers, which is revealed by pricing practices and monopoly profits, is the upper limit. If the return is reasonable, it must fall between these limits”. “Clearly, then, the required earnings of a utility cannot be represented by a specific sum, nor determined by a precise formula. Rather, they will vary with the economic conditions of both the company and the economy” (Phillips, 1993).³⁰

One of the best examples of this kind of balanced, pragmatic middle course is the United States Supreme Court decision in *Cedar Rapids Gas Light Co. v. City of Cedar Rapids*: “An adjustment of this sort under a power to regulate rates has to steer between Scylla and Charybdis. On the one side, if the franchise is taken to mean that the most profitable return that could be got, free from competition, is protected by the 14th Amendment, then the power to regulate is null. On the other hand, if the power to regulate withdraws the protection of the Amendment altogether, then the property is nought. This is not a matter of economic theory, but of fair interpretation of a bargain. Neither extreme can have been meant. A midway between them must be hit” (United States Supreme Court, 1912).

As a result, public utility regulation is based on a notion of limits and not on rigid formulae.³¹ *Ex-post* regulation on matters of public utility services is accepted, as long as it does not prevent a reasonable return on the investment. In *Munn v. State of Illinois*, the United States Supreme Court held that: “It matters not in this case that these plaintiffs in error had built their warehouses and established their business before the regulations complained of were adopted. What they did was from the beginning subject to the power of the body politic to require them to conform to such regulations as might be established by the proper authorities for the common good. They entered upon their business and provided themselves with the means to carry it on subject to this condition. If they did not wish to submit themselves to such interference, they should not have clothed the public with an interest in their concerns” (United States Supreme Court, 1876).

In addition, the notion of reasonable returns is a zone of reasonableness. In *Federal Power Commission v. Hope Natural Gas Co.*, the United States Supreme Court held that the procedure and method of determining both the rate base and the rate of return should be left to the regulatory agencies, and that only in cases of obvious injustice would it interfere with administrative rulings: “It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important. Moreover, the Commission’s order does not become suspect by reason of the fact that it is challenged. It is the product of expert judgment which carries a presumption of validity. And he who would upset the rate order under the Act carries the heavy burden of making a convincing

³⁰ “But what is a reasonable return on capital? This is inherently a matter of judgement — it would be difficult to argue that 6.5 per cent was a reasonable return on capital but 6 per cent and 7 per cent were not — and, moreover, a matter on which judgements will quite properly vary over time. The law could prescribe a formula for determining the appropriate return — choosing, for example, between the capital asset pricing model and the dividend growth model and specifying how coefficients were to be calculated. But any such law would be rapidly overtaken by events” (Holtram and Kay, 1994).

³¹ “What is a fair return within this principle cannot be settled by invoking decisions of this court made years ago, based upon conditions radically different from those which prevail today. The problem is one to be tested primarily by present-day conditions ... A rate of return upon capital invested in ... public utilities, which might have been proper a few years ago, no longer furnishes a safe criterion either for the present or the future ... Nor can a rule be laid down which will apply uniformly to all sorts of utilities. What may be a fair return for one may be inadequate for another, depending upon circumstances, locality, and risk ... What will constitute a fair return in a given case is not capable of exact mathematical demonstration. It is a matter more or less of approximation, about which conclusions may differ” (United States Supreme Court, 1930).

showing that it is invalid because it is unjust and unreasonable in its consequences” (United States Supreme Court, 1944).

The United States Supreme Court has reaffirmed the “end result” doctrine in *Duquesne Light Co. v. Barasch*: “Similarly, an otherwise reasonable rate is not subject to constitutional attack by questioning the theoretical consistency of the method that produced it. ‘It is not theory, but the impact of the rate order which counts’ ... The economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result. The Constitution is not designed to arbitrate these economic niceties. Errors to the detriment of one party may well be canceled out by countervailing errors or allowances in another part of the rate proceeding. The Constitution protects the utility from the net effect of the rate order on its property. Inconsistencies in one aspect of the methodology have no constitutional effect on the utility’s property if they are compensated by countervailing factors in some other aspect” (United States Supreme Court, 1989).

The United States Supreme Court puts the weight of providing evidence of the unjust and unreasonable consequences of the disputed rate level on the claimant. In *Duquesne Light Co. v. Barasch*, the Court stated that: “The overall impact of the rate orders ... is not constitutionally objectionable. No argument has been made that these slightly reduced rates jeopardize the financial integrity of the companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital. Nor has it been demonstrated that these rates are inadequate to compensate current equity holders for the risk associated with their investments under a modified prudent investment scheme” (United States Supreme Court, 1989). There is a coincidence between this statement and the Court’s argument that, in terms of utility rates, “The guiding principle has been that the Constitution protects utilities from being limited to a charge for their property serving the public which is so ‘unjust’ as to be confiscatory” (United States Supreme Court, 1989).

In *Covington & Lexington Turnpike Road Co. v. Sandford*, the United States Supreme Court recognized that: “In short, each case must depend upon its special facts; and when a court, without assuming itself to prescribe rates, is required to determine whether the rates prescribed by the legislature for a corporation controlling a public highway are, as an entirety, so unjust as to destroy the value of its property for all the purposes for which it was acquired, its duty is to take into consideration the interests both of the public and of the owner of the property, together with all other circumstances that are fairly to be considered in determining whether the legislature has, under the guise of regulating rates, exceeded its constitutional authority, and practically deprived the owner of property without due process of law” (United States Supreme Court, 1896). This lowest level is known as the confiscatory level.

In *Duquesne Light Co. v. Barasch*, the Court adds that: “If the rate does not afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments. As has been observed, however, ... [h]ow such compensation may be ascertained, and what are the necessary elements in such an inquiry, will always be an embarrassing question” (United States Supreme Court, 1989). Nevertheless, the undertaker itself might provoke such a defeat: “To the extent utilities’ investments in plants are good ones (because their benefits exceed their costs) they are rewarded with an opportunity to earn an ‘above-cost’ return, that is, a fair return on the current ‘market value’ of the plant. To the extent utilities’ investments turn out to be bad ones (such as plants that are canceled and so never used and useful to ... the public), the utilities suffer because the investments have no fair value and so justify no return” (United States Supreme Court, 1989).³²

³² According to Hantke-Domas (2005), “If one applies the previous Court approach to a natural monopoly, arguably, the confiscatory argument and the financial integrity test could be assimilated with the idea of covering long-run total cost of utilities ... The ... Supreme Court approach seems to distance itself from the discussion about the fair value, in terms of a point where economic efficiency is attained. For the court, the starting point is the price set by a regulatory agency, and then the discussion will be centred

2. Collisions regarding expropriation under international and national law?

The balancing characteristics of the United States regulation may enter into collision with international principles for expropriation. For example, the NAFTA's notion of investment is much broader than real property, and compensation applies for substantial or significant effect on the value of an investment, conceptual severance, hitherto rejected by the United States Supreme Court. For this reason, Porterfield (2004) argues that NAFTA differs from takings in the United States law in three significant ways: protected economic interests are broader, permissibility of conceptual severance is greater, and the degree of economic effect for a measure to be expropriatory is lower. Thus, not just real estate property is protected, but general interests such as market access and share, or making profit from an investment. Conceptual severance is accepted, opening the door for strategic organization of business and its location. Decreasing the value of an asset may also open the door for compensation.

At the international level, investor-State arbitrations and the literature on this question, go in divergent, irreconcilable directions, and are often based on predisposed ideological views on property rights and regard governmental regulations in general as often unnecessary interferences with private activity.³³ This in itself has left many governments in confusion as to the state of the law and as to how much of the traditional State right to regulate is removed by the broader claims for the definition of expropriation. For example, it is not clear whether an increase in pollution control levels that might cause an investment that is not capable of adapting to close would amount to an expropriation of that investment. Or, if a product is banned from sale and consumption due to its potential toxic characteristics, is that an expropriation? Then, if one adds as a twist on this example, when a commitment by a previous government not to change the environmental controls for a long period of time is rejected by a subsequent democratically elected government, would that alter the equation? Many international arbitration decisions suggest it should, including the *Methanex Corporation v. United States* decision, arguably the most favourable decision to date under NAFTA on a government's right to legislate retrospectively.

Uncertainty as to the scope of the expropriation rules has potentially serious consequences for regulators in developing countries. In part this is due to a lower level of regulatory standards to begin with, which may put a higher premium on the need to raise standards during the life of an investment. However, in the life of any investment one must also anticipate the need for the regulatory environment to change, as community needs, social and economic conditions, technology and knowledge change. For all countries, there is a concern that the potential for a foreign investor to initiate a claim under the expropriation rules may restrain the initiation of new regulations. For developing countries this risk is even greater as the potential damages awards, if a measure is found to be an expropriation, may create higher budget stresses. If investments are made in the absence of an appropriate regulatory framework, the efforts to introduce one later maybe made more difficult or even impossible due to the uncertainties in the scope of the expropriation provisions in the international investment agreements.

on the evidence the utility will provide to sustain that the price set will not cover its long-run average cost. The important point in this case is the reliance of the court on the price set by the regulatory agency".

³³ For example, according to Mann (2005), the final award in *Methanex Corporation v. United States* cannot be reconciled with the decision on expropriation in *Metalclad Corporation v. Mexico*.

E. Freedom from the imposition of performance requirements³⁴

Finally, there is a provision that is becoming increasingly popular in investment agreements. This is the prohibition to impose so-called performance requirements on foreign investors. Such requirements may include minimum levels of domestic purchasing, tying export levels to foreign exchange levels, imposing specific technical standards on business operations, setting minimum numbers of home appointed local officials as managers or directors, among others.

The major characteristic of performance requirements is that they reduce the independent business decision-making capacity of the foreign investor and may reduce efficiency from his or her perspective. The goal of the performance requirements for the government imposing them is to increase the benefits of the foreign investment for the host State or community. The imposition of such requirements is increasingly being proscribed by international investment agreements. In a water context, this could include requiring specific technologies to be purchased locally to control water pollution, requiring local suppliers to have a given percentage of supplier payments, or forcing a water supply and sanitation company to have high numbers of local citizens on its management team.

³⁴ This section is based on Mann (2006a).

III. Investor remedies under international investment agreements³⁵

Today, special remedies in most of the international investment agreements back the rights of foreign investors. Indeed, it is widely recognized that one of the major features of post 1980s international investment agreements is the articulation of special dispute settlement procedures for foreign investors. The so-called investor-State dispute settlement process was developed from international commercial arbitration models between private sector firms. Recent estimates indicate that it has been invoked 255 times between 1987 and November 2006 (UNCTAD, 2006b).³⁶

At least 70 governments, including 44 in the developing world, have faced investment treaty arbitration (UNCTAD, 2006b). Argentina tops the list with 42 claims lodged against it, and Mexico has the second highest number of known claims (17). A little less than half of the cases (42%) involves the services sector, including electricity distribution, telecommunications, debt instruments, water services and waste management. All primary sector cases relate to mining and oil and gas exploration activities.

³⁵ This section is based on Mann (2006a).

³⁶ These disputes were filed with ICSID (or ICSID Additional Facility) (156), the United Nations Commission on International Trade Law (UNCITRAL) (65), the Stockholm Chamber of Commerce (18), the International Chamber of Commerce (4), and *ad hoc* arbitration (4) (UNCTAD, 2006b). One case concerned the Cairo Regional Centre for International Commercial Arbitration, and for seven cases the exact venue was unknown. Since the ICSID arbitration facility is the only one to maintain a public registry of claims, these estimates are likely to underestimate the total number of investor-State cases.

The arbitration market is created by foreign investors. States cannot resort to the system, which works on demand by foreign investors, and solely by foreign investors.

The investor-State arbitration process allows foreign investors to initiate an international arbitration process before a tribunal composed of three arbitrators. A notice of arbitration is sent by the foreign investor to the responsible government official to begin the process. Each “side” chooses one arbitrator and a “neutral” one is then jointly chosen or appointed by a third party. Today, most of these arbitrations take place behind closed doors,³⁷ with only those under the investment rules of NAFTA and a few other recent United States agreements taking place in public. In most cases, but not all, the final decisions are made public. There is no appeal from the arbitral decision, only more limited forms of review that apply to correct what can loosely be described as egregious errors by a tribunal.

In looking at a claim by a foreign investor, the arbitration tribunals apply first and foremost the provisions of the treaty on which the claim is based, and other sources of international law that may be relevant. However, they may also examine domestic legal issues and review breach of contract claims in the domestic courts if the foreign investors phrase the legal issue as a breach of the international treaty as well as of domestic law. Thus, the arbitration tribunals can have a very broad mandate in regards to a complaint by a foreign investor, and can usurp the role of local courts in contract disputes or other circumstances. At the same time, this is usually done from the perspective of applying the investor rights to such other legal rules, rather than a perspective of balancing rights and obligations of different stakeholders.

The transposition of the commercial arbitration model to the investor-State arena has raised a number of problems.³⁸ These include a systemic conflict of interest in that many active arbitrators also serve as lawyers in other cases or have partners who do so (see Box 15); inconsistent decisions are exacerbated due to the lack of an effective appeals process; the usurpation of domestic court roles in contracts and other disputes; and, secrecy through much of the process.

As already noted, some 260 arbitrations have been commenced under this process. While certainly not all have been won by foreign investors, several recent awards have reached over US\$ 100 million in damages against host States, including two recent decisions in South America. This is, therefore, a very significant feature of investment agreements. Not all bilateral investment treaties or other investment agreements include investor-State dispute settlement processes. However, it is sufficiently widespread to assume for present purposes that most if not all of the agreements that one will encounter in practice today in relation to water and public services-related issues will have such a process.

In addition to the need for care in appointing arbitrators for an investor-State arbitration, and the costs of preparing a defence, the investor-State process carries other risks for developing countries. For example, they may not have sufficiently well-trained lawyers for the highly specialized process involved. Awards, as already noted, can be very high, in several cases reaching

³⁷ According to Marcos Orellana (2007), an attorney with the Center for International Environmental Law (CIEL), “At a time where the international community and human rights tribunals recognize the linkages between access to information, transparency and democracy, the secrecy shrouding investor-state arbitrations ... compromises the quality of decision-making, the credibility of the arbitral process, and the ability of civil society to hold governments accountable”. Makhdoom Ali Khan (2006), Attorney General of Pakistan, acknowledges that tensions may arise between the public’s right to know, and the procedural integrity of the arbitration process (for example, some witnesses or claimants might be intimidated if arbitrations are subjected to the full glare of publicity). On the other hand, Noah Rubins (2007), an arbitration lawyer, notes that when governments draft investment treaties they “are free to impose additional disclosure of information or to open hearings to the public, as the United States and Canada have done”. Ultimately, he says that “public interest groups should use internal measures in the respondent State (like the ... [United States] Freedom of Information Act) to obtain the information they need, or pressure the States to implement transparency legislation if none exist. That is the more appropriate path to transparency”.

³⁸ When only the financial dealings of private companies are involved, how they resolve their disputes may be less important than when a balance of public and private interests is concerned, as it is in the investor-State cases interacting rights of different stakeholders.

Box 15

WHO IS QUALIFIED TO BE AN ARBITRATOR?

As international investment treaty arbitrations between foreign investors and their host governments continue to proliferate, the thorny issue of who is qualified to resolve such disputes remains a subject of considerable debate. There is no permanent international court or tribunal charged with the interpretation of investment treaties. A typical feature of arbitration as a method of dispute resolution is that it provides the parties with a meaningful role in selecting the persons who will resolve a given dispute.

There are multiple sets of arbitration rules used to govern investment treaty disputes, and these rules differ as to the qualifications required of arbitrators. Generally speaking, however, the rules demand that arbitrators be impartial and independent. If there are doubts as to an arbitrator's impartiality or independence, a party may challenge that arbitrator. One traditional ground for such a challenge has been an alleged conflict of interest, for example where an arbitrator is alleged to have financial interests in the matter in dispute, or where that arbitrator has other ties to one of the disputing parties (for example, he or she may have provided legal or professional services to one of the parties).

Another emerging ground involves what are sometimes called "issues" conflicts, where an arbitrator's publicly-stated views on a particular subject are alleged to render him or her less than impartial for purposes of arbitrating a particular dispute. As yet, there are no clear guidelines as to what constitutes an actual "issues" conflict. There is growing debate amongst arbitration practitioners and observers as to how and where to draw the line.

Yet another strain of challenges raise questions as to whether, or under what circumstances, an individual can serve as counsel in one or more investment treaty arbitrations and as arbitrator in one or more other investment treaty arbitrations during the same time period. At its most general, this type of challenge appears rooted in a scepticism that a single individual can have the requisite impartiality — or appearance of impartiality — to be arbitrator in disputes where legal questions arising (for example, how to interpret basic treaty obligations owed to foreign investors) could have knock-on implications for other cases in which that arbitrator is acting as counsel on behalf of other parties.

According to Loretta Malintoppi, a lawyer who has undertaken research on arbitrator conflicts for the International Law Association, investment treaty arbitration is susceptible to this type of alleged conflicts in a way that international commercial arbitration is not. She notes that, in contrast to commercial arbitration, where the legal issues are often grounded in unique contractual or legal instruments, investment treaty disputes may raise many of the same types of legal questions (for example, jurisdictional requirements under treaties, definitions of standard bilateral investment treaty obligations such as fair and equitable treatment or national treatment, etc.). As a result, investment arbitration has witnessed challenges which are targeted at the dual-role adopted by arbitration practitioners (i.e., serving as arbitrator and counsel simultaneously, albeit in parallel cases).

Some critics have questioned whether the commercial-arbitration-model is wholly appropriate for investment treaty disputes, which involve sovereign governments, potentially significant matters of public interest, and recurring questions of international law interpretation (requiring arbitrators to interpret both international treaties and customary international law). Judge Thomas Burgenthal, a member of the International Court of Justice, and an investment treaty arbitrator, in a speech to a 2006 Geneva conference, argued that lawyers ought to choose whether to practice as arbitrators or counsel in investment treaty arbitrations, "and be held to the choice they have made, at least for a specific period of time". He explained that this choice is necessary, "in order to ensure that an arbitrator will not be tempted, consciously or unconsciously, to seek to obtain a result in an arbitral decision that might advance the interests of a client in a case he or she is handling as counsel".

The International Institute for Sustainable Development (IISD) of Canada has voiced concerns about the potential for conflicts where individuals "wear more than one hat" in the arbitration world. Howard Mann, Senior International Law Advisor to IISD, argues that "The standard for conflict of interest is not simply that an actual conflict of interest must be sanctioned, but that the appearance of conflict must be prevented in order to promote the

integrity of the judicial process". Mann adds that "A person acting as counsel in one case has a duty to that client to protect and promote their interests. But acting as an independent arbitrator in another case may require them to take a diametrically opposite interpretation of the law that they must plead for their client. Is it even possible to meet both obligations in such circumstances?". Mann advises that arbitrators ought not to be placed in situations where they may have to rule on legal issues which could help or hinder their other clients.

Malintoppi says that some individuals are reportedly beginning to make a conscious choice to practice either as an arbitrator, or as counsel to investors or States. This type of choice pre-empts some challenges which may arise. But she notes that many practitioners, particularly younger lawyers, may be reluctant to self-designate themselves as one or the other. Malintoppi says this reluctance may stem from various reasons, including a concern that a single line of activity might yield insufficient work opportunities in future, or a more general conviction that there is no inherent problem with wearing "two hats" in this field. She adds that arbitration lawyers also express fears that the talent-pool of available arbitrators and arbitration counsel could be diluted dramatically if more-experienced lawyers have to choose one exclusive role.

Indeed, a view expressed by some arbitration lawyers is that arbitration, at its very essence, is a party-directed form of dispute resolution where the parties should be able to choose the persons who arbitrate a given dispute. For this reason, parties should be free to select someone who has experience both as arbitrator and counsel, as that person might bring greater experience, expertise, and prestige to the task.

Todd Weiler, a lawyer who has practiced as counsel in numerous investment treaty arbitrations, and as arbitrator in at least one such case, tells "that to the extent problems exist in the area of professionals wearing multiple hats, they are not demonstrative of a systemic flaw in the practice". He cautions against viewing arbitrators as if they were judges on a permanent court. Weiler argues that individuals acting as arbitrators are professionals offering a private service — not officials performing a public service — and that there should be no bright-line prohibition against individuals practicing as arbitrators and counsel contemporaneously.

For the moment, the practice of lawyers operating as both counsel to clients and arbitrators remains widespread in the investment treaty arbitration context. While challenges to arbitrators occasionally attract a great deal of publicity and discussion, there are numerous instances where international lawyers are working as arbitrators in some investment treaty disputes and as counsel in others. In those cases where a challenge is mounted against an arbitrator — be it in relation to a traditional conflict of interest, a so-called issues conflict, or some other type of alleged conflict — the question of who shall decide upon the merits of that challenge comes into view.

Thanks to the decentralized nature of this form of arbitration, and the multitude of different procedural rules and forums which may be used, it can fall to a range of persons or bodies to resolve such challenges. For example, in arbitrations governed by the ICSID Convention, the two-remaining members of a tribunal will be called upon to determine whether the challenge ought to be upheld. In the event that the two members reach differing views, the matter is then handed on to the Chairman of the International Centre for Settlement of Investment Disputes (ICSID) Administrative Council (the World Bank President) for a final decision.

By contrast, in arbitrations using the United Nations Commission on International Trade Law (UNCITRAL) procedural rules, there may be a role for national-level courts to pass judgment on such challenges. In the first instance, the two-remaining members of a tribunal may offer an informal opinion as to whether the third member of their tribunal ought to resign. However, such challenges are typically resolved by the so-called appointing authority (the body which has been designated by the parties to handle appointment of arbitrators in instances where the parties to an arbitration are unable to agree on such appointments). Beyond this appointing authority, however, lies the prospect of recourse to the domestic courts of the place of arbitration (every international arbitration is sited in a particular country for legal purposes).

Source: Peterson (2007b).

over US\$ 100 million in damages against host States. When large investments are involved, the ability of foreign investors to directly initiate the arbitration, as opposed to State-to-State dispute settlement, can also provide them with a privileged status in negotiations with other stakeholders. This status can also be enhanced by the fact of the litigation will take place under international law rules with a narrow focus on investor rights as opposed to a broad set of interacting rights of different stakeholders. In contexts where water-sensitive issues are raised, these advantages can have a significant influence on the final outcome of water management decisions, such as water allocation and water pollution control (Mann, 2006a).

International business managers often argue that there is a damages orientation in arbitration panels for investment disputes. Disputes generally conclude with a calculation of damages — a monetary award — if arbitrators decide that they have jurisdiction and that the case has merit. In contrast, other judicial processes often take steps to encourage settlements (Wells and Ahmed, 2007). There are no sure explanations of why arbitration panels so consistently look to damages, rather than to revised policies, new contract terms, or negotiated settlement. An economist may argue that their behaviour results from the fact that they are paid by the hour; judges on the other hand are paid fixed salaries, and thus have an incentive to clear their calendars. Many arbitrators vigorously deny that the payment system influences their behaviour, but they offer no alternative explanation.

Courts created for investors, and paid per case, could develop expansive laws favouring the creators of their service markets. In the *Dr. Bonham's* case decided in 1610, Sir Edward Coke, Chief Justice of England's Court of Common Pleas, found that because the same entity — the Royal College of Physicians — suffered the wrong, punished Dr. Bonham with fine and imprisonment, and received one-half of the fine, this made it not only judges, but also parties, in cases coming before them, and it is an established maxim of the common law that no person may judge in his or her own cause (Schwartz, 1993). Coke suggested that the impartiality of a judge is compromised when the judge is also the plaintiff who will benefit financially from any fines imposed on the defendant, or the prosecutor who is the advocate responsible for seeking such fines. Although the Royal College of Physicians had the authority under its charter and a parliamentary statute, Coke observed that it “appears in our books, that in many cases, the common law will control Acts of Parliament, and sometimes adjudge them to be utterly void: for when an Act of Parliament is against common right and reason, or repugnant, or impossible to be performed, the common law will control it, and adjudge such Act to be void” (American Law Encyclopedia, 2007).

Although arbitrators in contemporary international investment litigation are not plaintiffs themselves, it is clear that they have distinctive interests regarding the arbitration industry. The arbitration market is created by foreign investors and by them only. Arbitrators' honorarium is related to the existence of litigation (and its jurisdictional acceptability), and the nature and importance of cases. Therefore, although arbitrators are not plaintiffs themselves, they are not as impartial to the existence of cases and arbitration markets, as ordinary judges would be. Thus, our present international arbitration system may be, however distinctively, not that far removed from Sir Coke's concerns.

IV. Human rights³⁹

Water is an essential human right, and it is also of vital importance for the realization of other human rights. Specific applications of human rights legislation may be difficult to find in practice, but the water sector may indeed be one where human rights law can have an impact on people's lives. This possibility has, in fact, been expressly recognized in a water supply and sanitation services case in Argentina: "The factor that gives this case particular public interest is that the investment dispute centers around the water distribution and sewage systems of a large metropolitan area, the city of Buenos Aires and surrounding municipalities. Those systems provide basic public services to millions of people and as a result may raise a variety of complex public and international law questions, including human rights considerations" (Salacuse, Kaufmann-Kohler and Nikken, 2007).

What might these considerations be? A first consideration is the human right to clean and safe water. This right, now emerging more clearly as a human right (Salman and McInerney-Lankford, 2004), can be understood as setting a basic requirement for water service providers. In essence, by taking on the right to deliver water, they also take upon themselves the obligation to meet basic human rights in relation to the right that they exercise. The growing recognition is reflected in a number of international standards that consider multinational corporations to be obligated to comply with basic human rights standards, which adds weight to this approach (for example, the OECD Convention on Combating Bribery of Foreign Public Officials

³⁹ This section is based on Mann (2006a).

in International Business Transactions and the United Nations Convention against Corruption). At a minimum they spell out a clear link of business responsibilities, and hence go directly to the question of balancing the legitimate expectations of foreign investors with the legitimate expectations of the public from them.

Unlike other areas of law where it may be easier to contract out of certain obligations, or to limit State acts to levels below international obligations, it is arguable in the water context that this obligation cannot be contracted out of. The concept of an international obligation *erga omnes* or an obligation that has risen to the level of *jus cogens*, obligations owed to all humankind that cannot be derogated from, would be relevant here.⁴⁰ As water is a basic necessity of life, the consequences of allowing a contract or international investment agreement to be read as a contracting out of such a right are significant and obvious.

A second area where human rights laws may be relevant is in the protection of indigenous peoples. The special situations of indigenous peoples in many cases have been recognized in international human rights documents. This can be relevant, for example, in assessing water rights as between a foreign investor and an indigenous community. Often, the water rights of the latter have not been codified in any way. Drawing on the special recognition of indigenous people's status in international law may add weight to the argument that their rights are nonetheless cognizable in law and cannot be diminished by the needs of foreign investors, or at least not without their consent. Similarly, the right to receive clean and safe water may be heightened by the historical or traditional claims of indigenous peoples.

A number of human rights issues associated with foreign investment have arisen over time and are likely to emerge in the future. Water supply services may not be in accordance with human rights standards, or human rights may be violated, for example, by foreign investors polluting the environment or the water supplies, or employing child labour, or utilizing water on indigenous lands, without respecting their rights (Kriebaum, 2007). There may also be other areas of conflict between human rights and foreign investment protection.

For example, human rights can become an issue when a company pollutes its surroundings so heavily that it affects the rights to a home, to privacy and family life of persons living in its neighbourhood (Kriebaum, 2007): "These rights are for instance covered by ... the European Convention on Human Rights ... They have been successfully invoked with regard to pollution by waste treatment facilities and fertilizer factories ... The European Court of Human Rights in *López Ostra v. Spain* dealt with a case where a private waste treatment plant that was built on public land, had received public subsidies, had an operation permit and polluted the environment to an extent that the health of the persons living in the neighbourhood was at risk. The Court stated that the State had a positive obligation to protect the applicant's right to respect for her home and her private and family life. Thus the State had to balance these interests with the municipality's interests to operate the waste management facility. The Court held that the municipality violated this right by not striking a fair balance between these conflicting interests". In contrast, in *Técnicas Medioambientales TECMED v. Mexico*, the tribunal found a violation of the expropriation norm contained in the bilateral investment treaty (see Box 16).

An important complicating factor with respect to social, cultural and economic rights is linked to the lack of international mechanisms for considering individual complaints covering all aspects of human rights: "As a consequence, an exact delimitation of the concrete obligations of States is still missing" (Kriebaum, 2007).

⁴⁰ An obligation *erga omnes* is one that is owed by a State to all other subjects of international law, irrespective of whether they have signed a formal treaty with all or the status of individuals as citizens or not of that State. An obligation that has risen to the level of *jus cogens* is one that, in accordance with the Vienna Convention on the Law of Treaties, cannot be contracted out of by States in a treaty; any such contracting out is deemed invalid under international law.

Box 16

TÉCNICAS MEDIOAMBIENTALES TECMED V. MEXICO

In August 2000, Técnicas Medioambientales TECMED, a company incorporated in Spain, submitted before the International Centre for Settlement of Investment Disputes (ICSID) a request for arbitration against Mexico. On February 6, 1996, TECMED acquired through a bid procedure the land, buildings and other assets to operate a hazardous waste landfill in Hermosillo, Sonora, Mexico. The dispute concerned Mexico's denial in November 1998 of a license renewal for the operation of this hazardous waste landfill. TECMED brought a claim pursuant to the bilateral investment treaty for alleged violations by Mexico of the treaty provisions regarding expropriation, fair and equitable treatment and full protection and security.

The tribunal first examined the question of an alleged expropriation under the bilateral investment treaty. The claimant's key contention was that the Mexican authorities, by denying the renewal of the license to operate the landfill, expropriated its investment, causing damages to TECMED. The tribunal considered that a measure could be a *de facto* indirect expropriation by its effects when the measure was adopted by the State, whether being of a regulatory nature or not, was permanent and irreversible, and the assets and rights object of such a measure were affected in such a way that was impossible to exploit such assets and rights, thus depriving them of any economical value. It also stated that a regulatory measure could be an indirect expropriation by its characteristics when there was a lack of proportionality between the measure, the interest sought to be protected by such a measure and the protection of the investment, and as a result the economic value of the investment was destroyed.

The tribunal concluded that the decision of the Mexican authorities was: (i) by its effects a *de facto* indirect expropriation, i.e., the investment was permanently deprived of economic value and could not be exploited; and (ii) by its characteristics was also an indirect expropriation, i.e., the means used by the Mexican authorities did not keep a reasonable proportionality between the interest protected (the environment) and the protection of the investor's rights (TECMED was deprived of operating the landfill and lost thereby its investment). The tribunal pointed out the lack of proportionality between the interest pursued and the permanent loss of the economical value of the claimant's investment. In this regard, it considered the following facts: (i) although TECMED had committed breaches to the environmental regulations, the Mexican authorities at the time of the breaches considered them as minor; (ii) the social opposition to the operation of the landfill never amounted to a social unrest; and (iii) TECMED had agreed to relocate the landfill and was waiting for new land that the Mexican authorities would provide. The tribunal finally concluded that the respondent by expropriating *de facto* the claimant's investment and not paying an adequate compensation violated the bilateral investment treaty.

The tribunal then examined the question of an alleged violation of the standard of fair and equitable treatment. The tribunal explained that fair and equitable treatment standard was based on the principle of good faith, and therefore that provision implied that the conduct of the State needed to be coherent, without ambiguities and transparent in relation to the investor. The tribunal found that the conduct of the Mexican authorities violated that provision, pointing out in particular that they had acted in a contradictory way, by, on the one hand, reassuring TECMED that they could operate the landfill until the relocation was conducted and that new land would be provided together with licenses to operate the new landfill, and, on the other hand, denying the renewal of the license.

The arbitration tribunal dismissed the claim regarding the alleged violation of the provision on full protection and security and non-discriminatory treatment. It considered that Mexico acted in an appropriate way in connection with the demonstrations by the public against the operation of the landfill by TECMED. The tribunal further indicated that the full protection and security guarantee was not absolute and did not impose strict responsibility on the State.

Source: Alvarez (2004).

Moreover, foreign investors may challenge human rights-inspired regulations that interfere with their investments by resorting to bilateral investment treaties. And here is where bilateral investment treaties, foreign investor rights (property protection, fair and equitable treatment, etc.) and human rights will eventually collide.

Investors are protected from expropriation. However, the limit between expropriation and legitimate regulation is blurred, at best (see Box 17), and complicated by different doctrinal (and lobbying) positions, contradictory decisions, and lack of an authoritative system of appeals to force the unification of jurisprudence.

A. The “police power” doctrine

For the “police power” doctrine, *bona fide* regulation within the limits of police power is a legitimate exercise of police powers, according to decisions such as *Methanex Corporation v. United States*: “But as a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and, which affects, inter alios, a foreign investor or investment is not deemed expropriatory and compensable unless specific commitments had been given by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulation” (Rowley, Reisman and Veeder, 2005). In this case, a measure for a public purpose, non-discriminatory, without specific commitments, was found legitimate, and not expropriatory. The doctrine was reinforced in *Saluka Investments v. the Czech Republic* (Kriebaum, 2007), where it was sustained that “It is now established in international law that States are not liable to pay compensation to a foreign investor when, in the normal exercise of their regulatory powers, they adopt in a non-discriminatory manner *bona fide* regulations that are aimed at the general welfare” (Watts, Fortier and Behrens, 2006).

B. The “sole effects” doctrine

Under the “sole effects” doctrine, the determining factor whether an indirect expropriation has occurred is solely the effect of the governmental regulatory measure on the investment (Kriebaum, 2007). The purpose of the governmental regulatory measure is irrelevant for the determination whether an expropriation has occurred, and the only important consideration is the effect on the investment. We have already seen how this kind of approach conflicts with the takings doctrine in the United States, a country known for its regard for private property.

The sole effects doctrine was applied with full force in *Metalclad Corporation v. Mexico*, where the tribunal stated that: “expropriation under NAFTA includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favour of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State. By permitting or tolerating the conduct of Guadalcazar in relation to Metalclad ... Mexico must be held to have taken a measure tantamount to expropriation in violation of NAFTA Article 1110(1) ... The Tribunal need not decide or consider the motivation or intent of the adoption of the Ecological Decree. Indeed, a finding of expropriation on the basis of the Ecological Decree is not essential to the Tribunal’s finding of a violation of NAFTA Article 1110. However, the Tribunal considers that the implementation of the Ecological Decree would, in and of itself, constitute an act tantamount to expropriation” (Lauterpacht, Civiletti and Siqueiros, 2000).

Box 17

GENERAL MARGIN OF APPRECIATION DOCTRINE IN INTERNATIONAL LAW

In an award rendered on 6 February 2007, an International Centre for Settlement of Investment Disputes (ICSID) tribunal held Argentina liable for breaches of the Germany-Argentina bilateral investment treaty in relation to its treatment of an investment by German multinational Siemens. When it came time to assess the compensation owing to Siemens, lawyers for Argentina invoked international human rights law in an effort to argue that governments ought to be entitled to pay less than “fair market value” for expropriated property where compelling social reasons lay behind a government’s actions. The tribunal summarized this argument as follows: “Argentina argues that the fair market value of an expropriated property as the measure of compensation for an expropriated investment is not always applicable when an expropriation becomes necessary for social policy reasons. If this would not be the case, it would be a serious limitation on State sovereignty, and no social or economic reforms could be accomplished by poorer nations”.

However, the tribunal rejected this argument by Argentina — dismissing, for example, the relevance of Argentina’s efforts to invoke the jurisprudence of the European Court of Human Rights (ECtHR) — whose case law has permitted lesser compensation to be paid in some cases where property deprivations were motivated by compelling social reasons. The Siemens tribunal remarked, without further elaboration, that the European Convention on Human Rights affords a “margin of appreciation” not found in customary international law or the Germany-Argentina bilateral investment treaty. So, what is the concept of margin of appreciation?

The margin of appreciation doctrine establishes a methodology for scrutiny by international courts of the decisions of national authorities — i.e., national governments, national courts and other national actors. While the case law of the ECtHR and other international tribunals on the contours of the doctrine is somewhat inconsistent, two principal elements may be identified:

- **Judicial deference** — international courts should grant national authorities a certain degree of deference and respect their discretion on the manner of executing their international law obligations. Thus, international courts ought not to replace the discretion and independent evaluation exercised by national authorities — i.e., refrain from reviewing national decisions *de novo*. Rather, international judicial bodies should exercise judicial restraint.
- **Normative flexibility** — international norms subject to the doctrine have been characterized as open-ended or unsettled. Such norms provide limited conduct-guidance and preserve a significant “zone of legality” within which States are free to operate. Consequently, different national authorities, in distinct States, could conceivably reach different, yet lawful decisions regarding the application of the same international norm.

Although these two elements are analytically separable — the first element primarily relates to norm-application, while the second to norm-interpretation — international courts have not always distinguished between the two. Furthermore, the two elements intertwine: the construction of international norms in an ambiguous manner might facilitate the exercise of judicial deference and vice versa. Hence, the policy rationales that support granting national actors some deference and those which sustain judicial acknowledgement of normative ambiguity reinforce one another.

However, it must be stressed that the margin of appreciation afforded to States is never unlimited — i.e., there is no total deference to the national decision-making process. First, States must always exercise their discretion in good faith. Second, international courts are ultimately authorized to review whether national decisions are reasonable — namely, whether the course of action selected by the State conforms with the object and purpose of the governing norm. This might include *inter alia* assessment of the national decision-making process (for instance, whether all pertinent considerations were taken into account) and the substantive outcome (for instance, whether the decision promotes the attainment of the overarching norms). Hence, the margin of appreciation doctrine does not preclude judicial review, but rather works to limit its scope of operation.

Source: Shany (2005); Peterson (2007d) and (2007e).

In *Técnicas Medioambientales TECMED v. Mexico* (see page 59), the tribunal held that: “Under international law, the owner is also deprived of property where the use or enjoyment of benefits related thereto is exacted or interfered with to a similar extent, even where legal ownership over the assets in question is not affected, and so long as the deprivation is not temporary. The government’s intention is less important than the effects of the measures on the owner of the assets or on the benefits arising from such assets affected by the measures; and the form of the deprivation measure is less important than its actual effects” (Grigera, Fernandez and Bernal, 2003).⁴¹

Neither governments nor foreign investors can be sure of the decisions of international arbitrators, both facing uncertainty. And there is a lack of interface between human rights and foreign investment protection. Bilateral investment treaties do not typically contain special considerations for human rights, or rules for conflicts between foreign investments and human rights. There are no individual complaints procedures with regard to economic, social, and cultural human rights and their monitoring is relatively weak. In the present international arbitration system, foreign investors cannot be held accountable by individuals for violations of human rights. There are no institutions before which foreign investors, as such, can be brought.

⁴¹ According to Kriebaum (2007), in this case, “After having examined the impact of the measure upon the investment, the Tribunal assessed whether the impact of the interference was proportional to the measure’s stated aim (protection of the environment and public health) and found that this was not the case. Therefore it did not only rely on the impact of the measure but also on its purpose. Hence, it also included human rights considerations in balancing the various interests at stake”.

V. Enhancing the role of the general principles of law

A. The issue of expansive interpretations

Some of the expansive interpretations applied by international arbitration tribunals go against the grain of national public interest legislation. This concern has been expressed, for example, by some governmental authorities and legal experts in the United States, where international investment decisions in such important matters as expropriation and fair and equitable treatment are perceived to go much farther than national law and jurisprudence on the same subjects (see Box 18 and Box 19).

In the case of *MTD Equity Sdn. & MTD Chile v. Chile* (see page 40), the company invoked all the grounds for indirect expropriation, but the arbitration tribunal rejected them all but one: that it did not receive fair and equitable treatment. The tribunal concluded that in approving the investment the government should have warned the company that the land was zoned for agricultural use, even though foreign investment contracts do not relieve the investor of investigating whether other laws apply. In sum, the tribunal found that any government official in carrying out his or her public duties commits a government. In the view of the government of Chile this is a dangerous precedent (Culagovski, 2007). There seems to be potential for corruption and abuse, since “privatization and the introduction of independent regulators have, at best, only partial effects on the consequences of corruption for access, affordability, and quality of

**UNITED STATES: EXCERPTS FROM A LETTER BY CHRISTINE GREGOIRE,
WASHINGTON GOVERNOR, TO ROB PORTMAN, U.S. TRADE REPRESENTATIVE**

I am writing to express my strong concerns over the investor-State dispute provisions of recently enacted and proposed international trade agreements. These investment provisions are not an appropriate model. They should be significantly revised to bring the rights of foreign investors in line with those accorded to domestic investors under the United States Constitution.

I am extremely concerned about the potential impact that the investor-State dispute mechanism will have on policies essential to the public interest, including those relating to environmental protection, public health and safety, workers' rights, and consumer protection. The investor-State dispute resolution mechanism of the North American Free Trade Agreement (NAFTA) (Chapter 11) has been used to challenge government measures designed to safeguard the public interest in areas such as these. Originally, the mechanism was created to ensure that investors would be protected from illegitimate direct seizures and expropriations of their property. It since has taken on a far broader role and now enables foreign investors to challenge traditional regulatory actions — even when those provisions do not appear to contain any language that discriminates against them.

It is deeply troubling that foreign investors can use this mechanism to bypass domestic courts to directly challenge legitimate and broadly applicable government measures before international arbitration panels. It is one thing for individual commercial enterprises to settle business disagreements through private dispute resolution. It is quite another for governments to leave determination of the validity of their regulations to *ad hoc* bodies — entities that have no settled body of law to rely upon and to apply, no life-time tenure to ensure their independence, and no appellate mechanism that can be used to review their decisions and assure uniform outcomes and analyses.

In response to concerns over NAFTA Chapter 11, Congress included language in the Trade Act of 2002 that directed future trade agreements not to provide foreign investors with “greater substantive rights” than those accorded to United States citizens under domestic law. Despite this guidance from Congress, it appears that United States trade negotiators have failed to adequately address this matter in the investment chapters of recently enacted and proposed trade agreements. Under the Central America Free Trade Agreement (CAFTA) and the Moroccan Free Trade Agreement, for example, the type of property eligible for regulatory takings includes the “expectation of gain or profit” and the “assumption of risk”. This definition is far broader than that found in the United States law, which to a large degree is restricted to real property.

The investment provisions of recent trade agreements also allow the investor to argue for compensation even when the measure causes only a “significant” or a “substantial” reduction in the value of the property. By contrast, United States courts require the value of the property to be almost completely destroyed or demonstrate a compensable taking. As a result, foreign investors can challenge many more regulatory actions in lawsuits that, if filed by a domestic investor, would be considered frivolous.

Until these critical problems are addressed, foreign investors will continue to seek compensation whenever their interests have been hurt by regulations that fall within the traditional scope of government authority. And, unless the current model for resolving investment disputes is significantly altered, federal and state governments will find it difficult to protect our environmental, health, and safety laws.

Again, I strongly urge that the investor-State dispute mechanism be revised to ensure that foreign investors are not granted greater substantive rights than domestic investors.

Source: Gregoire (2005).

Box 19

**UNITED STATES: EXCERPTS FROM THE “FREE TRADE AND FEDERALISM” POLICY
ADOPTED BY THE NATIONAL CONFERENCE OF STATE LEGISLATURES**

Following the passage of the North American Free Trade Agreement (NAFTA), several foreign investors have used the “investor-State” provisions of that agreement to attack state laws and state court decisions before an international tribunal. By providing access to international investment arbitration by foreign investors, NAFTA and various related free trade agreements provide greater procedural rights for review of claims against United States law and policy than would be provided to a United States investor under similar circumstances. Consequently, the decisions of these tribunals have had an adverse impact on state sovereignty and federalism. The ability of foreign investors to bring claims in front of an international investment tribunal, as opposed to through the United States courts, is clearly a greater procedural right than that enjoyed by United States investors; and the National Conference of State Legislatures (NCSL) is concerned that these tribunals, because they are frequently unfamiliar with United States federalism and jurisprudence, would in any case provide foreign investors with greater substantive rights.

Trade agreement implementing language must include provisions that deny any new private right of action in United States courts or before international dispute resolution panels based on international trade or investment agreements. Implementing legislation must also include provisions stating that neither the decisions of international dispute resolution panels nor international trade and investment agreements themselves are binding on the states as a matter of United States law. Implementing legislation for any agreement must include provisions that promote effective and meaningful consultation between the states and the federal government related to any dispute involving state law or any dispute that could prompt retaliation against states. It is imperative that when state laws are under challenge in international proceedings, the federal government defend state laws as vigorously as it defends federal law.

The federal government retains the power to sue a state to enforce international trade agreements. However, NCSL urges the federal government to assure states that the federal government will not seek to pre-empt state law as a means of enforcing compliance with an international agreement unless Congress has expressed clear intent to pre-empt state law in implementing legislation or other law. Likewise, the federal government must not withhold federal funds otherwise appropriated by Congress to a state as a means of enforcing compliance with provisions of an international agreement. Specifically, the federal government must indemnify the states for costs incurred relating to trade challenges and ensure that the federal government will not seek to use administrative measures to compel compliance or to pay a damage award.

Because the federal government retains the power to sue a state to enforce international agreements, federal legislation implementing any new trade or investment accord must include appropriate protections for the states related to rules of procedure, evidence, and remedies in such litigation. The federal government must bear the burden of proof in court showing that state law is inconsistent with an international agreement, regardless of the finding of an international dispute resolution panel. The President must be required, at least 30 days before the Justice Department files suit against a state, to file a report with Congress justifying its proposed action. In the event of an unfavourable judgment, states must be protected from financial liability. If the federal government agrees to allow foreign firms to collect money damages for “harm” caused by a state law, then the federal government must bear the burden of any such award by international tribunals and not seek to shift the cost to states in any manner. Additionally, state Offices of Attorney General must be fairly compensated by the federal government for the time and expense associated with defending against a foreign investor claim.

Source: NCSL (2007).

utilities services” (Estache, Goicoechea and Trujillo, 2006). A combination of moral hazard problems, that can encourage investors to avoid renegotiation even at the expense of project failure, and corruption, may explain the rescission of some recent international public utilities contracts. In some of these cases, sectoral lobbies have convinced governments to denounce contracts, in circumstances that raise serious doubts regarding the legal and economic wisdom of doing so.

As the jurisprudence of international arbitration courts enters into national jurisdictions, with expansive interpretations regarding issues as important as most-favoured-nation, expropriation, and fair and equitable treatment, it becomes obvious that the gaps between national and international law will become a likely concern of more and more countries. There are several reasons, substantive and procedural, to be concerned:

- National law looks for balance and sustainability, while international investment law is concerned only with foreign investor protection.
- Since the time of the Romans, national law has evolved from rigid contractual considerations to systems where public interest and policy provisions temper and amend the contents of actual contracts, whereas investment law is contractual at heart. In *AES Corporation v. Argentina*, the court observed that each bilateral investment treaty has its own identity and its very terms should be carefully analyzed (Di Pietro, 2007).
- International arbitration procedures are only available to foreign investors. International arbitration may be a captive market. Each individual arbitration is an *ad hoc* event. Panel members have to be selected by both parties, but one party, and one party only, has the initial call: the foreign investor.
- As a result, “global investment rules lack mechanisms to generate a socially and politically responsive body of international civil or common law” (Wells and Ahmed, 2007).

1. Substantive considerations

The concern with balance in national law is best seen in regulatory cases related to tariff adjustment or public controls at times of national crisis. There is only one case, in international investment arbitrations related to Argentina, where an economic crisis is individually considered a reason, *per se*, to refuse, in part, the pretensions of the claimant (see page 41).⁴² Other cases, where claimant’s pretensions have been reduced by international arbitration courts, have resorted to the conduct of the claimant for justification, rather than solely to the objective requirements of a situation of economic crisis.

Contract law has evolved over millennia to reach a fair balance between objective theories of contract and the multiple reasons for which one of the parties in a contract may be at a

⁴² In a ruling dated May 22, 2007, an ICSID tribunal held Argentina liable for violating treaty obligations to provide fair and equitable treatment and to observe (contractual and legal) obligations owed to Enron: “As a result, the tribunal held that Enron was entitled to fair market value compensation for losses suffered as a result of emergency legal and regulatory measures taken by Argentina arising out of that country’s earlier financial crisis. The ruling is the third ICSID award on the merits against Argentina in relation to a financial crisis claim by a multinational investor ... The ... Award in the Enron case is the second of three ICSID rulings which have determined ... that Argentina was not entitled to a defence of ‘necessity’ under international law in relation to its actions during the financial crisis — a defence which Argentina argued could have absolved it in whole, or at least in part, of liability for breach of investment treaty obligations owed to foreign investors. In rejecting the necessity plea, the Enron tribunal diverged from the approach taken in an arbitration resolved last October ... [see page 41], where a separate ICSID tribunal held that Argentina was entitled to a defence of necessity in the face of a claim by ... LG&E ... In diverging from the LG&E approach and holding that Argentina was not entitled to a plea of necessity, the Enron award hearkens back to the reasoning adopted in a 2005 award in another investment treaty claim against Argentina brought by ... CMS Gas Transmission Company” (Peterson, 2007c).

disadvantage. Ignorance, unequal bargaining strength, unfair persuasion and undue influence,⁴³ duress, mistake, misrepresentation and non-disclosure, fraud, unconscionability, a hard look at the contents of adhesion contracts, are some of the institutions through which national law has tried to provide answers to situations requiring redress: “the agreement may be void, voidable, or reformable because it is contaminated by duress, undue influence, misrepresentation, mistake or unconscionability” (Calamari and Perillo, 1977). Such principles provide an umbrella of public policy institutions that protect the disadvantaged, the weak, and the uninformed.

Furthermore, national law, aware of the natural limitations of individual contracting when dealing with public interest issues, where the political economy of some activities confronts huge conglomerates and individual citizens, has radically altered the conditions of contracting by establishing, through regulation, the conditions, considerations, and contents of public utility services. The quality of such regulation is crucial to ensure equity and efficiency in the provision and the sustainability of services. This umbrella of principles is designed to protect the public. In addition, national legal systems usually establish the conditions under which a court will admit expropriation, lack of due process, and violations to equality principles. Since international arbitration tribunals are sovereign regarding each specific case, and they apply the reasoning of international law to questions that are essentially domestic problems, there is no certainty that they will take into account the umbrella principles designed to keep balance in national law.

Moreover, there are no indications that international arbitration tribunals take into account the quality and the context of privatizations, and the process through which public utility regulations and contracts were put in place. If at times some of them do so, there is no policy rule applicable across the board, since each tribunal is sovereign in each particular case. Neither is there a duty to consider the substantive quality of regulation as an element determining allocation of risks and benefits, and equality, or lack thereof, among the parties to a public utility contract. This may be against the interest of developing countries, which were persuaded to privatize, within very short periods of time, considering that many cases before international arbitration courts deal with failed privatizations. Such failed privatizations represent the most important public services that governments have to guarantee to their citizens, such as drinking water supply, electricity, sewerage, transportation, telephones, etc.

The “sanctity of contracts” is the standard under which the international arbitration system operates. Yet, critical thinking based on experience and national precedent, indicates that under a number of conditions (changed circumstances, unconscionable terms, public policy, compulsion, corruption, inconsistency, asymmetry, moral hazard, etc.), contracts and other aspects of property rights may not be held sacred: “The ‘magic’ of property rights in the industrialized countries comes not from their being absolute, but rather from a balance between individual or corporate rights and fairness, and, especially, overall economic benefits. That balance is regularly fought over ..., but the battles are engaged in forums that enjoy broad public acceptance” (Wells and Ahmed, 2007). International arbitration, as conceived today, does not address these fundamental issues.

2. Procedural considerations

Most countries in the world share some common characteristics in the organization of their judiciary. Such characteristics result from experience. Judges are normally designated in agreement between the executive and the legislative branches of government. They are not paid by either of the parties. Tribunals pre-exist cases and there are precise rules on jurisdiction, which judges cannot alter at will. Any possible party can resort to the existing tribunals. There are systems of

⁴³ “Euphoria rather than fear is often, but certainly not always, the state of mind of the party unduly influenced” (Calamari and Perillo, 1977).

appeals. Judges are not presumed to be infallible. In order to ensure independence and equanimity and to prevent conflicts of interests, judges are not allowed to represent private parties.

Moreover, they can resort to *jura novit curia* — the court knows the law — to identify applicable law, having considerable discretion in this respect. In addition, most systems have principles and procedures to unify jurisprudence, which are obviously alien to international investment arbitration, since each arbitration tribunal is sovereign and different solutions may be chosen for resolving the same problem (Di Pietro, 2007). Because there is no system of appeals, and each decision is sovereign, there is no certainty regarding the arbitrator's application of principles and criteria intended to protect the public, although there are a number of cases where public interest, and other considerations favourable to countries, have been applied.

The investor-State process can be initiated, usually, by the foreign investment or by an investor, including a minority shareholder in a company (Mann, 2004). In some cases, both an investment and an investor have initiated proceedings, and in one well known case, this has led to two different results. One was a finding of no fault by a country, while the second was a finding of a breach of an investment agreement and an award of over US\$ 300 million to the investment. Despite the conflicting results, the finding of culpability held and the award has been enforced.

The odds against the standardization of principles protecting States and their populations are reinforced by the excessively expansive interpretation of foreign investor rights. Interestingly, this expansive interpretation is the result of decisions, which do not relate their content to either State practice, or the internal national law of sets of representative States. It is, rather, a circular evolution that takes place on its own, resulting from the decisions themselves. The legitimacy of the procedure has been questioned, as has been discussed above.

Lacking non-ambiguous treaty provisions or international custom, the accepted practice in international law is to resort to the notion of actual minimum threshold, when trying to provide commonality contents to standards with some pretension of universality. The procedure is to identify and assess coincidences among national legislation through comparative law analysis. The criteria to be applied are restrictive. Only common grounds would be part of accepted international principles (Permanent Court of International Justice, 1926).

Thus, foreign investor protection principles result from agreements between States, but their content, scope, and extension must be related to either agreements or international practice (i.e., actual State conduct). Lacking both, content should logically result from principles of law commonly accepted by relevant national systems. Otherwise, host States would in fact be surprised by the expansive interpretations of international arbitration courts, which are difficult to justify, except on advocacy grounds.

There are no rational grounds for legitimating praetorian interpretations that significantly depart from shared national standards when the issues addressed have long been part of national decisions and are only recently becoming a substantial part of international law. This takes us back to Judge Coke and Dr. Bonham (see page 55). There are no objective reasons why international decisions regarding expropriation or due process should go beyond the shared thresholds of relevant national legal systems, particularly when such systems have been sustainable and have consistently ensured respect for basic investor rights.

Because the role of international arbitration courts has expanded into domestic area, these tribunals should consider in detail general principles of law accepted by nations regarding the above-mentioned principles, and enhance, their role in these decisions. Otherwise, by creating gaps between their decisions, and principles of national law, such as the ones identified in relation to regulation of public utilities, water resources management, expropriation, and due process, they will, in protecting only particular stakeholders, increase inequity, inefficiency, and possibly

corruption. It may be advisable to draw inspiration from the *jus gentium* of the Romans, a system of equity, based on principles of law common to all civilized peoples, rather than on privileges or the need to protect special subjects.⁴⁴

B. International principles of law on water and related public services

1. Water resources

Most legal systems in the world share the following principles (Solanes and Jouravlev, 2006; Solanes and Getches, 1998; Solanes and Gonzalez-Villarreal, 1999):

- Water belongs to the public domain of the State.
- Water uses are allocated by governments, with exceptions for common uses for basic needs.
- Water rights are subjected to conditionalities, including the requirement of effective and beneficial use.
- The establishment of a system of preferences, related to either type of use (drinking water supply) or time (first-in-time first-in-right), or both.
- The acceptance of and respect for uses and rights, including traditional and indigenous uses, pre-dating legal change, without this affecting the possibility of imposing appropriate regulations.
- Governments have a right to regulate water resources, even after rights have been granted or uses have been instituted.
- Provided there is no functional curtailment of the economic value of water rights, the laws may allow for the exercise of these rights to be generally regulated as needed for ecological and social sustainability, and in the public interest.
- Governments have a right to establish, as a condition for the acquisition and maintenance of water rights and discharge permits, that their holders have to pay the corresponding financial charges.
- There is no vested right to pollute or contaminate water resources.
- Polluters can be forced to remediate, and pay for, the pollution they cause.

2. Regulation of water utilities

There are a number of regulatory principles that may be considered as shared by a relevant number of nations with mature regulatory systems. They include (Mann, 2006a; Solanes and Jouravlev, 2006):

- Universal and non-discriminatory service; and service to the poor.

⁴⁴ “The early Roman law (the *jus civile*) applied only to Roman citizens. It was formalistic and hard and reflected the status of a small, unsophisticated society rooted in the soil. It was totally unable to provide a relevant background for an expanding, developing nation. This need was served by the creation and progressive augmentation of the *jus gentium*. This provided simplified rules to govern the relations between foreigners, and between foreigners and citizens ... The progressive rules of the *jus gentium* gradually overrode the narrow *jus civile* until the latter system ceased to exist. Thus, the *jus gentium* became the common law of the Roman Empire and was deemed to be of universal application” (Shaw, 1997).

- Efficiency and due diligence.
- Transparency, appropriate information and regulatory accounting.
- Good faith.
- Reasonable tariff levels and returns to investment, in relation to the economic needs of consumers and of efficient system operators.
- Use of essential facilities.
- Adequate quantity and quality of service; maintaining safe drinking water quality.
- Appropriate levels of indebtedness and reinvestment.
- Tariff adjustments in times of crisis.
- Control of transfer prices.

Conclusions

The following conclusions can be drawn from the analyses carried out in this study:

- The global economy has generated a set of principles and procedures for the protection of international investment.
- While the principles to protect foreign investors are specific and well defined, there are no equally well-defined and specific sets of foreign investor obligations *vis-à-vis* host countries.
- As a result, the standard of reference for conflict adjudication is the protection of foreign investors. This creates moral hazard problems.
- Principles on foreign investor's duties and protection of host countries have sometimes been accepted by international arbitration courts, on a case-by-case basis, and without certainty regarding their application in similar cases.
- International arbitration tribunals are created by foreign investors and by investors only, for the protection of their particular interests. The lack of a compulsory system of appeals impedes the unification of jurisprudence.
- Both foreign investor protection principles and international arbitration tribunals have penetrated areas and functions traditionally belonging to national sovereignty and jurisdiction, without the checks and balances, and without

the values developed by national legal systems to preserve social peace, governance, and public welfare.

- There are already areas of tension between national legislation and international principles for the protection of foreign investors.
- There are gaps between national public interest legislation, such as the regulation of public utilities or the declaration of economic crisis situations, and international principles for the protection of foreign investors.
- While international arbitration courts may consider general principles of law developed by relevant legal systems, they are not compelled to apply them.
- In the present system for the protection of foreign investors, countries have no guarantees that their legitimate public interest concerns, public policies, and regulations will be considered or taken into account, including issues associated to human rights.
- Countries with weak governance, regulation, or economies face serious risk when opening their water-related sectors to foreign investment.
- Since the international investment protection system has entered areas and services traditionally reserved to national jurisdiction, there is an urgent need to develop compulsory principles to balance the application of foreign investor protection principles with parallel sets of foreign investor duties.
- Such balancing principles should be based on regulatory principles accepted by nations having good regulatory practices, and should also include standards regarding foreign investor obligations.
- International investment agreements could serve as an important invitation for States and companies to think responsibly by concluding contracts that can be reasonably adhered to. Another option is to introduce appropriate national legislation before agreements are signed.
- Present pressures to privatize water-related public services may be against the public interest in countries with weak regulatory systems, or unstable economies.
- Developing countries that open their water-related public services to international investment should first ensure the quality of their regulatory systems, reserve the right to improve their regulations according to regulatory principles accepted by relevant national legal systems, conduct adequate studies of economic affordability and sustainability, and include relevant foreign investor obligations in their contracts.
- There is an urgent need to begin a process of systematizing principles establishing the duties of those investing in water-related activities, especially public services.

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