



# Benchmarking South Africa's Foreign Direct Investment Policy

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## EXECUTIVE SUMMARY

This policy insights paper examines South Africa's proposed law on the promotion and protection of investment, and highlights the differences between this law and SADC's regional approach as adopted by South Africa. It illuminates the problematic differences with international investment law and the implications for attracting foreign direct investment (FDI), and discusses South Africa's considerations in balancing the competing interests of national development objectives and its obligations under international law.

## INTRODUCTION

South Africa's policy framework on investments is undergoing review, which prompted the decision in 2013 to terminate certain bilateral investment treaties (BITs). The Promotion and Protection of Investment Bill of 2013 (PPIB) has been introduced to promote and protect investments so as to limit the role of international investment agreements (IIAs) in protecting FDI.<sup>2</sup> This review was prompted by the Piero Foresti case,<sup>3</sup> in which foreign investors challenged South Africa's black economic empowerment (BEE) policy in international arbitration and unsettled the South African government. As a

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result, the proposed regulation aims to strike a balance between the rights and obligations of investors and the state's sovereign right to regulate in the public interest; replace international investment arbitration with domestic dispute resolution; and afford equal treatment to foreign and domestic investors.<sup>4</sup> Some of the justifications that have been put forward in support of South Africa's recent policy shift are the constitutional guarantees that mitigate the risks to foreign investors, the constitutionally mandated need to reclaim policy space from BIT practice; the unpredictability of interpreting BIT provisions; the ambivalent empirical evidence on the importance of IIAs in attracting FDI; and the importance of developing local institutions.<sup>5</sup>

This policy insights paper assesses this policy shift in the context of the balance between South Africa's national priorities and the protection standards provided for under international investment law; the extent to which its proposed policy succeeds in attracting FDI; and the effect of the proposed regulation on regional integration, by considering the future role of regional instruments such as the SADC Finance and Investment Protocol (FIP) and the SADC Model BIT<sup>6</sup> in South Africa's development strategy.

## THE PROMOTION AND PROTECTION OF INVESTMENT BILL OF 2013

Pending the passage of the PPIB into law, the regulatory framework governing foreign investments in South Africa is contained in its BITs. The PPIB is significantly different from the protection afforded foreign investors under South Africa's BITs for five reasons. First, the PPIB introduces a form of conditionality to the meaning of investment by requiring material economic investment or significant underlying physical presence.<sup>7</sup> Therefore, the definition of 'investment' requires more than contractual rights, which is not typical of BITs.

Second, the PPIB is unequivocal about the state's right to regulate in the public interest in order to redress inequalities, foster economic development and achieve the progressive realisation of socio-economic rights, and therefore adopts an approach to expropriation that is less onerous on the state.<sup>8</sup>

In general, expropriation can be direct or indirect. While direct expropriation results in complete acquisition of property by a state, indirect expropriation permits a state, for instance, to deprive the investor of all benefits of a property except its legal title.<sup>9</sup> Both forms of expropriation are compensable. However, customary international law also recognises a third form of property interference called state regulations. Where state regulations are legitimately exercised by a government, they are not regarded as being expropriation and are therefore not compensable.<sup>10</sup>

The PPIB guarantees the security of investments and provides that an investment may not be expropriated except for a public purpose or in the public

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The exclusion of indirect expropriation in the PPIB creates the most significant concern about South Africa's potential to attract FDI

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interest, under due process of law, against just and equitable compensation effected in a timely manner.<sup>11</sup> The PPIB introduces exemptions to what constitutes expropriation by carving out broad regulatory powers that will not constitute compensable indirect expropriation. It excludes measures taken by the government that have an incidental or indirect adverse impact on the economic value of an investment – measures aimed at protecting or enhancing legitimate public welfare objectives, environmental protection or state security, or where there is deprivation of property without any concomitant acquisition of ownership by the state.<sup>12</sup> The exclusion of indirect expropriation in the PPIB creates the most significant concern about South Africa's potential to attract FDI where the property rights of investors and market value compensation are not fully guaranteed. From a state perspective, the difference between indirect expropriation and state regulations is not clear and, as a result, has the potential to curtail the regulatory powers of the state.

These exceptions in the PPIB must be understood in the context of the objective of redressing some of the legacies of apartheid, which is not entirely at odds with emerging global practices, such as the Canadian and Australian governments' being in favour of the right to regulate in the public interest. What remains to be seen is how the courts in South Africa will balance the right of the state to regulate and the applicable public exceptions, while ensuring that the South African regulatory regime does not prejudice foreign investors. Under international arbitration, various approaches have been adopted in determining indirect expropriation and state regulation. In *Compania del Desarrollo de Santa Elena S.A. v The Republic of Costa Rica*<sup>13</sup> the tribunal held that the environmental purpose for the expropriation of the property did not 'alter the legal character of the taking for which adequate compensation must be paid', which negated the regulatory powers of the state entirely.<sup>14</sup> The tribunal in the *Methanex v United States of America*<sup>15</sup> case recognised a state's regulatory power, finding that a regulation enacted for a public purpose, which is non-discriminatory and enacted with due process, can affect a foreign investment without constituting expropriation or triggering compensation.<sup>16</sup> However, the rationale in the *Methanex* case is not binding since there are no precedents in investment arbitration, and the difference between indirect expropriation and state regulations remains unsettled. It is within this grey area of indirect expropriations and state regulations that the BEE policy in South Africa falls and was subject to arbitration in the *Piero Foresti* case, but it remains unresolved.

Third, unlike BITs that offer market-value compensation in cases of expropriation, the PPIB compensation model is based on the constitutional approach to balance the public interest and the interests of those affected, taking into account the current use of the investment; the history of the acquisition and use of the investment; the market value of the investment; and the purpose of the expropriation.<sup>17</sup>

Fourth, the PPIB is silent on the application of globally recognised investor protections. It recognises standard international investment obligations such

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as not treating foreign investors less favourably than domestic investors that operate in 'like circumstances'.<sup>18</sup> 'Like circumstances' is similar to a form of screening test, which requires consideration of the effect of the proposed investment in South Africa. However, other standards, such as prohibiting unfair and inequitable treatment of investors, established under international investment law and the most-favoured nation standard are absent. The absence of these protections implies that South Africa could offer advantages to investors from specific states without an obligation to extend the same advantages to all foreign investors, and accord different preferential treatment as the state deems fit to different foreign investors. Arguably, constitutional guarantees such as the right to just administrative action lessen the adverse effect of these absent standards.

Fifth, recourse to international arbitration has been explicitly removed from the PPIB. Investors will now have to request mediation through the state, approach the South African courts or undertake domestic arbitration through the Arbitration Act No. 42 of 1965.<sup>19</sup>

While the PPIB seeks to align its objectives with the South African constitution of 1996, it does so in a way that creates regulatory uncertainty with what applied previously in the old BIT regime and the regional investment approach that South Africa has adopted. It is necessary for these different fragmented approaches to be harmonised for consistency and certainty, and to consider the impact of these policies on regional integration within SADC.

## THE SADC INVESTMENT APPROACH AND IMPLICATIONS FOR REGIONAL INTEGRATION

The SADC FIP seeks to 'ensure that any changes to financial and investment policies in one State Party do not necessitate undesirable adjustments in other State Parties'.<sup>20</sup> The 'investment annex' of the FIP contains provisions that provide foreign investors with BIT-type protection.

The FIP guarantees fair and equitable treatment, and treatment no less favourable than that granted to investors from other states.<sup>21</sup> This is qualified with an exception that allows states parties in accordance with domestic legislation to grant preferential treatment to 'qualifying investments and investors in order to achieve national development objectives while safeguarding the principle of non-discrimination'.<sup>22</sup> With exceptions similar to those in the PPIB, the FIP also includes investment protection against the nationalisation or expropriation of investments'.<sup>23</sup>

Consistent with the overriding principle in the PPIB, the FIP recognises the right to regulate in the public interest,<sup>24</sup> while the preferred definition of 'investment' in the FIP is an 'asset-based' definition that is closed and exhaustive but different from the definition in the PPIB.<sup>25</sup>

Given the BIT-type protection offered in the FIP, such as international arbitration and fair and equitable treatment, South Africa's proposed policy is at odds with the policy adopted by SADC and will necessitate adjustments in other states parties. South Africa has the option of withdrawing from the FIP by giving 12 months' notice, but for regional integration reasons it may choose not to do so. While the FIP recognises standard international arbitration provisions provided local remedies are exhausted, the PPIB does not recognise this and the jurisdiction of the SADC tribunal has been limited to state–state dispute settlement. As a result, South Africa faces a balancing act of promoting domestic dispute settlement while supporting state–state dispute settlement. A bigger challenge to address will be the effect on its outward investments into other SADC countries, where South African investors will benefit from wider protection and the option of international arbitration, without similar protection being reciprocally offered for inward investments. Given that South Africa's BITs with other African countries are still in place, it finds itself in a situation where investors who come from countries that have BITs with South Africa can opt for international arbitration instead of domestic dispute settlement, leaving the country exposed to too many simultaneous platforms of dispute settlement.

South Africa either needs to review its domestic policy approach (given its misalignment with the regional position) and assume a policy more favourable to the integration and harmonisation of SADC states, or should advocate for a reform of SADC policies to make these consistent with the South African approach. The last-mentioned option is preferred, as will be discussed below.

## THE SADC MODEL BILATERAL INVESTMENT TREATY

The SADC Model BIT recognises the standard principles of international investment law relating to non-discrimination and expropriation, and fair and adequate compensation in cases of legitimate expropriation.<sup>26</sup> The Model BIT template recommends that SADC member states adopt a provision on 'fair administrative treatment' rather than the increasingly controversial 'fair and equitable treatment' provision found in most BITs.<sup>27</sup> The administrative treatment standard is consistent with the emerging framework of global administrative law that applies domestic administrative law principles to international law. This aligns IIAs with the domestic policy space of states, which builds up much-needed legitimacy for IIAs. This approach supports the fledgling democracy within SADC member states that is striving towards principles of participation and accountability.

The Model BIT provides for state–state dispute settlement as well as for international arbitration subject to the exhaustion of local remedies, although the drafting committee's preferred option is to exclude international arbitration and it noted that countries such as South Africa are looking to opt out of this process.<sup>28</sup> The suggestion for state–state dispute settlement is impractical, given that a state will not always agree with an investor on the cause of the grievance

in a dispute and the SADC tribunal has already failed in dealing with state–state disputes.

The inconsistencies between the Model BIT and South Africa's proposed domestic approach, on the one hand, and the provisions of the FIP, on the other, are unlikely to be accepted by SADC states for very long and necessitate the harmonisation of these various policy positions.

A way of harmonising these policies would be for SADC member states to terminate the FIP investment annex and adopt the SADC Model BIT in each respective state as their standard domestic investment policy rather than developing individual policies that may not be consistent with the regional approach, as South Africa has done.

While SADC member states may instead opt to adopt the FIP investment annex rather than the SADC Model BIT, the SADC Model BIT is more recent than the FIP and reflects a more considered, balancing approach between the regulatory interests of a state and foreign investors' legitimate expectations of protection. In addition, recent arbitration cases against Lesotho and Swaziland initiated under the FIP suggest that SADC states may be more willing to terminate the FIP in favour of domestic policies that adopt variations of the SADC Model BIT.

## BALANCING LEGITIMATE INTERESTS

Much has been said about South Africa's decision to opt out of BITs, but the PPIB is not entirely isolated from international law. Like all South African laws, the interpretation of the PPIB must be consistent with the South African constitution, which mandates the consideration of international law.

International investment protection standards sometimes differ from the objectives of South Africa's constitution to address socio-economic inequalities. In *Agri SA v Minister of Minerals and Energy*<sup>29</sup> (Agri SA case) the court found that the deprivation of rights in the Mineral and Petroleum Resources Development Amendment Act No. 49 of 2008 (MPRDA)<sup>30</sup> was not arbitrary, as a result of the objectives of the MPRDA to facilitate equitable access to South Africa's mineral resources.<sup>31</sup> The court suggested that acquisition of property must always occur for expropriation to be established, which differs from international practices, where indirect expropriation without acquisition of property is recognised.<sup>32</sup> The court acknowledged the social context of South Africa and decided 'not to over-emphasise private property rights at the expense of the state's social responsibilities'.<sup>33</sup>

The position taken by the court is consistent with the meaning of 'expropriation' as adopted by the PPIB, and raises questions about the balancing mechanism that the courts will employ where there are clashes between the interpretation of the constitution and recognised international standards.

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The PPIB, FIP and Model BIT offer different models of dispute resolution, ranging from domestic dispute settlement to international arbitration subject to the exhaustion of local remedies and a preference for state–state dispute settlement. At an international level, the trend for international arbitration has been around for much longer, but there is a mounting threat to the existence of this procedure.

Historically, international arbitration has been regarded as a ‘confidential, quick, and cost efficient method for resolving disputes, which creates an internationally enforceable award’.<sup>34</sup>

However, the advantages of international arbitration can no longer be declared in assertive terms. New rules of international arbitration are eroding claims of confidentiality<sup>35</sup> and the length of time spent on arbitrating has led to increased costs. On average, it takes about 1 325 days for a case to be concluded in International Centre for Settlement of Investment Disputes arbitration.<sup>36</sup> While international arbitration will remain attractive to investors, this is an approach to which South Africa will not return, but neither is state–state dispute settlement practical in all instances of investor–state disputes.

As South Africa pushes on with the domestic dispute resolution regime that it is advocating, it will do well not to create a system that replicates the many concerns that have been raised about international arbitration. To do so, instituting a conflict management system that lessens the political and economic costs of investment disputes will be necessary by revising the Arbitration Act to include emerging methods of conflict management and set clear criteria in relation to the appointment of arbitrators and the conduct of the proceedings. This will have to include enhancing the performance of public institutions to ensure policy coherence, which will prevent the possibility of disputes where states’ national and international obligations clash.

Consistent with the PPIB, the FIP and the Model BIT recognise the right of the state to regulate in the public interest, as well as an expropriation regime that is much less rigid than what applies in international investment law. This is a strong indication that the promotion of investment in South Africa and the SADC region will not come at the expense of national development objectives. While this does not ultimately determine the attractiveness of South Africa and SADC as an investment destination, it will likely have significant adverse implications for South Africa and SADC, at least as far as confidence in investing in such a volatile situation is concerned.

## IMPLICATIONS FOR FOREIGN DIRECT INVESTMENT

IAs such as BITs are the traditional model used to improve countries’ regulatory and institutional frameworks to reduce risks for foreign investors, but they are no substitute for effective domestic policies to attract FDI.<sup>37</sup> While the claim has often been made that IAs can promote FDI, it is important to realise that

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the state's conduct and its other policies are as important in making a country investor-friendly. The content of policies matters, and the potential for FDI usually depends on the extent to which these policies allay the concerns of potential investors. Furthermore, there needs to be appreciable conduct on the part of the state that it is committed to promoting and protecting FDI. Ultimately, the quality of governance institutions; economic and political stability; and the level of development in various sectors, including finance, production, the regulation of competition, access to labour, trade policies and the protection of property rights, all contribute to FDI decisions and sustainable investments. All these factors need to be taken into account holistically to attract FDI.<sup>38</sup>

### THE WAY FORWARD

South Africa's proposed domestic dispute resolution regime should include a conflict management system that lessens the political and economic costs of investment disputes. This should include enhancing the performance of public institutions to ensure policy coherence, which will prevent the possibility of disputes where the national and international obligations of states clash.

To attract sustainable FDI, the content of policies and the conduct of the state matter. The potential for FDI is usually dependent on the extent to which state conduct and policies allay the concerns of potential investors. The quality of governance institutions, economic and political stability, and the level of development in various sectors need to feed into South Africa's investment policy to make it investor-friendly. Without this, the PPIB will fail in its objective to promote FDI.

The PPIB reverses the gains of SADC in developing a common regional investment policy to attract FDI into the region and requires a considered effort by South Africa to review the PPIB in order not to alienate its regional partners.

### CONCLUSION

Due to South Africa's fragmented approach to investment policy domestically and regionally, the PPIB creates regulatory uncertainty. It is necessary to harmonise policy with the SADC approach in the adopted Model BIT for the sake of consistency and to promote regional integration within SADC. South Africa has not completely closed the door to negotiating future BITs, but it will ultimately depend on each individual case, following an assessment of the costs and the partners involved and the benefits to be gained. In determining this, South Africa needs to bear in mind the importance of regional cohesion within SADC; how its domestic policy will affect SADC as a whole, particularly with regard to a harmonised approach towards investment protection standards; and how this ultimately affects the attractiveness of South Africa and SADC in terms of FDI.

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A common regional policy approach that adequately balances the legitimate public interest regulatory objectives of a state with globally recognised international protection standards offered to foreign investors is key to ensuring that South Africa and SADC remain globally competitive for FDI. This is important, taking into account South Africa's unique history and the urgent need to redress the inequalities of the past. Ultimately, the success of South Africa's proposed policy will depend on investors' acceptance of the assurances offered by South Africa that this new policy will adequately protect investments.

## ENDNOTES

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## ACKNOWLEDGEMENTS

This *Policy Insights* paper is funded by the British High Commission of South Africa. SAIIA gratefully acknowledges this support.



