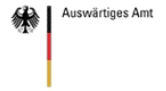


# International Conference



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### **The Global Governance of Trade, Environment and Sustainable Development**



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## **Will International Investment Rules Shrink Policy Space for Sustainable Development?**

### **Evidence from the Electricity Sector**

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**1. Introduction**

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 and analysis in this paper suggest that effective promotion of sustainable development may require use of heterodox and selectively interventionist policy instruments. Integrating sustainable development into the electricity sector involves addressing social, environmental and economic considerations, including ensuring access, reducing pollution, and meeting objectives related to social equity. The policies discussed in this paper have been motivated by legitimate public goals and have, in general, met with a reasonable degree of success. Although a high degree of uncertainty in the electricity sector and in international investment negotiations makes this work inherently speculative, the following discussion indicates that investment rules could indeed shrink the policy space for sustainable development in the electricity sector.

**2. Power Sector Reform, Investment, and the Public Benefits Agenda**

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 inexpensive power. However, technological change, higher risks, stagnant demand, and a rising global ideological predisposition toward markets challenged this model, and reformers aimed to increase efficiency by subjecting the sector to competition. Despite the absence of a blueprint for achieving competition in the technologically complex and heavily networked electricity industry, the United Kingdom and Chile “unbundled” the various components of the electricity system, privatizing generation and distribution businesses and establishing a market for upstream and downstream electricity services.

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.<sup>1</sup> 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 greater priority 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.”<sup>2</sup> In short, experimentation and heterogeneity are important ingredients of successful electricity sector policies.

Integrating sustainable development concerns into a rapidly changing and increasingly deregulated industry may therefore require innovative and flexible policies. In short, such integration requires *policy space for sustainable development*, a term whose intellectual lineage derives from debates over the proper role of government in economic development. Contrary to the basic tenets of the neoliberal model of economic policy immanent in the “Washington Consensus,” recent economic research suggests that space for heterogeneous and selectively interventionist policies can play a critical role in economic development.<sup>3</sup> 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. Similarly, policymakers restructuring electricity sectors 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.<sup>4</sup> Furthermore, the need for such measures is as great in industrialized countries as it is in developing nations.<sup>5</sup> In an era of intensive international economic integration, preserving the space for such policy measures will become increasingly important.

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<sup>1</sup> 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.

<sup>2</sup> World Bank, 2003, *Private Sector Development in the Electric Power Sector*, OED, p. ix.

<sup>3</sup> 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.

<sup>4</sup> Dubash, Navroz ed. *Power Politics: Equity and Environment in Electricity Reform*. Washington: World Resources Institute, 2002

<sup>5</sup> 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.

Despite the failure to launch talks on the Singapore issues in Cancun, the proponents of investment negotiations continue to support the inclusion of investment disciplines in the World Trade Organization. These demands raise a set of issues directly relevant to policy space for sustainable development in the electricity sector. In the proposed 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.<sup>6</sup> As the two illustrative case studies that follow suggest, new disciplines in these areas could have serious implications for policy space in the electricity sector.

### 3. 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.<sup>7</sup> While renewable portfolio standards can effectively stimulate the development of a local market for sustainable 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.<sup>8</sup> Others believe that rewarding clean energy sources discriminates based on non-product-related process and production methods (PPMs), and therefore violates the GATT.<sup>9</sup> 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.<sup>10</sup>

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

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<sup>6</sup> For a detailed explanation and discussion of these issues, see the full working paper.

<sup>7</sup> 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.

<sup>8</sup> 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.

<sup>9</sup> Campbell, Laura. "Energy Globalization and the Environment: Bridging the International Governance Gap." In Energy Market Restructuring and the Environment.

<sup>10</sup> 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.

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.<sup>11</sup> 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.<sup>12</sup> 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 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.<sup>13</sup> 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.<sup>14</sup>

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

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<sup>11</sup> AZ Corporation Commission mandate R14-2-1618, February 2001.

<sup>12</sup> "Electricity Providers Face New Mandate on Renewable Energy." Associated Press, 4/27/2000.

<sup>13</sup> 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.

<sup>14</sup> 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.

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.<sup>15</sup> 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.

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.

#### **4. 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.<sup>16</sup> The South African government is also developing a multi-sectoral program of black empowerment, including a specific set of objectives for the electricity sector.<sup>17</sup> 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 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

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<sup>15</sup> 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>

<sup>16</sup> 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>

<sup>17</sup> 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.

unbundled and privatized, and the government intends to integrate equity issues into the restructuring process.<sup>18</sup> 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.<sup>19</sup> 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.<sup>20</sup>

Other BEE provisions require companies to make progress on black empowerment as a condition of eligibility for government contracts<sup>21</sup>. 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.<sup>22</sup>

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.<sup>23,24</sup> 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. BEE policies could also be construed as performance requirements, which are prohibited in several extant investment treaties.<sup>25,26</sup>

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

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<sup>18</sup> 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.

<sup>19</sup> Scott, Norval. "Eskom Sets 2006 As Privatization Deadline." *World Markets Analysis*, March 4, 2003.

<sup>20</sup> Stoppard, Anthony. "Black Empowerment Policy Worries Investors." *InterPress Service*, August 12, 2002.

<sup>21</sup> Mortished, Carl. "Black Empowerment Hurdle for Government Contracts." *London Times*, April 26, 2003

<sup>22</sup> 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>

<sup>23</sup> Oppenheimer, Nicky. "A Fairer Society Needs Faster Growth." *Financial Times*, 15 August 2003.

<sup>24</sup> "Black Empowerment." Editorial, *Financial Times*. 7 August 2003.

<sup>25</sup> 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 and similar clauses in other treaties.

<sup>26</sup> Peterson, Luke. "South Africa's Black Economic Empowerment Plans an Obstacle to a US FTA?" *Investment Law and Sustainable Development Weekly*, July 8, 2003

agreements that included national treatment provisions without making exemptions for programs targeting socioeconomically 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.

## **5. Cultivating Policy Space for Sustainable Development**

As these cases suggest, new disciplines and further liberalization often come at the price of policy space. In Arizona, disciplines on performance requirements could present problems for policies designed to build support for environmentally friendly electricity. The case of South Africa suggests potential conflict between the principles in investment rules and the pursuit of objectives related to social equity. The full version of this paper identifies further potential for conflict between investment disciplines and rural access policies, environmental planning and crisis management in a variety of different contexts.

While few would dispute that limiting 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 a multilateral framework on investment needs to be weighed against the possible costs of diminished policy space for sustainable development.

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 "GATS-style positive list" 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. For various reasons, comprehensive exemptions are difficult to schedule even under a positive list approach.<sup>27</sup> Requiring exemptions to 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. In light of these

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<sup>27</sup> For a detailed explanation and discussion of these issues, see pages 8-9 of the full working paper.

and other arguments, the cases we have discussed support the view that the ability to retain policy space exists more in theory than in practice.

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.