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Investor Legitimate Expectation and Indirect Expropriation in Domestic Regulation Concerning the Application of Domestic Raw Application

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Abstract

Law No 11/2020 concerning Job Creation (Omnibus Law') mandates the use of domestic raw materials for all industries in Indonesia. Following the passage of the Omnibus Law, Indonesia issued Government Regulation No 28/2021 concerning Industrial Management and Presidential Regulation No 12/2021 concerning the amendment of Presidential Regulation No 16/2018 concerning Government Procurement of Goods and Services. Both regulations oblige all industries in Indonesia to use domestic raw materials pursuant to the Omnibus Law. In investment law, this kind of policy could lead to indirect expropriation because when an investor makes an investment in a host country, the raw material and machines for production might come from their home state or other states. Furthermore, a public-private partnership contract with investors funding infrastructure projects for at least 50 years using materials agreed upon in advance will lead to indirect expropriation. The method used in this research was legal research theory with statute and conceptual approaches. From this research, the policy of the Indonesian government can be described as indirect expropriation because the regulation is effective and enforced.

Keywords: Investment; Domestic Raw Materials; Indirect Expropriation.

Introduction

Investment dispute settlement consists of state-to-state dispute settlement, investor-state dispute settlement (ISDS) and business-to-business dispute settlement. The current forums used to settle investor-state disputes are international commercial arbitration, the International Centre for Settlement of Investment Disputes (ICSID) and the Investment Court Systems (ICS). Investor-state dispute settlement permits investors to sue host states for breaches of international law; therefore, ISDS is said to protect investor interests. Moreover, the protection of investor interests is based

on the minimum standard of treatment of investment activity and legitimate investor expectations. Nonetheless, there is the same proportion of protection for the host state because it has the right to regulate based on sovereignty and the public interest.

This article examines the Indonesian government's goal of regulating the use of domestic raw materials in the industrial sector and the limits on such regulation by international law, particularly the legitimate expectations of investors, the standard of treatment of investors and regulation 'tantamount' to expropriation that requires compensation. Law No 11/2020 concerning Job Creation ('Omnibus Law') is an omnibus law. The Omnibus Law focuses on the uncertainty of the global economic slowdown and geopolitical dynamics, changes in technology, industry 4.0, digital economy, average economic growth in the range of 5% in the last five years with an investment realisation of approximately IDR 721.3 trillion in 2018 and IDR 792 trillion in 2019, overlapping regulations, low investment effectiveness, unemployment, new workforce and informal workers, and the low productivity of micro-companies.¹

Following the passage of the Omnibus Law, Indonesia issued Government Regulation No 28/2021 concerning Industrial Management ('GR 28') and Presidential Regulation No 12/2021 concerning the amendment of Presidential Regulation No 16/2018 concerning Government Procurement of Goods and Services ('PR 12'). Both regulations oblige all industries in Indonesia to use domestic raw materials pursuant to the Omnibus Law. In investment law, this kind of policy could lead to indirect expropriation because when an investor makes an investment in a host country, the raw material and machines for production might come from their home state or other states. Moreover, this regulation can also add costs to their investment activity, leading to claims of indirect expropriation. Therefore, this situation calls into question whether the implementation of a domestic raw material restriction will cause an indirect expropriation based on a breach of legitimate expectations of investors.

¹ Kementerian Hukum dan HAM RI, 'Laporan Akhir Analisis Dan Evaluasi Undang-Undang Nomor 3 Tahun 2014 Tentang Perindustrian' (2021).

Fair and Equitable Treatment

The fair and equitable treatment (FET) standard is a cornerstone of international law protecting investors and their investments. It has attracted significant attention in doctrinal writing by international scholars and recent arbitral jurisprudence under the auspices of the North American Free Trade Agreement (NAFTA) and the ICSID. To date, the standard has been discussed primarily as a measure for determining the obligations of host countries to investors and investments.² It is now well settled that FET requires an approach to government action and policy on the part of the host country that encapsulates the obligations to act in a consistent manner free from ambiguity, with transparency, without arbitrariness and in accordance with the principle of good faith.³

The general assumption is that ‘fair and equitable’ must be considered to represent a single, unified standard. Indeed, it has been opined that there is no difference between ‘equitable’ and ‘fair’. It is also understood that the relationship between FET and the concept of a minimum standard is based on the general international law that a state must always observe in its relations the bilateral investment treaties (BITs) made with its partners.⁴

From the *Metalclad* case, the tribunal requires ‘a transparent and predictable framework’ and an ‘orderly process and timely disposition in relation to an investor of a Party acting in the expectation that it would be treated fairly and justly...’.⁵ Thus, the tribunal indicates that an investment shall enjoy full security and shall in no case be treated less than that required by international law. Hence, the arrangement of FET based on a treaty shall be no different in international law. However, parties in their initial action of making a treaty should consider that the definition of FET given

² Peter Muchlinski, ‘“Caveat Investor”? The Relevance of the Conduct of the Investor under the Fair and Equitable Treatment Standard’ (2006) 55 *International and Comparative Law Quarterly*. [527].

³ *ibid.*

⁴ ‘*ADF Group, Inc v United States*, 18 ICSID Rev 195, 228, 276 (9 January 2003) Lamm, Arbs), Remarkably, the UNCTAD Secretariat Has Questioned Whether the Stan UN Conference on Trade & Development, Fair and Equitable Treatment 15, U (Vol III), UN Sales’.

⁵ London Ct Int’l Arb, ‘*Occidental Exploration and Production Company (OPEC) v Ecuador*, Case No UN 3467’ (2004) <www.asil.org/ilib/OEPC-Ecuador.pdf>.

by international law will cause wide variations in its implementation. Therefore, treaty drafters should provide details on the interests of the parties, which will lead to clearer limitations on the implication of the FET standard.

The FET standard aims to achieve substantive and procedural fairness. Based on the principle of rule of law, international investment agreements must provide clear arrangements and procedures. Investment disputes are to be resolved by a neutral body to ensure independence and impartiality. Therefore, it is necessary to balance the protection of the state's right to regulate and the legitimate expectations of investors.

'Consequently, the concept of Fair and Equitable Treatment (FET), National Treatment (NT), Most Favoured Nations (MFN) as the substantive rights of foreign investors should also be based on the principle of rule of law'.⁶ The FET standard, for example, should not go beyond the limits of protecting the national interest (public interest) of the host state. In other words, the concept of FET is not widely applied, which can violate the protection of the public interest. Therefore, FET in some BIT models is adjusted at a minimum based on protecting standards regulated in customary international law.

The FET clause is considered the main clause in investment agreements because foreign investment protection seems to be guaranteed in its entirety with only this one clause. There is no definite limit on its scope. Sometimes it is difficult for the investment destination country to determine whether an action is fair or unfair.

The scope limitation of the FET clause can be seen in *Tecmec v Mexican*.⁷ There, the arbitral tribunal decided that to avoid the obligations in the FET clause, the investment destination country must avoid:

- a. Influencing legitimate expectations by investors when deciding to invest in the country; and

⁶ Kenneth J Vandeveld, 'A Unified Theory of Fair and Equitable Treatment' (2010) 43 International Law and Politics 43, 49.

⁷ *Tecnicas Medoambientales Tecmed SA v United Mexican States*, ICSID Case No ARB(AF)/00/2, Award (29 May 2003).

- b. Issue inconsistent rules, rules must be free from ambiguity and transparent. So that investors can find out every relevant rule and the desired investment results before making their investment.

The standards set by the tribunal appear to be high and burden the governments of investment destination countries. The governments become limited in their scope of movement if they are required to consider the legitimate expectations of foreign investors.

In contrast, the tribunal in *Saluka Investment BV*⁸ applied a looser standard to the FET clause. It considered the FET standard in *Tecmed* inaccurate and unrealistic. The tribunal decided that legitimate expectations must be adjusted to the conditions in the investment destination country.

Regardless of considering the conditions of the investment destination country, the FET clause still causes problems. Its broad scope makes it harder for the governments of developing countries to issue new rules protecting economic, social and environmental rights. The result is a regulatory chill, where the government does not dare issue new laws and regulations that could disrupt or harm foreign investors.

Legitimate Expectations of Investors

The general structure of BITs includes definitions of ‘investor’ and ‘investment’, protection provisions regulating general treatment, absolute treatment provisions and dispute resolution provisions. Protection provisions regulate FET, most favoured nation (MFN) status and national treatment (NT). Absolute treatment provisions regulate expropriation and compensation and the (free) export of profits. Dispute resolution provisions regulate investor-state dispute resolution and state-to-state dispute resolution.

An FET clause has procedural and substantive content. The procedural content regulates the host state’s administrative decision-making process; the substantive content regulates the legitimate expectations of investors. The tribunal has different

⁸ *Saluka Investments BV v Czech Republic*, UNCITRAL, Partial Award (17 Mar 2006).

views on legitimate expectations. For example, in *Parkerings-Compagniet AS v Lithuania*,⁹ the investor should have known that changes to the law might occur. In that case, the tribunal decided that it was not legitimate for the investor to expect Lithuania, a country undergoing significant regulatory changes for accession to the EU, to remain at a legislative standstill.

In *Tecmed*,¹⁰ the host state has no right to introduce unforeseen regulations. There, under the FET clause, the host state had to act in a manner that, among other things, '[d]oes not affect the basic expectations that were taken into account by the foreign investor to make the investment', is consistent, and is '[f]ree from ambiguity and totally transparent,' so that the investor may know all the relevant rules, regulations and respective goals before investing. Tecmed required the host state to respect the basic expectations of the investor at the time of the investment and not arbitrarily revoke any decisions upon which the investor had relied in planning its investment.

The notion that the FET clause protects the legitimate expectations of investors is standard. Would result in host state obligations that were 'inappropriate and unrealistic'. Moreover, in *Saluka Investments BV v Czech Republic*,¹¹ the tribunal reasoned that investors' expectations must be reasonable and legitimate in light of the circumstances prevailing in the host country.

In *Occidental v Ecuador*,¹² the tribunal confirmed that the unilateral change of the legal and contractual framework existing at the time of the original investment

⁹ *Parkerings-Compagniet AS v Republic of Lithuania*, ICSID Case No ARB/05/8 Award (11 September 2007) <www.iisd.org/itn/en/2018/10/18/parkerings-v-lithuania/#:~:text=The%20Claimant%2C%20Parkerings%E2%80%93Compagniet%20AS%20%28%E2%80%9CParkerings%E2%80%9D%29%2C%20initiated%20its%20ICSID,bilateral%20investment%20treaty%20%28BIT%29%20between%20Lithuania%20and%20Norway> accessed 8 April 2022.

¹⁰ *Tecnicas Medioambientales Tecmed SA v United Mexican States*. ICSID Case No ARB(AF)/00/2, Award (29 May 2003) <<https://www.iisd.org/itn/en/2018/10/18/tecmed-v-mexico/>> accessed 8 April 2022.

¹¹ UNCTAD Investment Policy Hub, 'Saluka Investments BV v The Czech Republic' (*Investment Dispute Settlement Navigator*).

¹² *Occidental Exploration and Production Company v Republic of Ecuador (I)* (Case No UN3467), *Occidental v Ecuador (I)* | *Investment Dispute Settlement Navigator* | UNCTAD Investment Policy Hub.

would frustrate the investor's legitimate expectations and violate the FET standard. As the tribunal explained, 'There is certainly an obligation not to alter the legal and business environment in which the investment has been made'.

The tribunal in *LG&E v Argentina*¹³ stated that the understanding of FET involves consideration of the investor's expectations when making its investment in reliance on the protections to be granted by the host state. In *LG&E*, the tribunal held that FET requires that a host state maintains the 'stability of the legal and business framework'. Similarly, in *Alpha v Ukraine*,¹⁴ the tribunal emphasised the duty of the host state not to arbitrarily change the rules to the detriment of the investor.

*Thunderbird v Mexico*¹⁵ ruled that an investor may rely on the host state's conduct, which creates justifiable expectations:

The concept of 'legitimate expectations' relates... to a situation where a Contracting Party's conduct creates reasonable and justifiable expectations on the part of an investor (or an investment) to act in reliance on such conduct, such that a failure by the Party to honor those expectations could cause the investor (or the investment) to suffer damages.

In *National Grid v Argentina*,¹⁶ the tribunal ruled that FET standards protect the investor's expectations, which were 'reasonable and legitimate in the context in which the investment was made.' Here, the Tribunal pointed to the economic situation and regulatory legal framework of the host state and the inducement of the investment by the host state. In *Total v Argentina*,¹⁷ the majority decided that the legal order could not serve as a basis for legitimate expectations. The legal order would have been relevant only where the relevant laws were prospective in nature.

In *El Paso v Argentina*,¹⁸ 'There is an overwhelming trend to consider the touchstone of fair and equitable treatment to be found in the legitimate and reasonable

¹³ *LG&E Energy Corp, LG&E Capital Corp and LG&E International Inc v Argentine Republic LG&E v Argentina*.

¹⁴ *International Thunderbird Gaming Corporation v The United Mexican States, Thunderbird v Mexico*.

¹⁵ *ibid.*

¹⁶ UNCTAD Investment Policy Hub, 'National Grid PLC v The Argentine Republic, National Grid v Argentina'.

¹⁷ *Total SA v The Argentine Republic Total SA v The Argentine Republic*.

¹⁸ *El Paso Energy International Company v Argentine Republic*.

expectations of the Parties, which derive from the obligation of good faith'. In *El Paso*, the tribunal stated that a host state 'should not unreasonably modify the legal framework or modify it in contradiction with a specific commitment'.

Expropriation and Compensation

International law provides for expropriation or the expropriation of assets or ownership of foreign investors by the destination country of investment. Governments expropriate investments for many reasons, including infrastructure and industrial development that affects the lives of many people. Expropriation can be carried out if it is effected for the public interest in a non-discriminatory manner (ie does not target certain companies and countries) under due process of law.

There are two types of expropriation: direct and indirect. Direct expropriation (ie nationalisation) is the transfer of assets and ownership. Fewer problems are caused by direct expropriation because the investment destination country is obliged to compensate. In contrast, indirect expropriation does not result in the transfer of assets or property, but there is a partial or total relinquishment of effective control over the investment. For example, the government may include its representatives on the boards of directors of foreign companies.

There are at least three approaches to demonstrating indirect expropriation. First, there is the doctrine of 'sole effects'. This approach tends not to consider the objectives of government action; the only consideration is the result of the government's actions against investors. If the government's actions result in a loss of investor control over their investment, an indirect takeover has occurred.

The doctrine of sole effects was applied in *Metalclad v Mexican*. The government refused to extend the hazardous waste management business licence for Metalclad. In this regard, the tribunal opined:

Thus, expropriation under NAFTA includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favour of the host State, but also covert or incidental interference with the use of property which has the effect of

depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State.¹⁹

Meanwhile, regarding the government's decision to convert the location of the waste processing business into an environmental conservation area, the tribunal stated, 'The Tribunal needs not decide or consider the motivation or intent of the adoption of the Ecological Decree'. Thus, the purpose of the government regulation issued becomes unimportant, even though the reason is to increase the prosperity of the people. The tribunal found there had been an indirect takeover because the government's actions affected the business activities of foreign investors.

Second, there is the proportionality approach. This approach provides a balanced consideration of the public interest and the losses borne by foreign investors. Both must be proportional, meaning that foreign investors' losses should not exceed the expected public gains.

The proportionality approach was adopted in *Tecmed*, where the government refused to extend the hazardous waste management permit because Tecmed had violated several legal provisions. According to the tribunal, the government carried out an indirect expropriation because its reason for refusing to extend the permit was due to protests from local residents, not environmental conservation.

Third, there is the 'police powers' carve-out approach. This approach uses the state's police powers to regulate its jurisdiction. If the state's actions are non-discriminatory and intended for the public benefit, these actions can be carved out.

The tribunal relied on the police powers approach in *Methanex Corporation v United States*. The State of California government banned the use of methyl tertiary butyl ether (MTBE), an additive to gasoline, because this substance pollutes groundwater. Methanex was a producer of methanol, one of the elements in MTBE. The tribunal decided that 'as a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process'.

¹⁹ *ibid.*[103].

As long as the government acts for the public interest in a non-discriminatory manner (ie does not target certain companies and countries) under due process of law, the government's action is permissible.

Indirect expropriation actions by the government can be analysed from several cases. Although there are inconsistencies, these cases provide several indications of indirect expropriation claims originating from judicial or arbitration decisions as follows.²⁰

1) The effect of the government's action on the rights of investors

Several international cases concern government actions that cause losses for investors due to restrictions on their economic rights. The economic rights of investors are substantially affected, such as terms of ownership, use and management of their business. When investors still enjoy the use of ownership rights, the action cannot be categorised as indirect expropriation.

In the context of NAFTA, the court in *Pope & Talbot* found that although implementing export quotas reduced the profits from the sale of Pope & Talbot companies, the government did not completely prohibit the action, and investors could still benefit. As stated, the tribunal observed, '...mere interference is not expropriation; rather, a significant degree of deprivation of fundamental rights of ownership is required'.²¹

In *Marvin Roy Feldman Karpa (CEMSA) v United States of America Mexico*, CEMSA, registered as a Mexican foreign trading company and exporter of cigarettes, was allegedly denied the right to a certain tax refund to the exporter and claimed expropriation under article 1110 of NAFTA. The plaintiff argued that a series of tax regulations and reforms constituted confiscation. However, the court refused to find that confiscation had occurred because (i) ordinary business matters

²⁰ Sara Mansour Fallah, 'Judicial Expropriations-Difficulties in Drawing the Line between Adjudication and Expropriation' (2019) 2 Judicial Measures and Investment Treaty Law <www.transnational-dispute-management.com/article.asp?key=2635>.

²¹ *Pope & Talbot, Inc v Canada*, UNCITRAL, Interim Award (26 June 2000).

did not constitute confiscation; (ii) NAFTA and customary international law do not require countries to permit the export of cigarettes; (iii) the tax regulation in no way guarantees cigarette sellers the ‘right’ to export cigarettes; and (iv) the plaintiff’s investment activities are always under his control. The court found that the alleged indirect expropriation action was not proven.²²

2) The character of the government’s actions, based on the purpose and basis for carrying out takeover actions as regulated in the laws and regulations.

A significant factor in classifying a government action as expropriation is to measure whether the action refers to the right of the state to promote recognition of the ‘public interest’ by a national level statutory regulation. The international court will not refer to such action as expropriation.

Other actions that include expropriation but do not require compensation for the expropriation are ‘[n]on-discriminatory measures’ related to takeovers:

1. Protection of the environment,
2. Protection of human rights,
3. Consumer protection as long as it is considered a fundamental element for the state.

This is regulated in article 1 of Protocol 1 of the Convention on Human Rights. In addition, the existence of national laws and regulations is an indicator that expropriation is based on creating transparency and political, social and economic stability to ensure legal certainty.

3) The parameters used as a measure are based on the principle of fairness and expected reciprocity.

Another criterion identified is that the government’s actions affect ‘the investor’s reasonable expectations’. In this case, the investor must prove that its

²² Peter D Isakoff, ‘Defining the Scope of Indirect Expropriation for International Investment’ (2013) 3 Global Business Law Review 189 <<https://engagedscholarship.csuohio.edu/gblr/vol3/iss2/4>>.

investment is based on circumstances that do not belong to the contested regulatory regime. Moreover, such claims must be objective, reasonable and not based entirely on the subjective expectations of investors.

The protection of the property rights of foreign investors is known as the 'Property of Aliens' in investment law. Such property cannot be taken over, even for public purposes or in the public interest, without prompt, adequate and effective compensation. However, international law stipulates that not all state actions impact indirect expropriation. As Brownlie stated.

State measures, prima facie a lawful exercise of powers of governments, may affect foreign interests considerably without amounting to expropriation. Thus, foreign assets and their use may be subjected to taxation, trade restrictions involving licenses and quotas, or measures of devaluation. While special facts may alter cases, in principle such measures are not unlawful and do not constitute expropriation.²³

Sornarajah also states that 'non-discriminatory measures related to antitrust, consumer protection, securities, environmental protection, land planning are non-compensable takings since they are regarded as essential to the efficient functioning of the state'.²⁴

An expropriation or restriction of the rights of investors necessitates the government compensating for this situation. Doing so creates legal certainty for the recipient country of capital and investors. As Dolzer observes:

Due and actions qualifying as indirect expropriations (that require compensation) may well make the difference between the burden to operate (or abandon) a non-profitable enterprise and the right to receive full compensation (either from the host State or from an insurance contract). For the host State, the definition determines the scope of the State's power to enact legislation that regulates the rights and obligations of owners in instances where compensation may fall due. It may be argued that the State is prevented from taking any such measures where these cannot be covered by public financial resources.²⁵

Therefore, in Indonesia, the Omnibus Law was followed by GR 28 and PR 12. Both regulations oblige all industries in Indonesia to use domestic raw materials

²³ Ian Brownlie, *Public International Law* (6th edn, OUP 2003).

²⁴ M Sornarajah, *The International Law on Foreign Investment* (CUP 1994).

²⁵ Rudolf Dolzer and Margrete Stevens, 'Bilateral Investment Treaties' [1995] ICSID 98.

pursuant to the Omnibus Law. This obligation, especially for procuring goods and services, will cause losses for investors and have a major effect on the planning of investment activity. Therefore, investors may claim indirect expropriation.

Furthermore, based on article 175 of GR 28, the regulation is effective because the government issued it; therefore, investors are not given any opportunity to adjust to the law. With the regulation, all industries must use domestic raw materials. To avoid an indirect expropriation claim, the government should enact an additional policy implementing a grandfather clause, which allows persons or entities to continue with activities or operations approved before new rules, regulations, or laws. Such allowances can be permanent, temporary or instituted with limits.

To be permissible as an indirect expropriation, the policy must be carried out for the public interest or national interest in a non-discriminatory manner under due process of law. Industrial development is one of the main pillars of the development of the national economy, which is achieved by implementing the principles of sustainable industrial development based on aspects of economic, social, cultural and environmental development. Currently, industrial development faces global competition, which influences the development of the national industry. Increasing industrial competitiveness is one way for national industrial products to compete domestically and internationally. However, the content of the Omnibus Law, GR 28 and PR 12 together boost investors claims of indirect expropriation.

Conclusion

Indirect expropriation is conduct by the government or certain authorities who hold power in the sector and policy changes that cause losses to investors. To ensure legal certainty for the host state and investors, three parameters of government action are set: the effect of the action on the rights of investors, the character of government actions based on the objectives and reasons for the action, and the principle of fairness and reciprocity in performing the action. These parameters are needed because when investors conduct their investment activity, they have legitimate expectations protected by a minimum standard of treatment.

The Omnibus Law, GR 28 and PR 12 lead to indirect expropriation. Therefore, the Indonesian government should implement a grandfather clause to accommodate the needs of investors.

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