Resource Nationalism in International Investment Law

Sangwani Patrick Ng'ambi

ROUTLEDGE

Resource Nationalism in International Investment Law

Foreign direct investment in the natural resource industries is fostered through the signing of concession agreements between the host state and the investor. However, such concessions are susceptible to alteration by the host state, meaning that many investors now require the insertion of stabilization clauses. These are provisions that require the host state to agree that it will not take any administrative or legislative action that would adversely affect the rights of the investor.

Arguing that it is necessary to have some form of flexibility in concession agreements, whilst still offering protection of the legitimate expectations of the investor, *Resource Nationalism in International Investment Law* proposes the insertion of renegotiation clauses in order to foster flexible relationships between the investor and the host state. Such clauses bind the parties to renegotiate the terms of the contract, in good faith, when prevailing circumstances change. However, these clauses can also prove problematic for both state and investor, owing to their rigidity. Using Zambia as a case study, it highlights the limitations of the efficient breach theory to emphasize the need for contractual flexibility.

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Routledge
Taylor & Francis Group
LONDON AND NEW YORK

First published 2016
by Routledge
2 Park Square, Milton Park, Abingdon, Oxon OX14 4RN

and by Routledge
711 Third Avenue, New York, NY 10017

Routledge is an imprint of the Taylor & Francis Group, an informa business

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

Library of Congress Cataloging-in-Publication Data
Ng'ambi, Sangwani Patrick, author.
Resource nationalism in international investment law / Sangwani Patrick Ng'ambi.
pages cm
Includes bibliographical references and index.
ISBN 978-1-138-95158-7 (hbk)—ISBN 978-1-315-66811-6 (ebk)
1. Investments, Foreign—Law and legislation. 2. Mineral investment. 3. Mineral investment—Zambia. I. Title.
K3830.N496 2016
346'.092—dc23 2015019525

ISBN: 978-1-138-95158-7 (hbk)
ISBN: 978-1-315-66811-6 (ebk)

Typeset in Baskerville by
Keystroke, Station Road, Codsall, Wolverhampton

To my mother, Daisy Nkhata Ng'ambi

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Introduction

1.1 Background

Foreign direct investment involves 'the transfer of tangible or intangible assets from one country to another for the purpose of their use in that country to generate wealth under the total or partial control of the owner of the assets'.[1] Acquiring such an interest in another economy will invariably create a contractual relationship between the investor and the host state, which could span for a period of up to 30 years or more.[2] During the said period, the investor will pour substantial resources into the host state in order to foster viable operations. The investor expects to recoup this initial investment and also to make a profit from it over the period that the contract subsists. In the long term, however, the contract may become susceptible to various political risks.

As a result of these risks, historically, there was a general reluctance to invest in developing countries owing to the non-commercial risks which threatened the investments. These non-commercial risks manifested themselves inter alia through political risks, which led to war and any other civil disturbance or an outright regime change, typically through extra-democratic means such as military coups. Such events would often be succeeded by seizure of foreign owned property through nationalization or indirect seizure by making it more onerous for concessionaires to run their operations. This led to efforts by the international community, led by the International Monetary Fund and the World Bank to encourage investment in developing countries.[3]

Many of these non-commercial and political risks are addressed by insurance schemes through the Multilateral Investment Guarantee Agency (MIGA), which

1 M. Sornarajah, *The International Law on Foreign Investment* (3rd edn, Cambridge University Press 2010) 8. See also *International Monetary Fund, Balance of Payments Manual* (International Monetary Fund 1993) 86.

2 Rudolph Dolzer and Christoph Schreuer, *Principles of International Investment Law* (2nd edn, OUP 2012) 21.

3 ibid. See also *World Bank, Legal Framework for the Treatment of Foreign Investment* (World Bank 1992).

operates under the auspices of the World Bank.[4] In addition, the World Bank encouraged potential host states to create an environment that attracted foreign direct investment. For many resource rich nations, this involved liberalizing their economies and revising their investment codes. The purpose of this was to enable developing countries to attract new capital, the transfer of technology and know-how, the creation of jobs, increased access to other markets and the strengthening of the local private sector.[5]

Host states thus began introducing investment friendly legislation. Such legislation included various incentives, including preferential tax breaks for a given period. In addition, they addressed issues such as compensation for expropriated property, provisions for externalization of profits and dispute settlement. For example, the Zambian Development Agency Act 2006 provides tax incentives for investments that exceed US$500,000 and these are to last for a period of five years.[6] Furthermore, if the investor is operating in a priority sector or rural area, then they are exempt from paying customs duties on any machinery acquired.[7] The Act also provides that any disputes arising out of the privatization process are to be settled by arbitration. This legislation is a means through which Zambia, as a host state, consents to have such disputes settled by arbitration.[8]

Furthermore, should the government expropriate the investor's property, the latter is entitled to compensation, which 'shall be made promptly at the market value and shall be fully transferable at the applicable exchange rate in the currency in which the investment was originally made, without deduction for taxes, levies and other duties, except where those are due'.[9] Moreover, investors are allowed to transfer profits made from their operations.[10] Neighbouring Namibia has similar provisions in its Foreign Investment Act.[11]

Certainly, since the 1980s, the flow of foreign direct investment to developing countries has increased dramatically.[12] A plethora of resource rich nations have been recipients of this foreign capital. The relationship between resource rich host states and foreign investors is governed inter alia through concession agreements between the aforementioned parties. The purpose of the concessions is to enable

4 See Ibrahim F.I. Shihata, 'The Multilateral Investment Guarantee Agency' (1986) 20 *International Lawyer* 485–97. See also Article 2(a) of the Convention Establishing the Multilateral Investment Guarantee Agency 1985.
5 *Invesment Law Reform: A Handbook for Development Practitioners* (World Bank 2010) 6.
6 See sections 55 and 56 of the Zambian Development Agency Act.
7 Section 57 of the Zambian Development Agency Act.
8 Andrea Marco Steingruber, *Consent in International Arbitration* (OUP 2012) 119–201.
9 Section 19 of the Zambian Development Agency Act.
10 Section 20 of the Zambian Development Agency Act.
11 Act No. 27, 1990.
12 Zakia Afrin, 'Foreign Direct Investments and Sustainable Development in the Least Developed Countries' (2004) 10 *Annual Survey of International & Comparative Law* 215, 217 and Tim Büthe and Helen Milner, 'The Politics of Foreign Direct Investment into Developing Countries: Increasing FDI through International Trade Agreements?' (2008) 52 *American Journal of Political Science* 741, 742.

the investor to explore and exploit their natural resources for a period of time. During the course of operations, investors are to pay the host state taxes and royalties, often at a preferential rate.

Within these concessions, investors will often seek additional contractual undertakings from the host state, designed to protect their investment even further. These invariably come in the form of stabilization clauses which are express undertakings on the part of the host state that they will not unilaterally jeopardize the investor's interests through legislative or administrative means. Given the length of concession agreements, a change of prevailing circumstances may episodically necessitate the renegotiation of certain terms of the contract. Stabilization clauses lead to rigidity, when what the parties need is flexibility.[13] In this book, I therefore argue that in addition to stabilization clauses, renegotiation clauses should also be included. These, in turn, will foster a flexible relationship between the two parties to the concession.

1.2 An overview of resource nationalism

1.2.1 The resource nationalism cycle

The investor is exposed to various risks when commencing operations in the host state. These risks are particularly evident in the advanced stages of the resource nationalism cycle.[14] This cycle begins when the host state grants a concession to the investor, who is invariably a foreign company. The cycle ends with the host government wishing to exert greater control over its natural resources, once the operations have commenced and have become more profitable.

Resource rich nations, typically, do not possess sufficient capital or know-how needed to explore and exploit their vast endowments of natural resources. Invariably, resource rich nations rely heavily on foreign direct investment, which brings in the much needed capital and other peripheral benefits.[15] Government policy is usually structured towards attracting foreign direct investment. They will do this through liberalizing the economy and also including tax incentives in the concession agreements. The agreement is usually structured in a way that the investor will run the operations and generate and retain its profits. However, out of these profits, the investor is expected to pay the host state taxes and a royalty. These terms are negotiated at a time when prices of the particular

13 Anne van Aaken, 'International Investment Law Between Commitment and Flexibility: A Contract Theory Analysis' (2009) 12 *Journal of International Economic Law* 507, 509.

14 See generally Thomas W. Wälde, 'Renegotiating Acquired Rights in the Oil and Gas Industries: Industry and Political Cycles Meet the Rule of Law' (2008) 1 *Journal of World Energy Law and Business* 55.

15 James C. Baker, *Foreign Direct Investment in Less Developed Countries: The Role of ICSID and MIGA* (Quorum Books 1999) 5.

natural resource are experiencing a low.[16] The government, to encourage investment, may adopt a very liberal stance and grant the investors various legal and fiscal incentives.[17]

When the prices begin to experience a sustained upward trend, the perception is that the foreign investor is making a larger profit. In such an instance, the host state may wish to exert greater control over its natural resources. This may be influenced by a national anti-investment sentiment. Stoking the fires of this nationalistic mood, might be the fact that, owing to low tax and royalty rates, the state is not fully maximizing the benefits of this windfall in the price of the nation's natural resource.

Whether or not the government takes a resource nationalist stance also depends largely on the type of political regime in the host state. Resource nationalism will typically occur where the political pressure exists and there are few checks and balances on the executive. An authoritarian regime is less likely to adopt a resource nationalistic stance, because even though there are fewer checks and balances, there are no elections and therefore the political pressure is not quite present. They may only act if their political hegemony is threatened. A democratic regime is also less likely to adopt a resource nationalist stance. This is owing to the fact that, whilst the political pressure may exist by way of regular elections, ultimately the checks and balances that typically exist in a fully democratic state may preclude them from acting in a manner that has an adverse effect on the investor.

The host state is most likely to adopt a resource nationalistic stance in a hybrid system. This is a system where the executive is still accountable to the people through set elections but where once in power it is less susceptible to checks and balances. Under such a system, the host state is likely to adopt a resource nationalistic stance because it is influenced by their need to retain power in the next election and there are no institutional mechanisms in place to prevent it from taking actions that will increase its actions of doing so. An example of such a system is Russia.

Once the host state takes a resource nationalist stance and seeks ways and means to have a greater share in the profits being generated by the investor, it ultimately means taking a less liberal stance than that taken during the negotiation stage. In moderate cases, this may mean a revision of the tax incentives that the foreign investors are receiving. In extreme cases, this may even lead to the outright nationalization of the investor's assets.[18]

16 Wälde (n 14) 55.

17 Thomas W. Wälde and George Ndi, 'Stabilizing International Investment Commitments: International Law Versus Contract Interpretation' (1996) 31 *Texas International Law Journal* 215, 223.

18 G. Joffé, P. Stevens, T. George, J. Lux and C. Searle, 'Expropriation of Oil and Gas Investments: Historical, Legal and Economic Perspectives in a New Age of Resource Nationalism' (2009) 2 *Journal of World Energy and Business* 3, 22.

1.2.2 The obsolescing bargain model

The obsolescing bargain model states that concession agreements are susceptible to later alteration by the host government once operations have commenced.[19] During the negotiation stages, investors are very aware that most resource rich nations depend on their capital to explore and exploit their natural resources. They are also aware that all the incentives given by the host state could easily be taken away once operations commence. Because the state needs the investment, it is in a relatively weaker position because at this point the investors could easily take their capital to a jurisdiction where they have the best chances of maximizing their investment. In this sense, the investor has a wider selection than the host government, who really has to make do with a relatively small number of investors seeking to enter its jurisdiction.

Taking advantage of this fact, the investor will use its economic muscle to request conditions from the host state that will work to the former's benefit. However, there remains the possibility that once the operations have commenced, the host state could then intervene by utilizing the legislative and administrative prerogatives at its disposal. For example, the host state could, through its legislature, pass laws to reverse any tax incentives previously granted or simply to foster the process of nationalizing the investor's asset, as mentioned above. It could also use its national army to occupy the premises of the investor's operations.[20] In this sense, once operations have commenced, the host state becomes the stronger party and the investor is in a considerably weaker position than it was during the negotiating stage.[21]

1.2.3 The rigidity of stabilization clauses

Wary of the eventualities raised in section 1.2.2 above, foreign investors will often insist on the insertion of various clauses into the concession agreement. They may, for example, insert arbitration clauses into the contract as a means of ensuring that, should a dispute arise, it will be heard in a neutral forum outside the scope of national law. They may also insist on the insertion of stabilization clauses into the concession agreement.[22] These are provisions that generally state that, for a given period of time, the government is precluded from making any legislative changes or taking administrative action that will have an adverse effect on the rights contained within the concession agreement.

19 See generally Raymond Vernon, *Sovereignty at Bay: The Multinational Spread of US Enterprises* (Longman 1971).
20 See *Benvenuti et Bonfant v People's Republic of Congo* (1982) 21 ILM 740.
21 See Sornarajah (n 1) 281.
22 Piero Bernardini, 'Investment Protection under Bilateral Investment Treaties and Investment Contracts' (2001) 2 *Journal of World Investment* 235, 241.

Therefore, in an instance where there is a conflict between the contractual rights contained within the concession containing a stabilization clause and subsequent municipal law, the former will always take precedence.[23] Although arbitral tribunals, for practical reasons, do not claim the right to compel specific performance, their respect for stabilization clauses and the sanctity of contracts is reflected in the compensation awards they render.[24]

The difficulty with such a position is that it leads to rigidity in the contracts. Such rigidity may not withstand the realities of the mines and minerals industry. The world prices of natural resources, such as copper and oil for example, are rather mercurial. A mineral that costs a certain amount one year may experience a dramatic increase in subsequent years. This was certainly evidenced in my case study on the Republic of Zambia as detailed in Chapter 5 of this book, which had seen a dramatic increase in the flow of foreign direct investment.[25] This increase was largely as a consequence of the liberalization of the Zambian economy, which was undertaken subsequently to the fall of socialism which took place in 1991.[26]

The Zambian economy has historically been linked to copper production. Prior to liberalization of the economy, the mines were in state hands, under the auspices of Zambia Consolidated Copper Mines (ZCCM). After 1991, however, the government embarked on a privatization programme. This eventually culminated in the mines being split into seven and being sold to foreign mining companies. To attract these companies, the Government of Zambia, amongst other things, offered a preferential tax regime. Mineral royalties were to stand at 0.2 per cent, which was lower than the 3 per cent stipulated in the Mines and Minerals Act. Furthermore, the corporate tax rate was reduced from 35 per cent to 25 per cent.[27]

In 2004, when most of the concessions were signed, the price of copper stood at US$2421.48 per ton on the London Metal Exchange (LME). In July 2006, this increased dramatically to US$7726.74 per ton. By October 2007, this had further increased to US$8020.59 per ton. These dramatic increases led to calls for the Government of Zambia to reconsider the preferential tax regime that the mining companies were enjoying. In 2008, the Government of Zambia acceded to these

23 See *Sapphire International Petroleum Ltd v National Iranian Oil Co (NIOC)* (1967) 35 ILR 136; *Saudi Arabia v Arabian American Oil Co (Aramco)* (1963) 27 ILR 117; *BP v Libya* (1979) 53 ILR 297; and *Texaco Overseas Oil Petroleum Co/California Asiatic Oil Co v Libya* (1978) 17 ILM 1.

24 See Jason W. Yackee, 'Pacta Sunt Servanda and State Promises to Foreign Investors Before Bilateral Investment Treaties: Myth and Reality' (2009) 32 *Fordham International Law Journal* 1550.

25 See generally Muweme Muweme, 'Foreign Direct Investment: What Difference for Zambia?' (2001) 50 *Jesuit Centre for Theological Research Bulletin* http://www.jctr.org.zm/publications/968-muwemecsr/file (last accessed 12 June 2015).

26 See generally John Lungu, 'Copper Mining Agreements in Zambia: Renegotiation or Law Reform?' (2008) 117 *Review of African Political Economy* 403.

27 John Lungu, *The Politics of Reforming Zambia's Mining Tax Regime* (Southern Africa Resource Watch 2009) 15.