# Will Investment Rules Shrink Policy Space for Sustainable Development? Evidence from the Electricity Sector

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## EXECUTIVE SUMMARY

Will the emergent international framework of international investment rules unduly constrain national governments' ability to make policy, and, ultimately, to govern? Negotiations on a multilateral investment framework and the expansion of the General Agreement on Trade in Services raise timely and important questions about the balance between investor rights and national space for policy development. This paper seeks to add depth to this debate by examining case studies of social and environmental policies in the electricity sector, as well as potential conflicts with current and proposed disciplines in the international trade and investment regime.

The cases in this paper demonstrate how effective promotion of sustainable development may require use of heterodox policy instruments. All of these policies have been motivated by legitimate public goals, and in many cases have met with a reasonable degree of success. Although a high degree of uncertainty in the electricity sector and in international investment negotiations makes our work inherently speculative, the cases and analysis presented in this paper suggest that investment rules could indeed shrink the policy space for sustainable development in the electricity sector.

To summarize the cases in brief:

- In Gabon, the government instituted a monopoly concession that bundled together the electricity and water sectors with incentives for service expansion, a policy that could conflict with GATS commitments on market access.
- In the 1930s, the United States government subsidized rural cooperatives to promote grid expansion, paving the way for universal electrification in the US, a policy that could conceivably be interpreted as discriminatory under the GATS.
- The US state of Arizona provided competitive advantages to local solar manufacturers in the form of a performance requirement to guarantee local economic benefits from renewable energy.
- The Government of Denmark introduced a discriminatory tariff that privileged purchases of electricity from locally-owned cooperatives, a policy inconsistent with the principle of national treatment.
- To mitigate a history of inequality, the Government of South Africa mandated ownership shares for black populations as part of public asset sales, and conditioned eligibility for government contracts on black ownership as part of a larger policy of "Black Economic Empowerment."
- The Government of Malaysia has conditioned industrial licenses on ethnic ownership guidelines, potentially diffusing political conflict among communal groups.
- To help resolve a financial crisis, the Government of Argentina imposed an electricity rate freeze and mandated renegotiation of utility contracts to spread the burden of crisis resolution to include foreign investors, a move that produced billions of dollars in claims for international arbitration under the terms of bilateral investment treaties.

These cases suggest that policies designed to integrate social and environmental goals into electricity governance could conflict with international investment disciplines. Proponents of investment rules argue that such conflicts could easily be avoided, since both the GATS and most proposals for a multilateral investment framework include a positive list approach, which allows countries to commit sectors gradually and exempt space for policies inconsistent with GATS norms. Yet for reasons explored in this paper, including inherent limitations on *ex ante* knowledge, governments may find that signing international investment disciplines do in fact reduce policy space for sustainable development.

Given apparent conflicts between investment disciplines and policies for public benefits in the electricity sector, this paper suggests a set of issues for careful scrutiny and consideration. A multilateral investment framework will be much more restrictive if it includes disciplines such as pre-establishment national treatment of investments, prohibitions on performance requirements, restrictions on indirect expropriation, and an investor-state dispute settlement mechanism. Likewise, GATS rules on subsidies and government procurement will intensify the regulatory rigor of an agreement that is already mandated to grow in sectoral coverage through the progressive negotiation of specific commitments.

Given its economic size, political sensitivity and environmental impact, sustainability in the electricity sector may require political compromises and innovative, heterodox policies. Restrictive investment rules could preclude the use of policy instruments that have been reasonably successful in a variety of contexts, making social and environmental goals more difficult to achieve. Based on these cases, the paper argues that investment rules would impose real constraints on policy space for sustainable development in electricity, and that the cost of foreclosing policy options could be significant.

## 1. Introduction

Will the emergent international framework of investment rules unduly constrain national governments' ability to make policy, and, ultimately, to govern? Critics of the World Trade Organization (WTO) argue that internationally negotiated disciplines shrink the "policy space" for development and, by extension, undermine national democratic processes.[1] Proponents of an international investment regime, by contrast, contend that such disciplines are necessary for expanded trade and investment, economic growth, and ultimately for development. Moreover, they argue that current and proposed policy instruments provide adequate flexibility to satisfy domestic political preferences. This discussion is particularly salient as delegates meet in Cancun to discuss whether, and how, to proceed with negotiation of a Multilateral Investment Framework (MIF) and to deepen and extend the General Agreement on Trade in Services.

In this paper we seek to inform this debate by asking: are there policies that national governments could reasonably seek to pursue that are hindered by international investment disciplines? By "investment disciplines" we mean not only a multilateral investment framework, but also negotiations on GATS rules, since the GATS affects certain kinds of investment through the inclusion of commercial presence as a mode of supply. We examine this question in the specific context of the electricity sector, with a particular emphasis on the social and environmental dimensions of electricity policies.

The electricity sector represents a particular challenge because it is in considerable flux. Electricity has long been managed as a public service, one with great social significance and a large environmental footprint.[2] In recent years the dominant model of a public vertically integrated utility has given way to a more fluid mix of public and private approaches, which includes a considerable role for private investment. Due to the central role of electricity in industrial economies, its networked characteristics, and its substantial social and environmental impacts, there remains a strong public stake in the terms and conditions under which the sector is owned and managed. Consequently, liberalization of investment in the electricity sector must address the continuing public interest in the sector and the current context of uncertain and rapidly shifting national regulatory environments.

In this paper, we draw on experiences in the electricity sector to develop illustrative cases of innovative national policymaking that have aroused discussion among electricity professionals, and then examine these through the lens of international investment rules. In particular, we examine these cases in the context of the General Agreement on Trade in Services (GATS) and a proposed Multilateral Investment Framework under discussion in the World Trade Organization. Given the shifting nature of what is considered good practice in electricity, and the scattered, amorphous and incomplete body of international investment rules, this exercise necessarily involves extrapolation. Our goal is to identify

[1] Sinclair, Scott. "GATS: How the WTO's New 'Services' Negotiations Threaten Democracy." Ottawa: Canadian Centre for Policy Alternatives, 2000.

[2] Indeed, as this paper is being written, we are reminded of this fact by reports of a power failure across the northeast United States, resulting in the breakdown of transport and communication networks.

potential points of friction in the application of innovative electricity policies, with a view to informing the debate on trade, investment and policy space for sustainable development. Our discussion hinges on two avenues of inquiry that are implicit in our central question. First, can policies that depart from neoliberal orthodoxy be considered "reasonable"? In other words, how broad is the set of policies that governments might reasonably wish to pursue? A second and related question is: how much room do investment negotiations provide in practice for governments to pursue pragmatic and innovative policies?

The cases developed in this paper support the conclusion that in order to create a socially progressive and environmentally sustainable electricity sector, countries may reasonably wish to pursue heterodox policies that run counter to investment disciplines. Specifically, these cases demonstrate how both industrialized and developing countries have used available policy space to build a domestic political consensus around environmental policies, to direct foreign capital to needed social and environmental ends, to address long-standing social inequalities, and to deal with external shocks. This paper further argues that proposed extensions to international investment rules are likely to shrink policy space for sustainable development, and that measures designed to provide flexibility, such as the "positive list" approach whereby countries gradually schedule commitments over time, may nonetheless prove to be unduly limiting in practice.

In the following section we describe the concept of "policy space" and discuss its connection to investment rules. Section 3 provides a brief introduction to recent electricity policy debates and their relation to the World Trade Organization. Section 4 discusses key disciplines in investment rules that may affect the electricity sector. The bulk of the paper is devoted to the case studies of electricity policy in Section 5. Section 6 provides a synthesis of the case studies, and Section 6 offers some concluding observations.

## 2. Investment Rules and Policy Space for Sustainable Development

Advocates for international investment rules argue that such rules would substantially improve global economic efficiency. According to proponents of a multilateral investment framework, international rules will "secure transparent, stable and predictable conditions for long-term cross-border investment, particularly foreign direct investment, that will contribute to the expansion of trade."[3] From this perspective, investment rules will reduce the scope for arbitrary, capricious and economically pernicious government actions, providing investors with more certainty and guarantees against risk. Likewise, supporters of stronger GATS rules propose that more stringent disciplines on trade-distorting or otherwise onerous policies related to services will reduce discrimination, facilitate domestic policy reform and generate economy-wide gains.[4] Those who promote

[3] See WT/WGTI/W/122, "Communication from the European Community and Its Member States: Concept Paper on Non-Discrimination," 27 June 2002.

[4] Adlung, Rudolf. "Services Trade Liberalization from Developed and Developing Country Perspectives" in Pierre Sauvé and Robert Stern, eds. GATS 2000: New Directions in Services Trade Liberalization. Washington, DC: Brookings Institution Press, 2000.

deeper and more rapid liberalization voice their support in the language of benefits: more integration means more stability, more efficiency, and more growth.

New investment rules may indeed deliver some of these benefits, although recent World Bank research suggests that investment treaties may not substantially increase investment flows to the country that adopts them.[5] However, benefits are only one side of the equation; the costs that accompany increasingly stringent rules also merit closer examination. Resistance to international rules is not a reflexive reaction against economic integration. Instead, it frequently stems from a desire to protect socially, politically and environmentally sensitive spaces for domestic policy. By construction, international commitments encroach upon domestic policy autonomy; hence arguments that multilateral investment rules may infringe upon "policy space."

In one illustrative exchange in the Working Group on Trade and Investment (WGTI), India noted that developing countries need "policy space" because there is "no single formula" for economic growth. Since multilateral disciplines reduce investment-related policy options as a means of promoting development, developing countries "must never subscribe to any doctrine that would limit policy flexibility in this important area".[6] In response, the European Communities argued that investment rules would leave sufficient "policy space for development," since many policies addressing basic structural deficiencies in national economies would be left unaffected.[7] Moreover, should countries choose to implement measures inconsistent with investment rules, they would be able to do so under a multilateral framework by scheduling exemptions. As this exchange suggests, countries differ as to how broadly the concept of policy space is defined, and the degree of flexibility individual countries would have, in practice, to make use of this space.

Our discussion of the need for policy space and how it might be used is informed by interpretations of recent economic history. During the 1980s and early 1990s, the crystallization of the "Washington Consensus"[8] around sound macroeconomic policies married to liberalization, privatization, and trade openness, formed a stringent one-size-fits-all development policy. The World Bank and the International Monetary Fund are commonly associated with the Washington Consensus, but the World Trade Organization's increasingly broad approach to trade liberalization also reflects this approach.

In recent years, however, the consensus has weakened in the wake of the several major financial crises, as well as the economic collapse of its most willing adherent, Argentina. An emerging literature now advocates heterogeneous and strategic development policies similar to those that were used by the East Asian countries and today's industrialized

[5] World Bank. Global Economic Prospects and the Developing Countries 2003. Washington, DC: World Bank, 2003.
[6] WTO document WT/WGTI/W/148.
[7] WTO document WT/WGTI/W/154 para. 6 and 7 and WT/WGTI/M19, para. 65.
[8] Williamson, John. The Political Economy of Policy Reform. Washington: Institute for International Economics, 1994.

nations.[9] While it retains some elements of the Washington Consensus, this approach emphasizes the role of domestic institutional innovations and policies that actively steer and channel investment. Stimulating successful economic development, from this perspective, requires the freedom to experiment and selectively intervene. The debate between proponents of orthodox, *laissez faire* policy on the one hand, and supporters of heterodox, potentially innovative, and strategic policy on the other, remains unresolved. Recent economic events, however, suggest that it is premature to close the door to the latter approach.

If promoting economic growth requires innovation and experimentation, doing so in a manner that is environmentally sound and socially equitable requires an even larger dose of creativity. In restructuring electricity sectors, for example, policymakers must balance incentives for profitability and efficiency against measures to promote access to electricity, ensure affordability, and minimize local and global air pollution. Such considerations are particularly necessary because liberalization of electricity and the introduction of competition are unlikely to address social and environmental considerations unless additional policy measures are taken.[10] The need for such measures is as great in industrialized countries as it is in developing nations.[11]

The cases in this paper demonstrate that active social and environmental policies in the electricity sector may conflict with the principles guiding investment rules. Supporters of these rules counter such claims by emphasizing that policy space can be preserved if governments bind sectors slowly and schedule exemptions for derogations in advance.[12] If this is true, then investment rules pose no danger to policy space. However, critics of international investment rules reply that a multilateral framework for investment is unlikely in practice to afford countries the flexibility to experiment with unorthodox but potentially effective policies for a wide variety of reasons.[13,14] These include:

1. **Limited *ex ante* knowledge.** The requirement that all exemptions be scheduled at the time of commitment implicitly presumes an inconceivable degree of *ex ante*

[9] See Rodrik, Dani. Making Openness Work: The New Global Economy and the Developing Countries. Washington: Overseas Development Council, 1997, or Chang, Ha-Joon and Duncan Green. "The Northern WTO Agenda on Investment: Do As We Say, Not As We Did." South Centre and CAFOD, June 2003.
[10] Dubash, Navroz ed. Power Politics: Equity and Environment in Electricity Reform. Washington: World Resources Institute, 2002
[11] Some in the trade community have suggested incorporating policy space into the concept of "special and differential treatment" to permit developing countries to take advantage of policies that build competitiveness and growth. This would represent a good first step, but the policy space is not just an issue of special and differential treatment for developing countries. In all countries, policy space can play an important role in promoting social integration, local development and active environmental protection. See Corrales-Leal, Werner; Mahesh Sugathan and David Primack. "Spaces for Development Policy: Revisiting Special and Differential Treatment." Paper prepared for the joint ICTSD-GP International Dialogue on *Making Special and Differential Treatment More Effective and Responsive to Development Needs*, held 6-7 May 2003, Chavannes-de-bogis, Switzerland.
[12] WTO document WT/WGTI/W/154 para. 6 and 7 and WT/WGTI/M19, para. 65.
[13] Hardstaff, Peter. "The 'Flexibility' Myth: Why GATS Is a Bad Model For a New WTO Investment Agreement." World Development Movement paper to Seminar on WTO Investment Agreement held in Geneva, March 20, 2003.
[14] Sinclair, op. cit.

knowledge about an infinite range of policies. Requiring countries to carve out space for all the potentially useful measures they may wish to enact in the future is unreasonably onerous. If our intrinsically imperfect understanding of the world is constantly evolving, the process of locking in commitments and exemptions today could preclude the development of sound policies using tomorrow's knowledge.

2. **Limited capacity.** Capacity restrictions exacerbate the *ex ante* knowledge problem. The burden of forecasting and scheduling the theoretically infinite range of potentially useful but inconsistent policies is difficult under any circumstances, but it is especially perverse from the perspective of countries that lack the US or EU's legion of trade negotiators, industry groups and network of research institutions.

3. **Technological change.** Technological change can quickly change industry fundamentals such that the assumptions underlying initial policy orientations are dramatically altered. The rise of combined-cycle gas turbine generation, for example, played a major role in the decline of vertically integrated monopolies in the electricity sector, but their ascendancy could not necessarily have been predicted.[15]

4. **Changing political contexts.** Governments and political preferences change over time, but the commitments and schedules they create at the international levels do not. If one government expresses its commitment to deep liberalization by scheduling a wide range of sectors with few protective exemptions, subsequent governments who have contrasting but legitimate views about social policy may find it difficult to cultivate space for inconsistent investment policies.

5. **Domestic policy coherence problems.** A recent study of electricity sector reform in developing countries found that environmental and social government ministries were rarely consulted or involved in decision-making related to the power sector.[16] Limited communication or consultation between various parts of governments means that commitments may not reflect concerns articulated by ministries and agencies responsible for social and environmental issues.

6. **Inflexibility.** Once made, commitments are extremely difficult to reverse. In the GATS, for example, commitments may not be suspended until three years have passed, and suspension requires negotiating compensatory adjustments in other sectors.[17] While this certainly helps create a stable policy environment, it also means that governments are locked into potentially damaging policy commitments even if unforeseen crises or developments arise. As we will see in

[15] Patterson, Walt. Transforming Electricity. London: Royal Institute for International Affairs, 1999.
[16] Dubash, Navroz ed. Power Politics: Equity and Environment in Electricity Reform. Washington: World Resources Institute, 2002
[17] See GATS Article XXI

the following section, the electricity sector is in rapid flux and has generated its share of unpredictable events.

7. **Progressive liberalization**. The "bicycle" metaphor for trade liberalization, which suggests that negotiations must continuously move forward or risk stalling, is reflected in the GATS,[18] which includes a mandate for progressive liberalization. Once established, an investment agreement might also facilitate continuous demands to broaden and deepen the coverage of disciplines.

These arguments suggest that adopting new international investment rules may result in a *de facto* loss of policy space. To ground this debate in concrete examples, we turn next to the case of the electricity sector.

## 3. Electricity Sector Reform and the WTO

The decade of the 1990s witnessed dramatic changes in what had long been a stodgy and static industry. Around the world, governments began reconsidering their ownership and control over large, monopolistic electricity systems. Over the preceding four decades, these systems had worked reasonably well in the industrialized world (although less well in the developing world), providing safe, reliable, and increasingly cheap power. This model was challenged by technological change, higher risks, stagnant demand, and a rising global ideological predisposition toward markets and competition. Reformers aimed to increase efficiency by subjecting the sector to competition. Despite the lack of a blueprint on how to achieve competition in the technologically complex and heavily networked electricity industry, the United Kingdom and Chile were the first to "unbundle" the various components of the electricity system, privatize generation and distribution businesses, and establish a market for upstream and downstream electricity services.

The approach spread rapidly, but for reasons not always related to a coherent vision of change for the electricity sector. Developing countries unbundled and privatized their electric utilities in order to shed debt-ridden public utilities, to minimize the drain on public finances, or to satisfy lending conditions imposed by multilateral donor agencies. In some cases, particularly in Latin America, economic performance in the sector has improved, but in others, these changes have led to political unrest without measurable improvements in the sector. Critics of liberalization have questioned its applicability to developing countries, where the most pressing problems are ensuring broad access to electricity and providing adequate and transparent regulation, rather than squeezing additional efficiency gains from a mature and established market. The disastrous collapse of California's electricity market also cast doubt on the long-term wisdom of power sector reform. These doubts were amplified by the dramatic implosion of the Enron Corporation, which pointed to underlying regulatory failures in the world's most sophisticated electricity market. At minimum, these experiences suggest that kinks persist

[18] See GATS Article XIX

in the market-led model, and that countries with less regulatory capacity would be well advised to proceed with caution, if at all.[19]

Perhaps most problematic for the new model, a slew of studies has documented that markets, left to their own devices, are unlikely to address legitimate social and environmental concerns in the electricity sector.[20] For example, the rural poor are unlikely to be attractive customers for private operators, since remote locations and low population densities make them costly to serve, and their low consumption does not facilitate adequate returns. From an environmental perspective, while the electricity sector has a large and dirty footprint, an effective transition to a clean energy future may have to move beyond end-of-smokestack regulation toward creative strategies of energy transformation. A recent World Bank review of a decade of private sector-led strategies for electricity concludes that poverty reduction and environmental objectives deserve considerably more importance in policymaking for the sector than has been the case thus far. For this reason, as well as because of uncertainties in the underlying model, the study concludes that "there is no 'one-size-fits-all' reform model and each approach should be country-specific."[21] In short, experimentation and heterogeneity are important ingredients of successful electricity sector policies.

When the electricity sector was run as a vertically-integrated, state-owned monopoly, questions of governing international private investment and cross-border trade in electricity did not arise. The recent emergence of electricity and electricity services as tradable products has brought the sector within the ambit of the WTO, but in ways that are, as yet, unclear. The implications of WTO rules for electricity policy depend on whether electricity is a good or a service. This is not just a semantic issue. Under the asymmetric trade rules of the World Trade Organization, the classification of electricity has serious implications for investors and policymakers alike. As a tradable commodity but one that cannot be stored, electricity shares some qualities with both goods and services. The World Customs Organization (WCO), to pick one widely cited authority, classifies electrical energy as a commodity, although this is an optional heading, and countries are free to classify it as a service if they so choose.[22] In the WTO context, some parties maintain that electricity is a commodity subject to rules under the General Agreement on Trade and Tariffs (GATT). The parties to NAFTA explicitly classified electricity as a commodity.

In the course of power sector reform, countries unbundled the electricity sector into constituent parts: generation, transmission, distribution, and supply. Each of these functions requires classification. Even if electricity is a commodity, transmission and distribution qualify as services subject to the General Agreement on Trade in Services (GATS). Particularly relevant is Mode 3 of the GATS, which covers "commercial

[19] Indeed, this is the view of a World Bank study on the California experience, Besant Jones et. al. "California Power Crisis: Lessons for Developing Countries," ESMAP Working Paper, 2001.
[20] Dubash (ed.) *Power Politics*, Wamukonya (ed.), 2003, *Electricity Reform: Social and Environmental Challenges* (UNEP), World Bank, 2003, *Private Sector Development in the Electric Power Sector*, OED.
[21] World Bank, 2003, *Private Sector Development in the Electric Power Sector*, OED, p. ix.
[22] WTO document "Energy Services: Background Note by the Secretariat," S/C/W/52, 9 September 1998.

presence" and hence a range of investment activity. Since generating electricity may be a manufacturing process, however, it may or may not fall within the ambit of the GATS. According to an UNCTAD report,

> "most agree that the production of primary and secondary energy does not constitute services subject to the GATS, but that it results in goods whose trade is regulated by GATT rules. Transportation and distribution, on the other hand, are commonly regarded as services."[23]

Despite this seemingly clear distinction, these classifications remain ambiguous, even to experts. In the same UNCTAD publication, the author notes that "Mode 3 [of the GATS] is of paramount importance since it covers all different forms of foreign commercial presence, such as BOT and IPP." Both of these models – build, operate, transfer and independent power producers, respectively – refer to aspects of power generation, which does not fall under the GATS if electricity is strictly defined as a commodity. Whether or not GATS applies to power generation is at once a definitional and a political issue that is difficult to resolve, particularly since the GATS offers no definition of "services".[24,25]

The only definitive conclusion observers can reach is that the classification of electricity is an evolving – and extremely political – issue. The GATS and GATT rules offer very different kinds of protection to investments, so classification is of great economic importance to foreign investors.[26] Though it may seem like an obscure definitional issue, classification will have real legal implications for investment in electricity and related services. In any case, evolving trade and investment rules will have significant implications for the future development of the electricity sector. In the following section, we will explore key components of international trade and investment rules that may have implications for sustainable development policies in the electricity sector.

## 4. Investment Rules and Sustainable Development in the Electricity Sector

Investment-related disciplines can be found in three functional parts of the World Trade Organization: in the Working Group on Trade and Investment (WGTI), which is spearheading preparations for negotiations on a multilateral framework for investment; under the Agreement on Trade-Related Investment Measures (TRIMs); and under the General Agreement on Trade in Services (GATS) as part of Mode 3, supply through commercial presence.[27] Two of these arenas remain active sites of negotiation. Members of the Working Group on Trade and Investment are engaging in detailed discussions

[23] Zarrilli, Simonetta. "International Trade in Energy Services and the Developing Countries" in UNCTAD, Energy and Environmental Services: Negotiating Objectives and Development Priorities. UNCTAD, 2002.
[24] Evans, Peter C. Liberalizing Global Trade in Energy Services. Washington: American Enterprise Institute, 2002.
[25] Tacoa-Vielma, Jasmin. "Defining Energy Services for the GATS: An Issue Under Discussion" in UNCTAD, Energy and Environmental Services: Negotiating Objectives and Development Priorities. UNCTAD, 2002.
[26] See WTO document "Energy Services: Background Note by the Secretariat," S/C/W/52, 9 September 1998.
[27] See http://www.wto.org/english/tratop_e/invest_e/invest_e.htm

about a possible multilateral framework for investment, while Members of the Committee on Trade in Services have a number of issues to resolve with respect to the depth and breadth of GATS rules, as well as ongoing negotiations on specific commitments. The Appendix to this paper explores these negotiating areas in detail and identifies restrictive, intermediate and flexible versions of disciplines under consideration.

Progress in both arenas raises a set of issues directly relevant to policy space for sustainable development. In the multilateral framework on investment, four issues of special importance stand out: commitments on pre-establishment national treatment; prohibitions on performance requirements; guarantees against indirect expropriation; and the imposition of international dispute arbitration. In continuing discussions on GATS rules, major issues of importance include disciplines on monopolies and policies related to market size and structure; domestic regulation, services subsidies, and government procurement. As the case studies that follow will demonstrate, negotiations on each of these issues may have serious implications for the electricity sector.

*Issues in a Multilateral Investment Framework*

- **National Treatment.** Should the principle of national treatment apply to investment, and if so, at which phase? National treatment means that government policies should extend foreign investors and investments treatment no less favorable than that accorded to domestic investors and investments. It can apply at the pre-establishment phase, which entails giving foreign investors rights of entry and establishment equivalent to those enjoyed by nationals, or at the post-entry phase, which extends national treatment to established foreign investors and investments.[28]

- **Performance Requirements.** Should performance requirements be permitted or prohibited under investment rules? Performance requirements are conditions that countries may attach to inward investment in order to maximize host-country benefits. Many investors find performance requirements, which may include local content, export or technology transfer requirements, both inefficient and onerous. In the past, however, countries have used performance requirements to encourage technology transfer, stimulate domestic industries through backward and forward linkages, and increase employment. Some performance requirements are prohibited under the Agreement on Trade-Related Investment Measures (TRIMS) and bilateral investment treaties.

- **Indirect Expropriation.** Most investment treaties contain language prohibiting expropriation of investments; many also include prohibitions on measures "tantamount"[29] or "equivalent"[30] to expropriation. Measures "tantamount" to expropriation may include regulatory, judicial or legislative decisions that have

[28] UNCTAD. National Treatment. UNCTAD Series on Issues in International Investment Agreements, 1999.
[29] See Article 1110.1 of the North American Free Trade Agreement
[30] See Article 15.6.1 of the US-Singapore Free Trade Agreement

the effect of diminishing the value of an investment. A Canadian gold mining company, for example, is presently planning a NAFTA lawsuit against the state of California, claiming that new environmental regulations on open-pit mining have substantially diminished the value of its investment.[31] This case and others from the NAFTA experience[32] suggest that language on indirect expropriation could make governments liable for incidental costs of environmental and other regulations.

- **Dispute Settlement.** What are appropriate dispute settlement procedures for investment-related conflicts? NAFTA and many bilateral investment treaties include provisions for investor-state arbitration, wherein investors can claim damages from alleged violations of treaty provisions. These provisions provide foreign investors with recourse to international arbitration if they are dissatisfied with the results of domestic dispute resolution procedures.[33] Investor-state arbitral provisions may mean that similarly situated domestic and foreign investors receive different treatment in the event of disputes with the state, since foreign investors alone can threaten to access international arbitration if domestic negotiations do not provide satisfactory solutions. This discriminatory treatment may persist even if the dispute settlement procedure is channeled through state-to-state arbitration.

*Issues in the General Agreement on Trade in Services*

- **Monopolies and Market Access.** The General Agreement on Trade in Services imposes market access disciplines that restrict the creation of monopolies and exclusive service providers in two places. In Article VIII, the GATS requires Members to notify the Council for Trade in Services if it creates any new exclusive service providers or monopoly rights in a committed sector.[34] This notification can trigger a requirement for compensatory adjustments that must be made before proceeding with the establishment of new monopolies. In Article XVI on Market Access, the GATS restricts the creation of limitations on the size or structure of markets, including a prohibition on monopolies and exclusive service providers.[35] These rules apply both to the creation of new national monopolies and the creation of monopolistic service areas at sub-national levels of government. While these rules are static, their coverage will evolve as negotiations under Article XIX on specific commitments achieve progressively greater sectoral coverage.

- **Subsidies.** Article XV, which falls under the general obligations section of the GATS, instructs negotiators to develop multilateral disciplines on subsidies with a

[31] Iritani, Evelyn. "Gold Firm Plans Suit Under NAFTA." *Los Angeles Times*, 20 August 2003.
[32] Commonly cited cases include *Methanex*, *Metalclad* and *S.D. Meyers*
[33] WTO document WT/WGTI/W/134. "Consultation and the Settlement of Disputes Between Members: Note by the Secretariat." 7 August 2002.
[34] See Article VIII.4 and VIII.5 of the General Agreement on Trade in Services
[35] See Article XVI.2a of the General Agreement on Trade in Services

view to eliminating their trade-distorting effects. Disciplines on subsidies would have immediate and obvious implications for energy service providers, but they could also have implications for investment policies by restricting policies through Mode 3 of the GATS, commercial presence. Discriminatory subsidies are relatively common public policy tools, and stringent multilateral disciplines could significantly impact their use.

- **Government Procurement.** While government procurement is already included in the WTO's plurilateral Agreement on Government Procurement (GPA), and transparency in government procurement is part of current multilateral negotiations, the framers of the GATS also included an independent track for negotiations on liberalizing procurement of services.[36] Article XIII, also framed as a general obligation, calls for multilateral negotiations on government procurement in services, which could bear directly upon government's ability to use procurement as an instrument to achieve national sustainable development objectives.

Negotiations on these new disciplines touch upon economically significant and politically sensitive policy measures, and the possibility exists that they may significantly encroach upon policy space necessary to achieve sustainable development. Supporters of new disciplines argue that conflict can easily be avoided because countries can schedule unlimited exemptions for policies inconsistent with investment rules. Critics respond that forward-looking exemptions alone do not sufficiently protect policy space. Determining who is right, however, requires more than conjecture. The case studies that follow attempt to add to the debate by highlighting reasonable sustainable development policies in the electricity sectors of both industrialized and developing countries. By analyzing provisions that could violate norms of existing and proposed trade and investment rules, the cases demonstrate that conflict between sustainable development policies and the emerging global trade and investment regime are potentially significant and a cause for concern.

[36] See Article XIII of the General Agreement on Trade in Services

## 5. Case Studies from the Electricity Sector

### 5.1. Access

Electricity delivers new benefits and opportunities, but only to those who are lucky enough to be plugged in. For the two billion people around the world who lack access to modern electricity services, however, dung, scrapwood and kerosene are among the only ways to cook dinner and illuminate the darkness. Expanding access to electricity improves health, local environmental conditions and educational opportunities, not to mention the fact that it frees people from the ceaseless, onerous task of gathering material to burn each day.[37]

An overwhelming proportion of households without electricity live in rural areas. Rural electrification offers new opportunities and capabilities to isolated communities, but it is unlikely to occur without government incentives and intervention. Remote and sparsely populated regions are technically difficult and expensive to electrify, so companies are often unwilling to initiate projects in these areas. Laying new infrastructure in isolated areas requires large initial investments that pay off only in the long run, a fact that deters investors with little patience or appetite for risk. Finally, rural populations are disproportionately likely to be poor and use relatively little electricity in the early stages of development. With low aggregate demand, they do not promise rapid and steady profits for utilities.

To surmount the difficulties inherent in rural electrification, governments and communities have developed a wide range of innovative – and often interventionist – tactics designed to expand access to modern sources of energy. However, successful programs and policies have frequently involved unorthodox solutions ranging from subsidizing non-profit cooperatives to bundling monopoly concessions across utility sectors. Many of these policies have departed from market-based intuition, and though they may not have been the only or the best solutions available to governments, they have achieved some measure of success. Yet some of these policies may conflict with international rules that apply to investment. The case studies in this section, which discuss rural electrification in the USA and Gabon, suggest that countries potentially require more space for policy innovation than emerging rules on services trade and investment may allow.

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**Rural Electrification in the United States**

Today's developed countries historically made use of interventionist and discriminatory policies to achieve rural electrification. In the late 1930s, urban Americans had modern amenities like pumped water and electric refrigerators, but their rural counterparts suffered from poor sanitation, poor diets and the drudgery of endless manual labor. Then, at the height of the Great Depression, rural electrification programs successfully

[37] United Nations Development Program. World Energy Assessment. New York: UNDP, 2000.

employed community-organized cooperatives to extend services to isolated areas through a mixture of government support and local initiative. This massive push toward state-led infrastructure development provided relief to Depression workers, laid the foundation for balanced regional development in the United States and brought modern services to some of the most under-served families in the country.

Under the aegis of the Rural Electrification Administration (REA), the American government created a system of subsidized loans and financial guarantees available on preferential terms to members of cooperatives.[38] To facilitate the extension of service to rural areas, funds earmarked for rural electrification projects were disbursed on a priority basis to public agencies and cooperatives. These funds were loaned at subsidized interest rates to make amortization less burdensome. Private companies and investors were eligible for these funds only after public bodies and cooperatives had borrowed what they needed. Since the scheme was regularly oversubscribed, the REA scheme was in practice a discriminatory measure that subsidized non-profit domestic service providers over their commercial counterparts. The REA measure was wildly successful, involving over 1,000 cooperatives that extended service to over 5 million households across the country.[39]

Rural electrification through cooperative subsidies is not a relic of the Depression era. In recent years, subsidizing rural cooperatives has emerged as a leading strategy for extending access in developing countries. For example, one highly successful rural electrification scheme in Bangladesh provides concessionary financing to electric cooperatives in addition to outright grants.[40]

Such programs could become more difficult to implement under increasingly stringent investment rules. While some international investment agreements "carve out" space to implement government grants and subsidy programs by exempting these instruments from national treatment obligations[41], it is conceivable that subsidy programs might face challenges in the future, either under new investment agreements or the General Agreement on Trade in Services. Subsidies are already considered "measures" affecting trade in services under the GATS[42], and Article XV of the GATS instructs governments to develop further multilateral disciplines on subsidies affecting trade in any of the modes of supply, including commercial presence. Furthermore, disciplines on subsidies apply equally to for-profit enterprises and non-profit organizations like electric cooperatives.[43]

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[38] Brown, D. Clayton. Electricity for Rural America: The Fight for the REA." Westport: Greenwood Press, 1980.
[39] Brown, op. cit.
[40] Khan, Shahidul Islam. "Protecting the Poor in the Era of Utility Privatization" in *Energy for Sustainable Development*, v.7 no.2, June 2003.
[41] See, for example, NAFTA Article 1108.7.
[42] Sinclair, Scott. GATS. Ottawa: Canadian Centre for Policy Alternatives, 2000. Also see the schedule of commitments under the GATS, in which several countries schedule exceptions for subsidy programs.
[43] Jackson, Andrew and Matthew Sanger. "When Worlds Collide: Implications of International Trade and Investment Agreements for Non-Profit Social Services." Ottawa: Canadian Centre for Policy Alternatives and Canadian Council on Social Development, 2003.

Though discussions on services subsidies are still at an embryonic stage, these negotiations could have considerable implications for subsidy programs such as extending credit to rural electrification cooperatives on favorable terms. Since cooperatives are generally owned and operated by the residents who consume the product, they are intrinsically domestic providers of potentially tradable services, and they therefore fall under commitments undertaken under the GATS.[44] As negotiators commence discussions on subsidy disciplines in the service sector, the potential for conflict with targeted subsidy policies could increase.

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**Rural Electrification in Gabon**

Due to sparse population patterns, rugged terrain and low purchasing power, modern electricity services may take decades to reach isolated communities. In Gabon, Chile and Argentina, however, preliminary experience with power sector reform suggests a possible model for successful rural electrification – and demonstrates the need for careful attention to the provisions of the General Agreement on Trade in Services (GATS).

Gabon has a per capita income of about $4,378 ($6,237 adjusted for purchasing power parity), but substantial parts of the country lack access to basic services like piped water or electricity.[45] This has started to change since 1997, when the government of Gabon concluded a competitive bidding cycle that awarded a 20-year exclusive concession to a consortium of French and Irish investors, Société d'Energie et d'Eau du Gabon (SEEG). Competition for the contract was intense because Gabon's water and electricity utilities were relatively well-run with bill payment rates approaching 93%, a rarity in the developing world.[46] The contract gives SEEG a geographically delimited monopoly over the provision of certain infrastructure services in parts of Gabon, and is linked to a strict set of performance criteria that include extending water and electric power to previously unserved households.

Under the competitively bid contract, which promised a 17.25% reduction in tariff rates relative to the previous service delivery regime, SEEG must invest a minimum of $135 million in infrastructure rehabilitation. But it must also meet strictly defined performance criteria for expanding the coverage of water and electricity services. For example, SEEG is contractually committed to increase water coverage in one district from 37.7% to 63% by 2015; during the same period, it is obligated to increase electricity coverage in underserved isolated regions from 0% to 54%. If it fails to meet these targets, SEEG

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[44] GATS Article XVII suggests that national treatment applies to policies "according to services and services suppliers of any other Member, either formally identical treatment or formally different treatment to that it accords to its own like services and service suppliers." Subsidies to cooperatives may not be facially discriminatory, but such subsidies make *de facto* distinctions between domestic and foreign suppliers, since cooperatives tend to be composed almost entirely of domestic residents who own and operate the investments they fund.

[45] World Bank data, taken from World Resources Institute, World Resources 2002-2004. Washington, DC: World Resources Institute, 2003.

[46] "Gabon Selects French/Irish Team For 20 Year Water and Power Concession." *International Trade Finance*, March 28, 1997.

faces stiff financial penalties equivalent to 25% of the investment shortfall in addition to the costs associated with meeting its contractual commitments.[47]

So far, the concessionaire has met or exceeded its obligations. SEEG has outperformed its coverage targets and has made excellent progress toward meeting its investment obligations. [48] Supply losses have diminished, while investment planning has increased in efficiency. The careful planning and execution of the infrastructure services concession in Gabon seems to have produced extremely promising results.

Chile and Argentina have also utilized the monopoly concessionaire model with some success. In Argentina, where over 90% of the population already has access to electricity, franchise rights for un-served rural areas are distributed through competitive bidding, with contracts awarded to companies willing to accept the lowest subsidy to electrify rural areas.[49] Likewise, distributors in Chile have been granted exclusive concessions to serve un-connected jurisdictions.[50]

The monopoly concession model encourages rural electrification by offering the exclusive right and obligation to serve all households in a particular geographic area. By bundling high-cost and low-cost connections together, monopoly concessions can make the overall concession package profitable even if connecting some of the constituent households would be cost-prohibitive on a case-by-case basis. Without exclusivity, private firms would evaluate each connection individually and connect only households where expected returns were high enough to make service attractive, making the rest even more difficult to electrify.

Policies like monopoly concessions can be accommodated within the framework of the GATS, but only by defending space for policy autonomy. Policy space can be preserved either by avoiding specific commitments in infrastructure services or by carving out specific exemptions in committed sectors. Given the built-in mandate to pursue progressively higher levels of liberalization in services[51], the former approach will become less effective over time. As more sectors are committed in progressive rounds of negotiations, the ability to derogate from the GATS will require increasingly extensive and rigorous *ex ante* attention to detail.

The importance of this concern is evident in the case of monopoly concessions. Article VIII of the General Agreement on Trade in Services disciplines the creation of new

[47] "French-Irish Team to Run Gabon's Main Utility." *FT Energy Newsletters – Global Water Report*, March 26, 1997.
[48] Tremolet, Sophie and Joanna Neale. "Emerging Lessons in Private Provision of Infrastructure Services in Rural Areas: Water and Electricity Services in Gabon"
[49] Covarrubias, Alvaro and Kilian Reiche. "A Case Study on Exclusive Concessions for Rural Off-Grid Service in Argentina" in Energy Services for the World's Poor, Washington, DC: World Bank, 2000.
[50] Basanes, C. Federico; Eduardo Saavedra and Raimundo Soto. "Post-Privatization Renegotiation and Disputes in Chile." IFM-116. Inter-American Development Bank, Washington, D.C., September 1999
[51] GATS Article XIX.1

monopolies in all committed sectors.[52] Concessions granted by local municipalities and local concessions granted by a central government are equally subject to these disciplines. Under the conditions of GATS Article VIII(4), any new monopoly granted in a committed sector is subject to a notification process that can lead to arbitration and compensatory adjustment if other Members choose to challenge the measure.[53] The GATS is silent on the question of whether or not competitive bidding for the monopoly concession exempts countries from Article VIII provisions, but a strict interpretation of definitions suggests that it does not.

The implications of these rules are readily apparent in the case of Gabon. If Gabon had made specific commitments to liberalize either its electricity transmission or its water delivery sectors without making exemptions, it could have been subject to onerous, time-consuming and potentially costly arbitration procedures that might have made it even more politically difficult to pursue sectoral reforms. Even though its bidding procedures for the concession were competitive, transparent, and nondiscriminatory, the privatization process would essentially have been subject to external review and approval. While the Gabonese authorities had not made specific commitments in this area, their experience is still instructive for other countries facing pressure to undertake new obligations.

The Gabonese experience demonstrates that it is possible to introduce structural reforms and private sector participation without making binding commitments that constrain future policy options. SEEG was willing to invest in Gabon because it saw a profitable opportunity and coordinated closely with authorities to create a secure climate for its operations. Even without specific commitments in the GATS, Gabon was able to attract world-class consortia to its competitive bidding process. Furthermore, the structure of the

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[52] Article XXVIII (h) defines a "monopoly supplier of a service" to include "any person, public or private, which in the relevant market of the territory of a Member is authorized or established formally or in effect by that Member as the sole supplier of that service," which includes exclusive concessions granted even under competitive and non-discriminatory bidding procedures.

[53] According to Section 4 of GATS Article VIII, "if, after the date of entry into force of the WTO Agreement, a Member grants monopoly rights regarding the supply of a service covered by its specific commitments, that Member shall notify the Council for Trade in Services no later than three months before the intended implementation of the grant of monopoly rights and the provisions of paragraphs 2, 3 and 4 of Article XXI shall apply." Article XXI introduces language subjecting the approval of monopolies to international negotiation: According to Article XXI, Section 1(b), Members must notify the Council for Trade in Services if they wish to modify commitments, a phrase that includes the creation of sub-national concessionary arrangements. In Section 2(a), WTO rules state that:

> "At the request of any Member the benefits of which under this Agreement may be affected (referred to in this Article as an "affected Member") by a proposed modification or withdrawal notified under subparagraph 1(b), the modifying Member shall enter into negotiations with a view to reaching agreement on any necessary compensatory adjustment. In such negotiations and agreement, the Members concerned shall endeavor to maintain a general level of mutually advantageous commitments not less favorable to trade than that provided for in Schedules of specific commitments prior to such negotiations."

Sections 3(a) and 4(a) specify that affected Members can refer the matter to arbitration if they are unhappy with the compensation offered. Until arbitration and the compensatory adjustments that ensue are resolved, the monopoly concession may not go forward.

Gabonese concession demonstrates that making specific commitments in the GATS may complicate future efforts to create attractive investment opportunities. The concession in Gabon bundled together two separate infrastructure sectors to attract well-qualified investors with whom to cooperate. Had commitments been undertaken in either sector, the entire process could have become more difficult, or stalled altogether.

Many Gabonese have lived their entire lives without reliable access to electricity. Under the terms of the 1997 concession agreement, however, many of them will enjoy the benefits of electric heat and light within the next decade. The transition to private management in Gabon has worked well in the absence of specific GATS commitments in the electricity sector. Indeed, successful reform in Gabon depended largely on the government's freedom to structure foreign investment in ways consistent with its development priorities. The Gabonese experience also suggests that countries need to exercise great caution during the request-offer process to preserve the autonomy needed to pursue policies that work for them.

### 5.2. Crisis Management

Crises happen for different reasons and affect different parts of the economy, but they share one characteristic in common: they require prompt and decisive government action. Investment agreements which constrain government action, however, can make countries pay twice for crises: first to solve the crisis, and again to compensate international investors on terms decided not through renegotiation, but through compulsory international arbitration.

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**Financial Crisis in Argentina**

After years of being the 'poster child' of the Washington consensus, Argentina's economy imploded in 2001. Hordes of people found themselves scrounging for food and other essentials, many resorting to a barter system to replace liquid assets that had evaporated overnight.[54] Buenos Aires erupted in violent protests that killed 28 and forced the successive installation of three presidents.[55] Between 2000 and 2001, per capita income fell from $12,377 to $7,327, and investments rushed out of the country, creating a severe balance of payments crisis from which the country has only now begun to recover.[56] Since the financial crisis, Argentina's citizens have suffered three years of negative economic growth, increasing unemployment, cuts in public services and tight restrictions on their ability to access deposits.[57] Now taxpayers face yet another potential blow: payouts to foreign investors who are using bilateral investment treaties to recover the losses they incurred during the crisis.

The financial crisis left many scars in Argentina, but one of its legacies was especially bitter: a groundswell of litigation before the International Center for the Settlement of Investment Disputes (ICSID), an organization closely tied to the World Bank. Argentina is involved in 20 of the 58 investor-state disputes currently pending at ICSID; of the 17 energy-related cases, Argentina is named in twelve.[58] The country faces several other lawsuits concerning public infrastructure projects, including telecommunications providers as well as water and sewer concessionaires. In *toto*, the claims for all the suits are said to exceed $17 billion, [59] an amount that exceeds 5% of annual GDP in Argentina.[60] These numbers represent a lower bound, since there may also be cases brought under United Nations Commission on International Trade Law (UNCITRAL) rules, which do not require public disclosure. Though the details of these cases are

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[54] "Argentines Barter to Survive." *BBC News*, May 9, 2002.
[55] "Argentina On the Brink of Collapse." *Daily Telegraph*, December 21, 2001.
[56] "Argentina Tops 'New' Development Report." *Latin American Southern Cone Report*, July 30, 2002.
[57] Roubini, Nouriel. "Why Should the Foreign Creditors of Argentina take a Greater Hit/Haircut than the Domestic Ones?" Working paper, December 14, 2001.
[58] For a current list of pending cases at ICSID, consult http://www.worldbank.org/icsid/cases/pending.htm.
[59] "Private Companies Demand 17,000 Million Dollars." *The News Says – Argentina*, August 3, 2003.
[60] Authors' calculations, based on World Bank GDP data reprinted in World Resources 2002-2004. Washington, DC: World Resources Institute, 2003.

confidential, with proceedings sealed *in camera*, it is reasonable to infer that the claims stem from alleged violations of bilateral investment treaties during the financial crisis.

At the height of the meltdown, Argentina took decisive action to avert the onset of total chaos. In January 2002, the government passed a suite of emergency legislation, including Law No. 25561, the Public Emergency and Foreign Exchange System Reform Act. Provisions in Law 25561 eliminated dollar-denominated tariff regimes for public utilities, struck out provisions pricing government contracts in foreign currencies, and imposed sweeping rate freezes across utilities sectors. All prices were automatically translated into pesos at an exchange rate of US$1 to 1 Argentine peso prior to a devaluation of the currency.[61] This policy was intended to reduce foreign exchange obligations, implicitly shifting some of the burden of the crisis onto private investors and their investments.

Investors claim that these actions violated guarantees made in bilateral investment treaties (BITs) signed by the Argentine Republic. The US-Argentina BIT, signed in 1991, guarantees American investors "fair and equitable" as well as national treatment in Argentina. Other treaties, including the Argentina-France BIT, provide similar assurances. These BITs provide guarantees against direct and "indirect" expropriation and offer recourse to international arbitration if disputes between parties arise.[62] Immediately after the imposition of Law 25561, international law firms began issuing advisories encouraging investors to explore litigation under the US-Argentina treaty.[63,64] Soon enough, suits against Argentina began appearing on ICSID's register of pending cases, with sources indicating that many of them arose directly in response to emergency measures taken during the financial crisis.[65] Some companies were even more explicit, issuing press releases to inform their stockholders that they would initiate arbitration to deal with the aftermath of the crisis.[66]

While information on the barrage of litigation facing Argentina is scarce, evidence suggests that companies are pursuing lawsuits based on violations of 'fair and equitable treatment,' non-discrimination, and indirect expropriation without compensation. According to one law firm, "the elimination of the peso/dollar parity…may amount to a breach of Argentina's obligations under applicable BITs, for which the investor may be entitled to compensation." Likewise, "the repeal of adjustment and indexation clauses in government contracts…may also furnish the investors with a claim under international

[61] "Public Emergency Regulations on Public Works and Utilities Contracts and Licenses." M. & M. Bomchil Abogados, February 2002.
[62] US-Argentina Bilateral Investment Treaty, signed November 14, 1991. Accessible at http://www.tcc.mac.gov/cgi-bin/doit.cgi?226:64:564161045:1:5
[63] "Argentina: Should Foreign Companies Shoulder the Burden?" *Currents Latin* America, v.1 issue 2. Coudert Brothers LLP, June 2002.
[64] "The Argentina Meltdown, BIT by BIT." Miller & Chevalier Chartered – International Alert. February 8, 2002.
[65] Peterson, Luke. *Investment Law and Sustainable Development Weekly*, December 27, 2002
[66] "SUEZ Invokes Procedures Provided Under the French-Argentine Bi-lateral Investment Treaty and Books Provisions to Cover All Its Exposure in Argentina." Press Release, SUEZ International, June 28, 2002.

law."[67] Central to the issue is the claim that Argentina's foreign exchange policy and freeze on electricity rate hikes amounted to unfair treatment and indirectly expropriated investors without compensation.

Cases affecting Argentina's electric utilities make up a large proportion of the total number of disputes. Sixty percent of the suits against Argentina deal with the energy sector, and half of these specifically involve electricity services and concessions. Due to an unusually permissive foreign investment regime, the majority of privatized electricity assets went to foreign companies during Argentina's recent experience of rapid and exhaustive privatization.[68] These firms claim injury from the rate freezes mandated by law, as well as from the financial impact of *pesofication*. Law No. 25561 provides provisions for comprehensive renegotiations with the government, but foreign firms intend to use bilateral investment treaty provisions to sidestep this process. Though domestic courts have repeatedly rejected proposed tariff increases because the law allows rate hikes only through renegotiation,[69] foreign investors hope to recoup their losses through recourse to international arbitration – an option that domestic investors do not have.

Law No. 25561 may not have been an optimal response to the Argentine financial crisis, but crisis conditions produce situations that call for second-best solutions. Over a year before the Argentine crisis unfolded, the state of California plunged into an energy crisis as problems with restructuring and deregulation created massive energy shortfalls and rolling blackouts. Handling the crisis required substantial and decidedly sub-optimal government intervention, including the imposition of price caps and contract renegotiations.[70] Because California's energy market is composed entirely of American investors, regulators have been able to handle the aftermath of the crisis through domestic consultations and processes without being subject to international arbitration.

By contrast, while privatization and international investment in Argentina's electricity sector proceeded relatively smoothly, the confluence of these processes with binding international investment rules and a crisis situation produced a wave of potentially devastating lawsuits. Though at press time these suits have not been concluded, their impact on Argentina is likely to be significant regardless of the outcomes. The prospect of a $17 billion payout is staggering, especially for a country recovering from a destabilizing economic crisis. The option of pursuing international arbitration sharply alters the playing field, since investors can in practice choose to involve ICSID if they believe they can extract more compensation by circumventing domestic renegotiation.

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[67] "The Argentine Crisis—Foreign Investors' Rights." Briefing by Freshfields Bruckhaus Deringer, January 2002.

[68] Energy Information Administration, US Department of Energy. "The Transformation of Argentina's Electricity Industry" in Electricity Reform Abroad and U.S. Investment. Washington: Energy Information Administration, 1997.

[69] Kerr, Juliette. "Gas Natural Takes Legal Action Against Argentine Government Over Frozen Rates." *World Markets Analysis*, June 3, 2003.

[70] Gerth, Jeff. "US Agency Widens Its Curbs on Price of Power in West." *New York Times*, June 19, 2001.

Fundamentally, foreign investors are suing the Argentine government to reclaim losses incurred during an economy-wide disaster. Since domestic investors do not have recourse to ICSID, the reparations paid to foreign and domestic investors via their respective arbitral and negotiating channels could be wildly different. Under the terms of the BITs, foreign investors can claim full compensation from the Argentine government even though Argentine citizens and companies have borne the full brunt of the crisis without compensation for the losses they have sustained.[71]

[71] Roubini, Nouriel. "Why Should the Foreign Creditors of Argentina take a Greater Hit/Haircut than the Domestic Ones?" Working paper, December 14, 2001.

### 5.3 Environment

Burning fossil fuels releases significant quantities of energy, but not without cost to the environment. Traditional electricity generation emits greenhouse gases, particulates and other pollutants, compounding the environmental costs and dangers associated with the extraction and transport of fossil fuels. Recognizing the need for a transition to sustainable energy sources, governments at the 2002 World Summit on Sustainable Development called for a shift to environmentally sustainable sources of energy, including renewable energy derived from naturally occurring biomass, wind and sunlight.[72]

Because they are relatively new, many renewable energy technologies are more costly than traditional fuels, which often benefit from substantial government subsidies. Sustainable energy technologies are therefore caught in a chicken-and-egg trap: cost-cutting technological advances will only develop if there is more demand for renewable energy, but demand will only develop if prices fall. To break out of this equilibrium, governments have used innovative public policies to drive the market forward. On the demand side, countries have established "feed-in" laws guaranteeing minimum prices for renewable energy, as well as renewable portfolio standards (RPS) requiring that a certain proportion of energy distributed comes from renewable sources. On the supply side, countries have subsidized research and development, as well as investments in generation equipment.

Creating an industry that many believe to be essential for our future survival has required substantial doses of political intervention. Building support for renewable energy in communities who must bear the cost of subsidizing new technologies has frequently required complex political compromises. The cases in this section, which describe policies in Arizona and Denmark, suggest that supporting green markets for electricity may require close attention to political, environmental, and economic interests, and that international rules on investment may infringe upon the space governments need to make tradeoffs between the three.

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**Renewable Portfolio Standards in Arizona**

Renewable portfolio standards (RPS) are an increasingly popular way for governments to encourage the generation of renewable energy. Through an RPS, governments mandate that a certain proportion of the energy distributed in an area be derived from renewable sources. According to industry leaders, RPS policies promote the use of renewable energy technologies, driving the market for them forward.[73] While renewable portfolio standards can effectively stimulate the development of a local market for sustainable

[72] United Nations. "Report of the World Summit on Sustainable Development." UN document A/CONF.199/*20, September 2002.
[73] Proceedings from "Overcoming Obstacles to Renewable Energy Sources in Mexico: Lessons from the NAFTA Partners." North American Commission on Environmental Cooperation (CEC) conference, 7 February 2003, Mexico City.

energy, these policies could become a victim of investment-related disciplines undertaken at the national level.

Some believe that RPS standards could be challenged under NAFTA trade rules because they may constitute a *de facto* form of market access discrimination between suppliers who deliver like goods.[74] Others believe that rewarding clean energy sources discriminates based on non-product-related process and production methods (PPMs), and therefore violates the GATT.[75] Still others dismiss these claims and argue that there may still be space for properly designed renewable portfolio standards because renewable energy falls into a distinct and legitimately separate category of electricity.[76]

It is unclear how this debate would be resolved in a dispute settlement panel, but there are good reasons to believe that investment rules, existing and future, may constrain governments' ability to design and implement effective and politically feasible renewable portfolio standards even more than rules on trade in goods. The case of Arizona demonstrates that international investment rules may encroach upon sub-national regulatory autonomy, making it increasingly difficult to achieve consensus around sometimes costly environmental policies.

Arizona boasts some of the best sites in the United States for solar energy development, and the state recently implemented a portfolio standard mandating that 0.2% of total energy distributed in 2001 come from renewable sources, of which 60% must be new solar capacity. This relatively small percentage is scheduled to grow to 1.1% by 2007.[77] Because solar photovoltaic generation is not yet a mature technology, investing in solar energy can involve significant costs to communities who enter the market early.

To finance the development of solar and other renewable energy facilities in Arizona, utilities currently levy a surcharge on retail consumers. During the policymaking process, some observers argued that financing renewable energy would put Arizona's industry at a competitive disadvantage.[78] Consequently, the framers of the RPS tried to maximize the benefits the state receives from its foray into renewable energy technology development by creating a comprehensive "solar development strategy."

Arizona's "solar development strategy" is a striking attempt to integrate both environmental and economic development concerns into the RPS. Enacted in 2001, the

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[74] Horlick, Gary; Christiane Schuchhardt and Howard Mann. "NAFTA Provisions and the Electricity Sector." CEC Background Paper, June 2002. The authors argue that RPS standards may constitute a *de facto* form of discrimination between power sources located in different countries. For example, definitions of renewable energy that exclude large hydro sources may discriminate against Canadian hydropower sources.

[75] Campbell, Laura. "Energy Globalization and the Environment: Bridging the International Governance Gap." In Energy Market Restructuring and the Environment.

[76] Hempling, Scott and Nancy Rader. "Comments of the Union of Concerned Scientists to the Commission for Environmental Cooperation In Response to its 'NAFTA Provisions and the Electricity Sector' Background Paper." Union of Concerned Scientists, January 2002.

[77] AZ Corporation Commission mandate R14-2-1618, February 2001.

[78] "Electricity Providers Face New Mandate on Renewable Energy." Associated Press, 4/27/2000.

RPS provides incentives for the development of a strong and robust renewable energy technology sector in Arizona. These incentives include a two-layer "extra credit" scheme of incentives for power sourced from solar facilities located in Arizona, in addition to further credits awarded for locally sourced manufacturing and installation content. These incentives have helped stimulate the growth of a dynamic renewable energy industry in Arizona.

The Arizona RPS, however, may be inconsistent with investment provisions in the North American Free Trade Agreement. While RPS measures may be discriminatory in the sense described above, national treatment is not the issue in this particular case. Rather, the conflict arises due to performance requirements attached to the portfolio standard. NAFTA Article 1106(b) explicitly prohibits governments from making the "receipt or continued receipt of an advantage" conditional upon the use of goods produced in its territory.[79] Since the Arizona RPS conditions the receipt of bonus portfolio credits upon the use of in-state inputs, it could reasonably be argued that the RPS violates NAFTA's prohibition on performance requirements.[80]

This does not, however, mean that the RPS – and its performance requirements – is not a good or an effective policy. From the perspectives of technology development and political economy, the provisions of the solar development strategy are certainly defensible. Arizona consumers pay surcharges to foster the development of a new and environmentally friendly technology, so they understandably want to channel as much of these resources into the development of local jobs and industries. Indeed, the renewable portfolio standard and the rate hikes that would accompany it were sold to the public explicitly on the basis of job creation and local economic development.[81] Investing in technological innovation involves financial commitments and complex political compromises, and constraining the capacity to make these trade-offs may inhibit the development of innovative and environmentally friendly policies.

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[79] NAFTA Article 1106(c): "No Party may condition the receipt or continued receipt of an advantage, in connection with an investment in its territory of an investor of a Party or of a non-Party, on compliance with any of the following requirements:

> (b) to purchase, use or accord a preference to goods produced in its territory, or to purchase goods from producers in its territory"

This language is stronger than provisions in other bilateral investment treaties. The OECD's draft Multilateral Agreement on Investment (MAI) explicitly exempted the conditioning of advantages on similar criteria in its section on performance requirements. The draft text of the FTAA includes separate bracketed elements that embrace both interpretations.

[80] It is possible that other provisions in the RPS violate the same language in NAFTA. Arizona's experience with ravaging forest fires has led it to pursue forest-management techniques that generate wood waste, and the state's numerous golf courses and other open spaces also tend to generate large quantities of biomass that require disposal. In a landfill, these wastes would generate methane, a dangerous greenhouse gas. Arizona's RPS includes locally sourced biomass as a renewable energy source. By incinerating organic wastes that would otherwise require costly disposal, biomass incineration closes a circle and generates useful thermal and electrical energy. But the requirement of local sourcing clearly violates NAFTA rules on performance requirements.

[81] Environmental Organization Comments on Rulemaking before the Arizona Corporation Commission, October 3, 2000. Available at http://www.grandcanyontrust.org/ggc/grcanyon/air/energy/comments3.html

The Arizona case demonstrates that international investment rules could place serious constraints upon electricity policies made at all levels of government. Furthermore, they may inhibit the development of environmentally friendly policies by making it more difficult for communities to capture the economic benefits of investments in innovative technologies. By shrinking the room for compromise between political, economic and environmental interests, investment agreements that straitjacket industrial policy could make it more difficult for governments to integrate a sustainable development agenda into the electricity sector.

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**Industrial Policy for Technology Development**

With 60 percent of the world's wind turbine manufacturing capacity and a 50 percent global market share, Denmark is a big player in renewable energy markets. In 1980, Denmark had 5 megawatts of installed wind energy capacity; by 2000, that figure had swelled to over 2,300 megawatts – equivalent to almost 20% of the country's annual energy consumption.[82,83] The Danish government now expects to produce 50% of its energy consumption from renewable sources by 2030.[84] Denmark's successful transformation from a fossil-fuel dependent economy to one of the world's most dynamic producers of wind power exemplifies the potentially positive role of a politically and environmentally sensitive industrial policy. It also demonstrates that international investment rules could restrict some of the instruments that made the country's energy revolution possible.

Denmark has committed itself to reduce greenhouse gas emissions by 22 percent between 1988 and 2005.[85] Early on, the government decided that environmentally friendly energy technologies would play a critical role in achieving this target by replacing coal-fired power plants with non-polluting energy sources. Using a mix of taxes, subsidies and other economic incentives, the Danish government stimulated the growth of a thriving and dynamic wind turbine export industry. These incentives successfully balanced social and economic objectives in a politically and environmentally sensitive industrial policy.

Shifting Denmark to wind energy faced both economic and political challenges. Initially, wind energy had to be made economically competitive to induce producers to set up wind turbines. In 1980, this was a major challenge, since the available technology could not compete with traditional generation methods. At the same time, there were political obstacles to overcome. Achieving the kind of coverage the government envisioned required wind turbines – lots of them. However, planners quickly realized that wind farms, though renewable, were far from perfect neighbors. Their large size, noise, and

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[82] Sawin, Janet. "The Role of Government in the Development and Diffusion of Renewable Energy Technologies: Wind Power in the United States, California, Denmark, and Germany, 1970-2000."
[83] Krohn, Soren. "Wind Energy Policy in Denmark: Status 2002." Danish Wind Industry Association, February 2002.
[84] Sawin, op. cit
[85] Moore, Curtis and Jack Ihle. "Renewable Energy Policy Outside the United States." Renewable Energy Policy Project Issue Brief No. 14, 1999.

visibility have sometimes caused communities to resist wind energy development. The task of creating a wind energy industry therefore required building political consensus around a technology that needed government support to become competitive.

Denmark used a wide array of taxes and subsidies to deliver economic incentives for renewable energy.[86] These policies operated both on the demand side by encouraging utilities to purchase renewably generated electricity, and on the supply side by subsidizing research and development, investment and production. To make the diffusion of wind energy politically feasible, the government drew upon a long-standing set of social institutions: local guilds and co-operatives. Denmark's long history of co-operatives had accustomed Danish citizens to controlling local affairs, and the government tapped into existing cooperative arrangements by encouraging cooperatives to invest in wind turbines and farms.[87] It also offered capital grants for the installation of wind turbines to Danish citizens amounting to $44 million.[88] The theory was that cooperative ownership would facilitate local acceptance of wind turbines and energy self-sufficiency. To make installation economically attractive, the Danish government required utilities to buy wind-generated energy at 85% of the utility's net cost but restricted these payouts to members of cooperatives.[89] While it was in place, this policy simultaneously met two objectives: it provided economic incentives for environmentally friendly technologies while simultaneously encouraging local ownership and acceptance.[90] Today, 100,000 Danish families own wind turbines or shares in wind cooperatives, a formidable constituency with a stake in sustainable energy development.

While it is difficult to isolate the impact of this particular policy from the broader impact of Denmark's supportive framework for renewable energy promotion, the outcomes speak for themselves. Denmark is a world leader in terms of installed capacity, and about three quarters of this capacity is locally owned by individuals and cooperatives.[91] Widespread ownership and acceptance of wind technology has reduced fossil fuel dependence, helped cement political support for further development of wind energy sources, and stimulated the development of vibrant firms to export homegrown technology.

Yet some of the incentives Denmark used to launch its path-breaking renewable energy industry may be inconsistent with rules emerging in international investment agreements. Policies like a discriminatory tariff that privileges purchases from locally owned cooperatives could conflict with national treatment provisions of the General Agreement on Trade in Services (GATS), which specify that foreign service providers should receive treatment no less favorable than that accorded to domestic industries. Though

[86] For a comprehensive discussion of these instruments, see Sawin, op. cit.
[87] Tranæs, Flemming. "Danish Wind Energy Cooperatives." Danish Wind Industry Association, http://www.windpower.org/en/articles/coop.htm
[88] Sawin, op. cit. at 544
[89] Sawin, op. cit. at 549
[90] According to Sawin, Denmark imposed limitations on cooperative membership and benefits. For years, only people living within the district where turbines were located could join wind cooperatives and benefit from the advantages accorded to private generators.
[91] Tranæs, op. cit.

cooperatives are non-profit entities, they are nonetheless part of the electricity market and may fall within the ambit of international trade agreements. [92]

To get to where it is today, Denmark had to tackle a problem of industrial policy and a problem of political economy. Creating a new industry based on immature technology required substantial investments in research and development, as well as market-based incentives to increase supply and demand. At the same time, Denmark needed to find ways to make potentially intrusive wind farms politically acceptable. Cooperative ownership of renewable energy systems simultaneously revitalized cooperatives in Denmark and led them to embrace the rapid development of wind energy. By tailoring its policies to local conditions, Denmark successfully developed both a constituency and a market for environmentally friendly technology.

[92] Jackson, Andrew and Matthew Sanger. "When Worlds Collide: Implications of International Trade and Investment Agreements for Non-Profit Social Services." Ottawa: Canadian Centre for Policy Alternatives and Canadian Council on Social Development, 2003.

## 5.4 Equity

With an annual turnover of over $1.7 trillion, energy is one of the largest industries in the world, and the electricity sector is a major part of it.[93] Electricity is not just a current flowing from generator to household; it is also a big business that employs workers, illuminates communities, and encourages entrepreneurship and skill development. Between 1990 and 1999, private investment in the electricity sector totaled over $160 billion, representing over 600 private electricity projects in 70 developing countries.[94] In many countries, electricity is seen as a public service, and even where privatization is most advanced, the industry is regulated in the public interest.

Given that electricity plays such a central role in the economic life of many countries, it is natural that governments have paid close attention to ownership and equity issues in the sector. Implementing ownership constraints may introduce economic inefficiencies, but ownership is a complicated concept that involves identity politics, status, and perceptions of social equity. Who owns what is economically irrelevant so long as competition induces firms to offer services efficiently to consumers. But in the world we inhabit, subjective identities and group affiliations matter a great deal, and governments ignore these social and political forces at their peril.

Imperialism and decolonization created countries whose boundaries included ethnic groups who competed for control of the post-colonial state. Where ethnic identities coincided with employment patterns or economic advantages, conflict frequently ensued. In countries like Malaysia, riots inspired policies designed to empower disadvantaged ethnic groups by encouraging property ownership; in South Africa, the government is attempting to redress the legacy of apartheid by actively promoting black economic empowerment in the electricity sector. Though unpopular with economists, such policies may help integrate the electricity sector into a stable social compact capable of delivering sustainable public benefits. As the cases that follow suggest, however, these socially integrative policies could conflict with emerging rules on international investment.

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### Ethnic Preferences in Malaysia

Violent riots rocked Malaysia in the summer of 1969 as decolonization exposed deep divisions between members of different ethnic communities. Following a pattern mirrored in many other post-colonial states, including Guyana, Fiji and Mauritius, Malaysian politics after independence took on a distinctly ethnic hue as various communal groups competed for control. Concerned by the disintegration of social order in Malaysia and the deep discontent it reflected, the Malaysian government in 1971

[93] Zarrilli, Simonetta. "International Trade in Energy Services and the Developing Countries" in UNCTAD. Energy and Environmental Services: Negotiating Objectives and Development Priorities. UNCTAD, 2002.
[94] "Private Participation in Energy." Public Policy for the Private Sector Note No. 208. World Bank Group, May 2000

adopted the New Economic Policy (NEP), which sought to advance the interests of the disaffected and disadvantaged Bumiputera[95] population.

The NEP had two major elements. The first aimed to reduce and eventually eradicate poverty to eliminate the gross economic inequalities that fueled and intensified communal rivalries. The second element was to reorganize the Malaysian economy by restructuring employment in various sectors as well as the ownership and control of wealth. Under the terms of the NEP, Bumiputeras were to hold 30% of corporate sector assets by 1990, other Malaysians were to hold 40%, and the foreign share was to plummet from 65% to 30%.[96]

Though controversial among foreign investors, the NEP managed to achieve many of its goals, sustaining a climate of political compromise and economic growth. The NEP deployed a wide range of unorthodox policies, including conditioning industrial licenses upon compliance with NEP guidelines of 30 percent Malay ownership.[97] Official figures indicate that Bumiputera ownership increased from 2.4% of assets in 1970 to over 20% in 1990; non-Bumiputera Malay ownership increased from 32.3% to of 46.2% over the same period.[98] This redistribution occurred against a backdrop of rapid economic growth averaging 4.2 percent per annum between 1970 and 1990. It is certainly possible that Malaysia would have grown more quickly in the absence of interventionist and redistributive policies. Yet the converse might also be true, for "if Malaysia had gone full-tilt for growth and not undertaken an affirmative action program like the NEP, it might have suffered other violent political blow-ups."[99] The merits of the NEP as an economic policy are certainly open to debate, but what is clear is that government flexibility was required to implement its provisions.

The Malaysian NEP was facially discriminatory and could have conflicted with commitments on pre-establishment national treatment of investments, as well as GATS disciplines on Mode 3. Because it conditioned the entry of inward investment upon compliance with local and ethnic ownership requirements, the NEP did not provide national treatment at the establishment phase of investment. Furthermore, the potential for conflict with GATS requirements of national treatment in bound sectors is evident in the Malaysian government's careful scheduling of exemptions in its horizontal commitments. In its current GATS schedule, Malaysia exempts "any measure and special preference granted to Bumiputera, Bumiputera status companies, trust companies and institutions set up to meet the objectives of the NEP and NDP."[100,101] Similarly, New Zealand exempts "current or future measures at the central and sub-central levels

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[95] *Bumiputera* literally means "sons of the soil," and refers to ethnic Malays

[96] Snodgrass, Donald. "Successful Economic Development in a Multi-Ethnic Society: The Malaysian Case." Harvard Institute for International Development Discussion Paper #503, 1995.

[97] Biddle, Jessie and Vedat Milor. "*Consultative Mechanisms and Economic Governance in Malaysia."* World Bank, PSD Occasional Paper No. 38, September 1999.

[98] Snodgrass, op. cit.

[99] Snodgrass, op. cit.

[100] Consolidated schedule of commitments under GATS, taken from WTO Services database: http://www.wto.org/english/tratop_e/serv_e/serv_commitments_e.htm

[101] "NDP" refers to the National Development Program, a successor to the NEP.

according more favorable treatment to any Maori person or organization in relation to the acquisition, establishment or operation of any commercial or industrial undertaking." Australia does much the same for indigenous peoples. Exemptions carving out space for social policy, however, are conspicuously absent in most other country schedules.

Some argue that the GATS agreement in no way circumscribes the ability to pursue social policies since countries choose which sectors to commit and which exemptions to make. Countries who need social policy exemptions, the argument goes, will carve out room to pursue them. However, reality is rarely so simple, transparent or predictable. Ethnic conflicts persist around the world, and though their causes are complex, most of them arise from communal frictions that economic integration may intensify.[102] Though the NEP was implemented decades ago and has receded in importance in Malaysia, countries may still need similar room to develop integrative – and innovative – social policies.

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**Black Economic Empowerment in South Africa**

Apartheid dehumanized everyone it touched. It also destroyed economic opportunities for black South Africans. Relegated to townships and excluded from positions of responsibility, black South Africans were forcibly prevented from participating in political and economic affairs. The democratic government in South Africa, however, has brought with it a new willingness to address the inequities of the past through a policy of Black Economic Empowerment (BEE), which encourages the transfer of skills and other productive assets to companies run by black entrepreneurs. The BEE agenda in South Africa suggests that socially integrative policies may require precisely the kind of government autonomy that binding investment norms may effectively eliminate.

As befits a program that aims at fundamentally changing ownership patterns, the Black Economic Empowerment agenda is comprehensive. It aims to leverage state resources to increase black economic participation through preferential procurement programs, financial incentives and other forms of state aid.[103] The South African government is also developing a multi-sectoral program of black empowerment, including a specific set of objectives for the electricity sector.[104] An initial glance into the framework of BEE reveals several potential conflicts between empowerment policies and the kinds of disciplines that have been promulgated in bilateral and regional investment treaties.

South Africa's government has identified reform in the power sector as a critical component of its BEE agenda. Broad-based access to reliable electricity services carries a

[102] Chua, Amy. World On Fire: How Exporting Free Market Democracy Breeds Ethnic Hatred and Global Instability. New York: Doubleday, 2003.
[103] South African Department of Trade and Industry. "South Africa's Economic Transformation: A Strategy for Broad-Based Black Economic Empowerment." Strategy document downloaded from: http://www.dti.gov.za/bee/complete.pdf
[104] Eberhard, Anton. "The Political, Economic, Institutional and Legal Dimensions of Electricity Supply Industry Reform in South Africa." Paper presented to conference on "Political Economy of Power Market Reform" at Stanford University, February 19-20, 2003.

great deal of symbolic weight in a country where access to modern services was once restricted on the basis of skin color. In the near future, parts of Eskom, South Africa's public, vertically integrated monopoly service provider, will be unbundled and privatized, and the government intends to integrate equity issues into the restructuring process.[105] While the BEE agenda in the electricity sector has not been finalized, discussions have focused on broadening ownership patterns within the sector by mandating that 10% of generation assets be transferred to BEE-eligible groups, with a further 20% open to general private sector participation.[106] In an institutional context in which restructuring and privatization are already taking place, linking the process of privatization to BEE-related ownership requirements is relatively simple. Indeed, such a policy would avoid some of the more controversial elements of the BEE plan for the mining sector, which required the redistribution of certain private assets to companies owned by black entrepreneurs.[107]

Other BEE provisions require companies to make progress on black empowerment as a condition of eligibility for government contracts[108]. The overall framework for the Black Economic Empowerment program involves a 'scorecard' system in which enterprises receive points for black ownership, preferential procurement from BEE enterprises and employment equity. Whenever the Government "engages in any economic activity," whether procurement, a concessionary arrangement or a divestment, it will award contracts or shares on a preferential basis to companies who achieve high scores according to these criteria.[109]

Though somewhat controversial, the program of Black Economic Empowerment is seen by many South Africans as an integral piece of post-apartheid reconciliation and development.[110,111] Policies like Black Economic Empowerment (BEE), however, require space for political flexibility in design and implementation – space that can shrink under investment disciplines without careful planning and scrutiny. In principle, BEE could be seen as inconsistent with the general principle of national treatment because it discriminates against investors who are not black South Africans. Ten percent of divested Eskom assets must by definition go to South African nationals, a reservation that is facially inconsistent with many interpretations of national treatment, particularly those which apply to the pre-establishment phase of investment. If sectoral commitments covering power generation and distribution were made under the GATS, this requirement

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[105] Philpott, Julia and Alix Clark. "South Africa: Reform With a Human Face?" in Dubash, Navroz ed. Power Politics: Equity and Environment in Electricity Reform. Washington, DC: World Resources Institute, 2002.
[106] Scott, Norval. "Eskom Sets 2006 As Privatization Deadline." World Markets Analysis, March 4, 2003.
[107] Stoppard, Anthony. "Black Empowerment Policy Worries Investors." InterPress Service, August 12, 2002.
[108] Mortished, Carl. "Black Empowerment Hurdle for Government Contracts." *London Times*, April 26, 2003
[109] South African Department of Trade and Industry. "South Africa's Economic Transformation: A Strategy for Broad-Based Black Economic Empowerment." Strategy document downloaded from: http://www.dti.gov.za/bee/complete.pdf
[110] Oppenheimer, Nicky. "A Fairer Society Needs Faster Growth." *Financial Times*, 15 August 2003.
[111] "Black Empowerment." Editorial, *Financial Times.* 7 August 2003.

could conflict with national treatment provisions unless specific exemptions were made *ex ante*.[112]

Several elements of these programs are also inconsistent with existing or proposed trade and investment rules. If services negotiations were to bring public procurement under GATS disciplines and countries made commitments without exhaustively scheduling *ex ante* exemptions, then conflict could emerge due to violations of national treatment.[113,114] Alternatively, under an investment regime similar to the North American Free Trade Agreement, BEE policies could conflict with the prohibition on performance requirements.[115,116]

Programs like BEE may make sense from a social or political economy perspective, but they are nonetheless incompatible with basic principles of non-discrimination. Yet the need for balanced social and economic development may justify derogations from non-discrimination. While there is room in WTO agreements to accommodate socially integrative policies if countries specify exemptions in advance, the exemption process presumes a depth of *ex ante* knowledge that is both theoretically and practically unreasonable. Had the pre-apartheid regime signed investment agreements that included national treatment provisions without making exemptions for programs targeting socio-economically disadvantaged groups, the post-apartheid regime could have found itself facing insuperable economic barriers to programs resembling BEE. Moreover, even democratic governments find it difficult to predict in advance what sorts of derogations might one day become necessary to advance social, political or economic objectives. If the first ANC government had signed bilateral investment treaties with stringent language on non-discrimination, the ability to launch BEE-type initiatives could have been greatly reduced.

Confronting polarizing social divisions is difficult. Removing government capacity to redress tragic legacies does little to help advance the causes of social or economic development. The South African case illustrates the importance of protecting the public sector's ability to develop active policies and lead societies away from the horrors of the past.

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[112] GATS Article XVI(e) prohibits "measures which restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service; and Article XVI(f) prohibits "limitations on the participation of foreign capital in terms of maximum percentage limit on foreign shareholding or the total value of individual or aggregate foreign investment."

[113] Bound sectors under the GATS are subject to national treatment requirements. If government procurement is incorporated into the GATS, then public authorities no longer have the authority to discriminate between enterprises on the basis of their ownership.

[114] See S/WPGR/W/42, "Communication from the European Communities: Government Procurement of Services," for a discussion of a GATS-style positive list approach to non-discrimination in government procurement of services.

[115] The BEE scorecard's proposed inclusion of benefits for firms that purchase from BEE enterprises implicitly imposes a domestic content standard upon investors, potentially violating Chapter 1106(b) of the NAFTA.

[116] Peterson, Luke. "South Africa's Black Economic Empowerment Plans an Obstacle to a US FTA?" *Investment Law and Sustainable Development Weekly*, July 8, 2003

## 6. Synthesis and Conclusions

Against the backdrop of current negotiations at the World Trade Organization, the debate over policy space is more than academic: it is highly relevant to proposals about a new multilateral investment framework. Discussions in the Working Group on Trade and Investment (WGTI) and the Working Party on GATS Rules (WPGR) have advanced proposals that would impose increasingly stringent disciplines on investment policies. In the former body, a proposed multilateral framework on investment could create new international rules affecting pre-establishment conditions, performance requirements and dispute settlement. In the latter, future discussions on government procurement and subsidies may well result in further disciplines.

These developments are significant because new disciplines and further liberalization often come at the price of policy space. While few would dispute that removing the capacity of governments to pursue perverse or ill-advised policies can improve country performance, adopting new commitments without due regard for policy space risks throwing the proverbial baby out with the bathwater. In an international context where economic considerations are often privileged above space for environmental planning, policies for achieving sustainable development require a great deal of innovation and flexibility. Governments currently retain some degrees of freedom to pursue heterodox investment policies, though these are already somewhat constrained by the Agreement on Trade-Related Investment Measures (TRIMS), the General Agreement on Trade in Services, and bilateral and regional investment treaties. Further movement toward stronger GATS rules or a multilateral framework on investment needs to be weighed against the possible costs of diminished policy space for sustainable development.

The cases discussed here show how governments have used non-conformist policies, which would likely fail to pass muster among practitioners of neoliberal orthodoxy, to advance social and environmental goals in the electricity sector.

To support access to electricity:

- The Government of Gabon instituted a monopoly concession that bundled together the electricity and water sectors with incentives for service expansion;
- The United States government provided subsidies for rural cooperatives to promote grid expansion, paving the way for universal electrification in the US.

To help resolve a financial crisis:

- The Government of Argentina imposed an electricity rate freeze and mandated renegotiation of utility contracts to spread the burden of crisis resolution to all participants in an economy, including foreign investors.

To promote innovative renewable energy technologies:

- The US state of Arizona provided competitive advantages to locally sourced solar power manufacturers in the form of a performance requirement to guarantee local economic benefits from renewable energy.

- The Government of Denmark introduced a discriminatory tariff that privileged purchases of electricity from locally-owned cooperatives.

To mitigate a history of inequitable treatment:

- The Government of Malaysia conditioned industrial licenses on ownership guidelines, potentially diffusing political conflict among communal groups;
- The Government of South Africa mandated ownership shares for black populations as part of public asset sales, and conditioned eligibility for government contracts on black ownership as part of a larger policy of "Black Economic Empowerment".

These policies, which represent only an illustrative subset of approaches to internalizing environmental and social considerations in the electricity sector, can and should be subject to debate. Specifically, critics might argue that there are alternative means of reaching the same policy goals that are less trade restrictive, and less likely to conflict with trade and investment disciplines. There are at least two responses to this charge.

First, many of the policies above illustrate that heterodox efforts at steering and channeling investment can indeed be successful, reinforcing recent work that emphasizes the importance of domestic institutional innovation. For example, by privileging local cooperatives, Denmark has spurred creation of the world's most successful wind power equipment export industry, which also generates 20% of national electricity needs.

Second, the needs of government to balance economic, political and social or environmental considerations in particular national contexts may require heterodox policies of the sort described here. For example, a neoliberal approach to rural electrification in Gabon might have dictated open access to the rural electricity market and the introduction of competition. However, the regulatory and design burden of a truly competitive market would likely have been beyond the capacity of the Gabon government at the time; a monopoly service provider was better suited to meet the needs of rural electricity expansion in the context of limited state capacity. Similarly, while South Africa's efforts at Black Economic Empowerment by reserving ownership for historically disadvantaged groups is anathema to market orthodoxy, the potential political and social gains in term of post-apartheid reconciliation may make the experiment worthwhile. In specific national contexts, first-best economic policies may well be second or third-best from a political economy perspective.

This is not to suggest that policy heterodoxy and experimentation always or even mostly result in positive change. Advocates for a more constrained policy space justifiably argue that policy heterodoxy can serve as a cover for arbitrary, capricious, and even venal government policies. However, since the use of institutional mechanisms to discipline governments is not without cost, ensuring responsible use of policy space is a task better addressed at the national level through transparent governance and accountability. International investment negotiations are unlikely to be an appropriate instrument to address venal domestic politics – and indeed, they may exact a substantial price in foregone ability for policy experimentation.

The policy case studies described in this paper strongly suggest that investment rules would indeed shrink available policy space. They also provide tangible illustrations of the costs of this reduced policy space. For example, Arizona's efforts at promoting renewable energy development, which also stimulates local industry, may violate prohibitions on performance standards that are present in many investment agreements. Subsidies to rural electricity cooperatives formed the backbone of a highly successful policy that turned on the lights across depression-era America. Developing countries today could be hard-pressed to deploy similar instruments if GATS negotiations on subsidies prohibit favoring domestic providers.

The degree to which investment and trade rules do, in actuality, shrink policy space lies in the details of the negotiated rules. The Appendix to this paper describes three hypothetical investment policy regimes – restrictive, intermediate, and flexible – and examines their differential impact on policy space. We return to specific elements of what would constitute a more open policy space in the following section.

Supporters of investment rules often contend that fears of restrictions on policy flexibility are overblown and stem from a failure to understand the flexibility structured into investment rules. Specifically, they argue that under the "positive list" approach used by the GATS, and favored for an investment agreement, countries can choose whether or not to subject sectors to disciplines, and can further choose to schedule exemptions. Consequently, there is no conflict between strong investment rules and policy space. Critics counter that, in practice, governments face serious obstacles to utilizing these mechanisms. In the introduction to this paper, we developed a taxonomy of reasons to suspect that even a positive list approach could make comprehensive exemptions difficult to implement. The cases we have discussed support the view that the ability to retain policy space exists more in theory than in practice.

The flexibility afforded by the ability to choose which sectors to commit in a positive list approach is limited by two factors: the mandate for progressive liberalization and the increasingly ambitious scope of requests made by Members. Under the GATS, there is an explicit call for regular and progressive liberalization, and such a mandate would likely be incorporated into any new policy on investment. Even without such a mandate, however, a structure akin to the GATS provides the framework for comprehensive requests for liberalization. Both the European Union and the United States have made substantial requests for commitments in energy services, which encompass a broad array of functions and activities in the sector. Through the bilateral request-offer process, countries with less negotiating capacity and leverage may face substantial informal pressure to acquiesce.

Second, for the reasons enumerated in the introduction, proponents of investment rules tend to overstate the amount of policy space that can be preserved through exemptions. Requiring that exemptions be scheduled at the time of commitment presumes that governments have an improbable degree of *ex ante* knowledge. Capacity constraints in

the developing world further limit the likelihood of adequately scheduling exemptions in order to preserve policy space.

For example, to address rural electrification under an investment regime, energy or rural development authorities in Gabon would have had to first identify the range of policies available to promote access to electricity, including monopoly concessions. They then would have had to persuade their trade counterparts of the need to include the necessary exemptions when scheduling the energy sector. This sequence of actions stretches credulity, particularly since social and environmental ministries are hardly influential in dictating trade positions. The problem of promoting access to electricity in the context of a privatized competitive electricity market has only recently been recognized, and governments are still experimenting with appropriate incentive based policies to achieve the goal of electrification. To urge countries that have only achieved minimal levels of rural electrification to endorse an investment framework that limits their policy options to current policy knowledge is irresponsible.

The loss of policy space can limit the capacity for effective governance. When governments bind sectors of the economy on their behalf, citizens lose the ability to re-direct their governments in keeping with changing political preferences and contexts. Had an earlier government in South Africa subjected itself to national treatment obligations in the electricity sector, the current government would not have had the option of implementing its program for Black Economic Empowerment. Finally, investment rules limit governments' ability to react to changing external circumstances. For example, Argentina's rapid privatization meant that its utility policies affected foreign investors, who are now deluging the government with lawsuits under bilateral investment treaties to avoid bearing any of the adjustment burdens following the crisis.

Reductions in policy space can have real consequences for the ability to govern the electricity sector in a socially and environmentally responsible way. To crystallize the points relevant for negotiations in the Doha Round and beyond, we conclude with a few issues for further discussion.

### *Final points for consideration*

The cases developed in this study are animated by potential friction between reasonable electricity policies and the principles inherent in international investment rules. Our analysis of these studies has identified several potential areas of conflict, including pre-establishment non-discrimination, performance requirements, indirect expropriation, dispute settlement, and disciplines on government procurement and subsidies for services. These studies suggest that the costs of investment negotiations, in terms of policy space foregone, may be underappreciated. Analysis of the cases in this paper suggests several areas of particular concern:

- **Specific Commitments.** Many disciplines under the GATS, and potentially under an investment agreement organized on a positive list basis, apply only to sectors that have been bound during negotiations. Only 8 countries made specific

commitments in "services incidental to energy distribution" during the Uruguay Round, which means that other countries have until now retained substantial autonomy in the electricity sector.[117] Making commitments in electricity services when the scope and definition of these services remains relatively unclear may lead to unpleasant surprises in the future.

- **Pre-establishment national treatment.** Disciplines on the admission and establishment of investments from abroad can have serious implications for national policy autonomy. As the cases in this study suggest, adopting the principle of pre-establishment national treatment could make it more difficult for governments to manage or attach conditions to the entry of investments, significantly reducing space for social and environmental policies.

- **Performance requirements.** Prohibitions on performance requirements have appeared in several recent incarnations of investment agreements, and they may constrain measures that may be necessary to achieve consensus around policies for sustainable development. Economic historians have demonstrated that performance requirements played an important role in the development trajectories of today's industrialized nations, and we have seen that they can play a part in encouraging states to adopt stronger environmental policies. While some performance requirements are not helpful, others can help harness the power of foreign investment to achieve better environmental and development outcomes. These should continue to be permissible components of country sustainable development strategies.

- **Indirect expropriation.** Indirect expropriation is an expansive concept that can include regulatory actions and judicial decrees. In Argentina, the government found that its crisis management strategy of *pesofication* and electric rate freezes spawned a wave of lawsuits even though no actual expropriation had taken place. The concept of creeping expropriation may unduly infringe upon governments' ability to promulgate legislation in the public interest by extending to private investors an implicit guarantee that their assets will retain full value.

- **Dispute settlement.** Experience with bilateral investment treaties demonstrates that investors have circumvented contractually specified dispute resolution methods by invoking BIT provisions that permit international arbitration. Providing foreign investors with privileged access to supranational arbitral bodies can result in severe inconsistencies in the treatment of national and foreign investors. Furthermore, the threat of recourse to international arbitration can produce a chilling effect that effectively reduces policy space.

- **Government procurement in services.** The Working Party on GATS Rules (WPGR) is beginning to address the question of government procurement in

[117] Evans, Peter C. Liberalizing Global Trade in Energy Services. Washington: American Enterprise Institute, 2002.

services under Article XIII. While government procurement is already being addressed in other WTO bodies[118], some countries have expressed a desire to move forward autonomously on services procurement in negotiations under the GATS. National treatment obligations in government procurement could block an important channel for policies supportive of social and environmental ends. Even a positive list for disciplines on government procurement could pave the way for progressive liberalization and the contraction of policy space for sustainable development.

- **Subsidies.** Article XV of the General Agreement on Trade in Services requires countries to discuss new disciplines on subsidies for services. Subsidies are one of the most flexible policy tools available to governments, and they can be targeted to meet specific social and environmental goals. Because they apply to the supply of services via commercial presence, new disciplines on services subsidies could limit the use of innovative policies for sustainable development.

Limiting electricity policy options with new disciplines would stifle experimentation at precisely the historical moment at which policy innovation is most necessary. Electricity restructuring is bringing sweeping changes to institutions, patterns of investment, and technological development in the sector. Governments will need maximal amounts of ingenuity, flexibility and policy space to integrate public benefits into a new and largely uncharted economic environment. Investment rules provide stability for investors, but they may ultimately limit governments' ability to integrate social and environmental concerns into their governance of the sector. Unless more attention is paid to the potential costs of new rules, the inclusion of such disciplines may be a poor investment in the future.

[118] Government procurement is currently governed by the voluntary, plurilateral Agreement on Government Procurement, and the issue of transparency in government procurement is currently being addressed in the Doha Development Agenda process.

## Appendix

Given the dizzying array of rules that potentially affect investment in the electricity sector, it is difficult to come to clear conclusions about their implications for policy space. But it is possible to differentiate between rules based on their intensity and scope, since investment treaties embody different trade-offs between investor rights and domestic policy autonomy. Some bilateral investment treaties, such as the South Africa – Iran BIT, simply encourage the promotion of investments between countries, while others provide reciprocal national treatment at the pre- and post-establishment phases. By contrast, bilateral treaties signed by the United States tend to feature very strong provisions, as do the North American Free Trade Agreement and the proposed Free Trade Area of the Americas. Finally, though case law in the GATS is nascent at best, Mode 3 brings investment issues into the realm of trade policy, imposing a host of restrictions on the basis of positive list commitments.

Based on existing rules and proposals advanced in various arenas, we develop three illustrative regimes, including a restrictive, intermediate and flexible set of rules. These regimes capture three possible points on the continuum between investor protection and national policy autonomy and suggest the kinds of conflicts one might see under various kinds of investment rules. The first regime bears a close resemblance to NAFTA and the US model bilateral investment treaty. The second is a less ambitious model that integrates existing proposals on multilateral investment rules. The third is a reflection of the status quo for many countries who have not signed highly restrictive bilateral or regional investment treaties. Because the scenarios vary in intensity, they entail different consequences for policy space for sustainable development. The regimes are described in detail in Table A1.

In the restrictive case, the potential for policy conflict is relatively high. Pre-establishment national treatment effectively removes government ability to impose equity restrictions on investment, a provision that could undermine redistributive programs similar to those undertaken by South Africa and Malaysia. As seen in the case of Arizona, strict prohibitions on performance requirements sharply reduce the scope for innovative industrial policies, which may make investments in new environmental technologies more difficult to mobilize. Restrictions on market structure may make packaging monopoly concessions more difficult, delaying rural electrification in the countries that need it most. Disciplines on government procurement in services could sharply limit public authorities' ability to jumpstart local industries or reward firms that help empower disadvantaged groups. Finally, some interpretations of creeping expropriation may curtail regulatory autonomy in ways that governments find excessively restrictive.

**Table A1.**

| Measure | RESTRICTIVE | INTERMEDIATE | FLEXIBLE |
|---|---|---|---|
| Establishment conditions | **National Treatment/MFN:** Non-discrimination provisions at both the pre- and post-establishment phases of investment, applied on the basis of a negative-list approach;[119] | **Selective Liberalization:** Limited pre-establishment provisions characterized by horizontal MFN and a positive-list approach to national treatment; post-establishment national treatment[120] | **Investment control:** No commitments on pre-establishment conditions; post-establishment non-discrimination;[121] |
| Performance requirements | A prohibition on performance requirements, both as a condition of establishment and as a condition of the receipt of special incentives or other advantages;[122] | A prohibition on performance requirements as a condition of establishment, but not as a condition of the receipt of advantages;[123] | Performance requirements restricted only by the TRIMs Agreement;[124] |
| Government procurement in services | Preliminary disciplines on government procurement in services, based on a positive-list approach;[125] | Disciplines on transparency in government procurement of services; | No disciplines on government procurement in services. |
| Subsidies for services | Disciplines on "trade-distorting" subsidies and a system for countervailing measures | No disciplines beyond existing GATS rules on MFN; national treatment in committed sectors | Establishment of an explicit "green box" to exempt subsidies for environmentally or socially significant sectors. |
| Regulatory takings | Prohibitions on direct expropriation and indirect or 'creeping' expropriation;[126] | Prohibitions on direct expropriation and indirect or 'creeping' expropriation; | Prohibition on direct expropriation, but no language on 'regulatory takings' |
| Dispute settlement | Recourse to international arbitration at ICSID, ICSID's Additional Facility, or UNCITRAL rules[127] | Recourse to international arbitration at ICSID, ICSID's Additional Facility, or UNCITRAL rules | Recourse to international arbitration at ICSID, ICSID's Additional Facility, or UNCITRAL rules when contracts do not specify domestic resolution of disputes. |

[119] This is what UNCTAD and the WTO call the MFN/National Treatment model for establishment conditions. See NAFTA Article 1102, which accords national treatment "with respect to the establishment, acquisition, expansion, management, conduct, operation and sale" of investments.
[120] This is what UNCTAD and the WTO call the "GATS-style 'selective liberalization'" model of establishment conditions. Also see WTO document WT/WGTI/W/121, "Communication from the European Community and Its Member States: Concept Paper on Modalities of Pre-Establishment."
[121] This relates to what UNCTAD and the WTO describe as the "investment control" model of establishment conditions. See, e.g. Articles 3 and 4 of the Iran – South Africa Bilateral Investment Treaty
[122] See NAFTA Article 1106(1-3), which prohibits such requirements
[123] See draft MAI text, Article III on performance requirements
[124] See Articles 1, 2 and Annex of the WTO TRIMs Agreement, which restricts disciplines to trade in goods
[125] See WTO document S/WPGR/W/42, Communication from the European Communities: "Government Procurement of Services."
[126] See NAFTA Article 1110 on expropriation and compensation
[127] See NAFTA Article 1120 on initiation of international arbitration

Relaxing these restrictions would increase the space for sustainable development policies. But potential for conflict could remain even under an intermediate regime. If the energy sector were bound without carve-outs for specific social policies, pre-establishment non-discrimination – even on the basis of a positive list – could pose problems for ownership restrictions in the electricity sector. A positive list for pre-establishment commitments creates more space than a negative list, but it ultimately makes sectoral coverage a political matter to be negotiated bilaterally between governments of potentially unequal negotiating capacity. Given the realistic assumption that governments will face pressure to make progressively broader commitments over time, even a positive list approach may eventually grow to encompass a significant portion of economic activity. Finally, a intermediate regime would still include recourse to international arbitration – even in cases where contracts specify that disputes be settled through domestic processes, as in the example of Argentina's utility rate freezes.

The flexible regime offers investors the stability of post-establishment national treatment while permitting countries to impose entry requirements on new investments. Under the flexible regime, the conflicts identified in the case studies are minimized, suggesting that more flexible investment rules provide governments more space with which to govern investments. There are always tradeoffs to be made between investor interests and policy flexibility, but our analysis illuminates the basic principle that expanding market access commitments and investor protection rapidly diminishes the policy space available to governments.