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Determinants and motives of outward foreign direct investment from China's provincial firms*

Chunlai Chen**

Based on Dunning's OLI framework and the investment development path theory, this paper investigated the determinants of outward FDI by China's provincial firms. The results show that provincial economic development, innovation and technology, and export to GDP ratio are statistically significant determinants, while FDI inflows, import to GDP ratio and provincial market size are not statistically significant determinants. The results suggest that the main motives for China's provincial firms to invest abroad are mainly market-seeking and efficiency-seeking.

Key words: China, outward foreign direct investment, home country determinants

1. Introduction

Since China launched the "go global" strategy, outward foreign direct investment (OFDI) from China has increased dramatically. By 2012, OFDI flows from China reached US\$84.22 billion while the stock of Chinese OFDI was worth US\$509 billion. China's outward investors can be categorized into two groups: central government-controlled State-owned enterprises (SOEs) and provincial firms (including local government SOEs but majority of them are non-SOEs).¹ China's OFDI flows have been dominated by central government-controlled SOEs. In 2009, central government-controlled SOEs accounted for 82 per cent of China's total OFDI flows. However, since 2010 provincial firms increased OFDI rapidly and their share in China's total OFDI flows increased to 34 per cent in 2012. Although China's OFDI flows are still dominated by

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¹ According to China's administrative division, China has 22 provinces, 4 municipalities (Beijing, Chongqing, Shanghai and Tianjin) and 5 autonomous regions (Guangxi, Inner Mongolia, Ningxia, Tibet and Xinjiang). For simplicity, in this paper "province" is used to represent provinces, municipalities and autonomous regions.

central government-controlled SOEs, the importance of provincial firms in China's OFDI flows has been increasing. This article examines the home province determinants of OFDI that have contributed to the rapid increase of OFDI flows from provincial firms and the main motives of provincial firms in conducting OFDI.

Many studies have used the national aggregate OFDI data to investigate and explain the determinants and motives of China's OFDI (e.g. Buckley et al., 2007; Cheung and Qian, 2009; Cheung et al., 2012; Kolstad and Wiig, 2012; Liu et al., 2005; Tolentino, 2010; Wei and Alon, 2010). These studies find that, apart from the market-seeking motive, the main motives of China's OFDI are natural-resource-seeking and strategic-asset-seeking for the purposes of securing supplies of natural resources (mineral resources and fuel) and acquiring advanced technology to support the long-term economic development of China. More importantly, studies find that the Chinese multinational enterprises (MNEs) fundamentally differ from MNEs from developed countries in terms of ownership advantages, internationalization motives and home country parameters (Buckley et al., 2007; Liu et al., 2005). Therefore, it remains an open question whether previous conceptualizations can adequately explain the investment behaviour of Chinese MNEs (Boisot and Meyer, 2008). However, because of the overwhelming dominance of central government-controlled SOEs in China's OFDI flows, what previous studies investigated was actually OFDI by central government-controlled SOEs. As a result, the characteristics such as the determinants and motives of OFDI by provincial firms have not been specifically analysed.

In addition, previous studies focused on national level variables in investigating the home country determinants (e.g. Liu et al., 2005; Luo et al., 2010; Tolentino, 2010; Wei and Alon, 2010). Through over 30 years of economic reform, China has substantially decentralized the decision-making power on economic and social development from the central government to provincial governments, and more importantly, provincial governments have been granted the power to approve OFDI projects by provincial firms. However, the provincial level variables which are expected to have more direct impact on OFDI from local provincial firms have not adequately been taken into account in existing studies.

Recently, a number of studies, using either firm-level data collected by various institutions (e.g. Amighini et al., 2012; Duanmu, 2012; Lu et al., 2014; Wang et al., 2012a, 2012b) or firm-level survey data (e.g. Cui and Jiang, 2012; Liang et al., 2012; Liu and Scott-Kennel, 2011; Voss et al., 2010) analysed the determinants and motives of China's MNEs and found significant differences between SOEs and non-SOEs in terms of government support, risk taking, entry mode, location choice and investment motives in conducting OFDI. These studies have contributed to our understanding of OFDI of non-SOEs. However, the use of firm-level data may suffer from coverage bias. For example, the data used by Amighini et al. (2012), which are from *fDi Markets*², cover only greenfield investment projects and do not include cross-border mergers and acquisitions (M&As); the data used by Duanmu (2012) cover only Chinese MNEs from Zhejiang province; and the data used by Lu et al. (2014) are collected from publicly listed companies which may be biased towards large and better performing companies. Likewise, survey-based results are not always reliable because investors may be reluctant to disclose their true motives (Hill and Munday, 1994; Wang et al., 2012a). Although the data used by Wang et al. (2012a, 2012b) overcome such limitations by employing two firm-level datasets collected by Chinese authorities, the data cover only two years (2006–2007), which would not be sufficient, especially for provincial firms which increased OFDI substantially since 2010.

This study will focus on investigating the home province determinants of OFDI and the motives of provincial firms by employing data on provincial OFDI flows for the period 2003–2012 published by the Ministry of Commerce of China. Although the data of provincial OFDI flows include OFDI conducted by local SOEs, majority of provincial OFDI flows are conducted by non-SOEs. In this study, we use the term “provincial firms” to distinguish them from central government-controlled SOEs.

The analysis is based on Dunning's OLI framework and the IDP theory. The results show that the level of economic development, innovation and technological level and export to GDP ratio are statistically significant determinants affecting OFDI flows from China's provinces, while FDI inflows, import to GDP ratio and provincial market

² www.fdimarkets.com/

size are not statistically significant determinants affecting OFDI flows from China's provinces. The results suggest that the main motives for China's local provincial firms to invest abroad are market-seeking and efficiency-seeking through exploiting technology and facilitating provincial exports.

This study makes three contributions to the existing literature on China's OFDI. First, this study finds that home province determinants are very important in determining the level of OFDI flows from each of China's provinces, demonstrating the usefulness of Dunning's OLI framework and the IDP theory. Second, this study reveals that the patterns of OFDI by China's provincial firms are consistent with the traditional international business theories. Third, this study finds that the main motives of China's provincial firms in conducting OFDI are different from those of SOEs as revealed by previous studies.

The paper is structured as follows. Section 2 presents a brief overview of OFDI from China during the period 1979–2012 with regard to the sources of China's OFDI and the characteristics of provincial OFDI. Section 3 presents the theoretical framework and discusses the hypotheses of provincial factors affecting OFDI. Section 4 conducts the empirical tests for the hypotheses. The final section summarizes the basic findings.

2. The development and characteristics of China's OFDI

2.1. The development of China's OFDI

Since the launch of the economic reform and open door policy in 1979, China has gradually liberalized its OFDI regime from a restricted and centrally controlled regime towards a more liberalized and transparent regime.³ The relatively short history of China's OFDI can be broadly divided into two phases, 1979–2000 and 2001 to present.

In the first phase of China's OFDI, the political factors played a more important role in China's OFDI than the economic incentives (Cheung and Qian, 2009). In addition, Chinese domestic firms were

³ For a detailed survey of China's OFDI policy change in the last 30 years, see Voss et al. (2008).

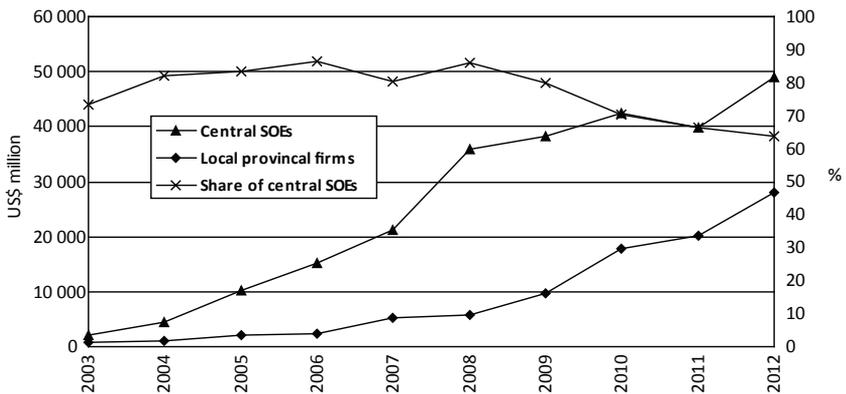
inexperienced in terms of foreign investments and operations (Voss et al., 2008). As a result, although there were some fluctuations, OFDI flows from China were at a very low level, reaching only US\$0.92 billion in 2000.

In 2001, China officially adopted the “go global” strategy as China’s national economic strategy, encouraging domestic firms to invest, operate and do business abroad. The implementation of the “go global” strategy, together with China’s accession to the World Trade Organization (WTO) in late 2001, boosted Chinese firms’ international expansion. Consequently, OFDI flows from China increased rapidly, particularly since 2005, and reached US\$84.22 billion by 2012.

2.2. The sources of China’s OFDI

Chinese firms undertaking OFDI can be categorized into two groups, namely SOEs under the direction of the central government and provincial firms. Figure 1 presents the annual OFDI flows from these two sources and the shares of OFDI flows of central government-controlled SOEs in China’s total OFDI flows during the period 2003–2012.⁴

Figure 1. China’s outward FDI flows by central SOEs and local provincial firms
(Current prices and %)



Sources: Ministry of Commerce of China (MOFCOM) (2010, 2012), *Statistical Bulletin of China’s Outward Foreign Investment*, Beijing: MOFCOM.

⁴ Data for OFDI flows from local provincial firms are not available before 2003.

As the figure shows, OFDI flows from China were dominated by central government-controlled SOEs, accounting for around 77 per cent of China's annual total OFDI flows during the period of 2003–2012. In terms of OFDI stock, central government-controlled SOEs accounted for over 75 per cent of China's total OFDI stock abroad. In terms of project size, the OFDI projects of central government-controlled SOEs are much larger, averaging US\$62 million for each OFDI project.

A distinctive feature of the rapid increase of OFDI flows from central government-controlled SOEs during 2003–2012 is the fact that the government provided substantial subsidies to SOEs in order to pursue long-term national interests. For example, Xiao and Sun (2005) suggested that the China National Offshore Oil Corporation (CNOOC) benefitted from a zero interest loan provided by the Government when bidding for the United States oil company Unocal. Yao et al. (2010) reported that Chinalco took advantage of preferential interest rates from the government to bid on Australian mining company Rio Tinto in 2009, and that the government provided this generous support for securing metal supplies.⁵

Compared to central government-controlled SOEs, provincial firms have played a relatively small role in China's OFDI drive. During the period 2003–2012, annual OFDI flows from the provincial firms accounted for around 23 per cent of China's total OFDI flows. However, since 2010 provincial firms increased OFDI rapidly and their share in China's total OFDI flows increased to 34 per cent in 2012. In terms of stock, provincial firms accounted for around a quarter of China's total OFDI stock abroad. In terms of the number of projects, provincial firms account for over 80 per cent of China's OFDI projects. However, in terms

⁵ Chinalco's first investment in Rio Tinto was in February 2008 when Chinalco invested US\$14 billion to buy 9 per cent of Rio Tinto's shares. In February 2009, Chinalco agreed to invest another US\$19.5 billion in Rio Tinto: US\$12.3 billion for minority stakes in iron ore, copper and aluminium assets and US\$7.2 billion for convertible bonds to take its equity stake in Rio Tinto to 18 per cent and two non-executive seats in Rio Tinto's board. Four of the biggest Chinese state-owned banks agreed to lend Chinalco US\$21 billion. These banks, moreover, charged very low interest rates, only 94.5 basis points above the six-month London inter-bank offered rate (LIBOR). Further, they did not set a time for Chinalco to pay back the loans. By comparison, BHP Billiton at the same time issued ten-year bonds which had to bear interest at 390 basis points above the six-month LIBOR. In June 2009, Rio Tinto unilaterally abandoned its deal with Chinalco and proposed an alternative, to raise US\$15.2 billion through right issues and US\$5.8 billion from BHP Billiton by forming a joint venture with the latter in Western Australia.

of project size, OFDI projects of provincial firms are small, averaging US\$3.57 million for each project.

Unlike central government-controlled SOEs, provincial firms, especially non-SOEs, have less connection with government, therefore, lacking government fiscal and financial supports. Their access to preferential loans from state-owned financial institutions is limited, and they face more obstacles in the OFDI approval process (Voss et al., 2010). As a consequence, while provincial firms may, on the one hand, face more difficulties in conducting OFDI, they may be less subjected to government intervention in making their business decisions and have more freedom to pursue their economic objectives. Hence, the determinants and motives of provincial firms might substantially be different from those of central government-controlled SOEs.

2.3. Characteristics of provincial OFDI

Figure 2 presents annual OFDI flows conducted by provincial firms in all provinces and three regions⁶ during the period 2003–2012. As the figure shows, in the early stage of the “go global” strategy (2003–2009), OFDI flows from China’s provincial firms increased moderately. With further implementation of the “go global” strategy and the adoption of a series of favourable policies, OFDI flows from China’s provincial firms grew rapidly since 2010. Total OFDI flows from China’s local provincial firms increased from US\$9.6 billion in 2009 to US\$28.14 billion in 2012.

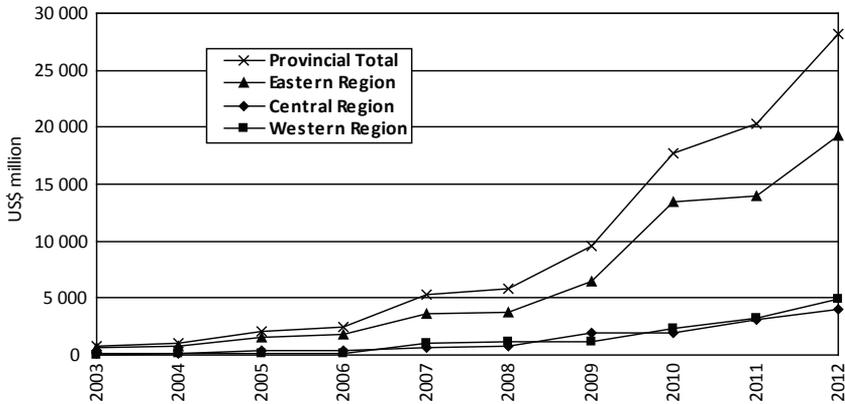
Among the three regions, OFDI flows from the provinces in the eastern region increased steadily with a remarkably high growth rate, particularly over 2007–2012. For the other two regions, the growth of OFDI was more limited. In 2012, OFDI flows from the eastern region reached US\$19.33 billion, compared to US\$3.95 billion and US\$4.86 billion in the central region and the western region respectively.

Within the eastern region, the province of Guangdong is the largest investor, followed by Shanghai, Zhejiang, Shandong, Beijing, Jiangsu and Liaoning. Fujian, Hebei, Tianjin and Hainan provinces

⁶ The eastern region includes Beijing, Tianjin, Hebei, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong, and Hainan. The central region includes Shanxi, Jilin, Heilongjiang, Anhui, Jiangxi, Henan, Hubei, and Hunan. The western region includes Inner Mongolia, Guangxi, Chongqing, Sichuan, Guizhou, Yunnan, Tibet, Shaanxi, Gansu, Qinghai, Ningxia, and Xinjiang.

made a relatively small amount of OFDI compared to other provinces in the eastern region. Among the central region provinces, Hunan and Heilongjiang are the major investors. In the western region, the provinces of Yunnan and Sichuan are the leading investors while most other provinces undertook a very small amount of OFDI.

Figure 2. OFDI flows from China by local provincial firms
(Current prices)



Sources: Ministry of Commerce of China (MOFCOM) (2010, 2012), *Statistical Bulletin of China's Outward Foreign Investment*, Beijing: MOFCOM.

Although provincial OFDI flows were dominated by the provinces in the eastern region, with further implementation of the “go global” strategy and a series of favourable policies, the sources of provincial OFDI gradually expanded from the initial few concentrated areas to other provinces. Increasingly important areas for Chinese OFDI are the Yangzi River Delta region including Shanghai, Zhejiang and Jiangsu and the Bohai Gulf region including Shandong and Liaoning. Several provinces, such as Hunan and Heilongjiang in the central region, Yunnan and Sichuan in the western region, also witnessed relatively large increases in OFDI flows since 2009.

The disparity in OFDI across regions and provinces raises the following questions: what are the determinants affecting OFDI flows from China’s provinces, and what are the main motives for local provincial firms to invest abroad? The following sections will address these questions.

3. Theoretical framework and hypotheses

The theoretical framework adopted in this study is Dunning's OLI framework and the IDP theory which is an extension of the OLI paradigm.

According to the OLI paradigm (Dunning, 1977, 1980, 1988, 1993, 1995, 2000; Dunning and Lundan, 2008), for a firm to conduct FDI, it must possess certain firm-specific *ownership advantages*. A firm's ownership advantage could be a patent or blueprint that gives rise to a product or a production process that other firms cannot emulate. The market power or cost advantage that the ownership advantage confers to the firm needs to be sufficient to outweigh the disadvantages of doing business abroad. Although ownership advantages are firm specific, they are closely related to the technological and innovative capabilities and the economic development levels of the source countries.

The foreign market must offer a *location advantage* that makes it profitable to produce the product in the foreign location rather than simply produce it at home and export. Location advantages include not only resource endowments, but also economic and social factors, such as market size and structure, prospects for market growth and the level of development, the cultural, legal, political and institutional environment, and government legislation and policies.

Finally, the MNEs must have an *internalization advantage*. If a company has a proprietary product or production process and if it is advantageous to produce the product abroad rather than export it, it is still not obvious that the company should set up a foreign subsidiary. An alternative is to license the technology to a foreign firm. However, because of market failures in the transaction of such intangible assets, it is advantageous for the firm to exploit the product or process internally within the firm rather than at arm's length through licensing. This is referred to as an internalization advantage.

The generalized predictions of the OLI framework are straightforward. At any given moment of time, the more a country's enterprises – relative to those of others – possess ownership advantages, the greater the incentive they have to internalize rather than externalize their use, the more they find it in their interest to exploit them from a foreign location, then the more they are likely to

engage in foreign production. The framework also can be expressed in a dynamic form. Changes in the outward or inward direct investment position of a particular country can be explained in terms of changes in the ownership advantages of its enterprises relative to those of other nations; changes in its location advantages relative to those of other countries; and changes in the extent to which firms perceive that these assets are best organized internally rather than by market (Dunning, 1993).

Based on the OLI paradigm, Dunning (1981) introduced the IDP theory explaining simultaneously both inward and outward FDI. The theory was later refined by Dunning and others (Dunning, 1986, 1988, 1993, 1997; Dunning and Narula, 1994, 1996; Duran and Ubeda, 2001, 2005; Narula, 1996). Although there are some shortcomings, empirical studies have shown that by incorporating some home country variables, like the level of technological and innovatory capabilities, economic and market structure, openness to international trade and institutional factors, the IDP theory is a useful framework for explaining the level of FDI flows (Andreff, 2002, 2003; Dunning et al., 2001; Kalotay, 2006; Kyrkilis and Pantelidis, 2003; Liu et al., 2005; Luo et al., 2010; Pantelidis and Kyrkilis, 2005; Stoian, 2013; Tolentino, 2010; Wei and Alon, 2010).

According to the IDP, the outward and inward FDI of a country depends on the country's level of economic development (usually measured by its GDP per capita). According to this theoretical approach, as a country develops, a structural change occurs, affecting FDI inflows and outflows which, in turn, change the country's economic structure, leading countries to follow an investment development path that consists of five stages. Along these stages, the ownership, internalization and location advantages of the firms change, making the country evolve from a net recipient of FDI to a net direct investor.

In stage 1, a less developed economy neither attracts nor generates FDI. In stage 2, industrializing developing economies attract FDI through their improved location advantages and perhaps generate minimum OFDI, resulting in a negative net investment position (i.e. inward FDI exceeds outward FDI). In stage 3, with the improvement of the country's technological capabilities and the expansion of its domestic market, the country attracts significant FDI and generates OFDI based on its innovations and international specialization. The net investment position remains negative. In stage 4, outward FDI is higher

than inward FDI and the net investment position becomes positive. In stage 5, most advanced countries are characterized by a balanced net investment position with very high levels of both inward and outward FDI. In this model, stages 1–3 are associated with developing economies and 4 and 5 are associated with developed economies (Duran and Ubeda, 2005). Each stage of economic development is associated with certain location advantages that attract FDI as well as certain ownership advantages of local firms that enhance OFDI (Stoian and Filippaios, 2008). Furthermore, the IDP theory assumes that inward FDI contributes to an improvement of the country's location advantages and the local firms' ownership advantages, thus enhancing both inward FDI and outward FDI in the future.

In Dunning's OLI paradigm and the IDP theory, the determinants of FDI can be classified into two groups, home-side and host-side factors. The home-side factors are ownership advantages and the internalization advantages, which determine the capability of a country to conduct outward FDI; and the host-side factors are location advantages, which determine the ability of a country to attract inward FDI. Both sets of determinants have been tested by scholars, examining them together or separately (Dunning, 1993; Dunning and Lundan, 2008). Some empirical studies based on the IDP theory⁷ have shown that the home-side factors, such as home country's economic development, innovation and technology, economic and market structure, openness to international trade and the institutional factors, are important in determining the level of FDI outflows. Using the same methodology, this study will focus upon the home-side factors to explore the determinants of FDI from China's provinces. Building on the FDI literature and the IDP theory, we examine the following home-side factors.

Level of economic development

The development-related variables of the home country can be used to explain levels of OFDI. According to the IDP theory, there is a strong positive relationship between the level of home country development and OFDI. This relationship is confirmed by empirical studies on developed countries (Barry et al., 2003; Bellak, 2001;

⁷ For example, Andreff (2002, 2003), Dunning (1981, 1986, 1993), Dunning et al. (2001), Kalotay (2006), Kyrkilis and Pantelidis (2003), Liu et al. (2005), Luo et al. (2010), Pantelidis and Kyrkilis (2005), Stoian (2013), Tolentino (2010), and Wei and Alon (2010).

Buckley and Castro, 1998) or on a mix of developed and developing economies (Dunning and Narula, 1994; Tolentino, 1993). Andreff (2002) finds that OFDI from transition and developing economies is a function of the home country's level of economic development. Stoian (2013) finds that per capita GDP is positively related to OFDI of the Central and Eastern European countries. An empirical study of macroeconomic determinants of OFDI by Kyrkilis and Pantelidis (2003) found that the level of income is associated with OFDI activity. For Chinese FDI, Liu et al. (2005) found that the level of economic development, proxied by GNP per capita plus refinements, was the main factor explaining Chinese OFDI. Economic development can generate ownership advantages that domestic companies can exploit when investing abroad. These ownership advantages arising from economic development of the home country include greater capital availability, higher productivity, specialized know-how and research and development (Duran and Ubeda, 2005). In this study, we use the real GDP per capita (*PGDP*) as the variable to reflect the level of economic development of the province. A higher level of economic development (*PGDP*) is the basis for a province to invest abroad. We therefore derive the first hypothesis:

Hypothesis 1: The level of provincial economic development (PGDP) has a positive impact on provincial OFDI flows.

Level of innovation and technology

The OLI framework and the IDP theory suggest that countries with larger innovative and technological capabilities generate more OFDI. This link has received extensive theoretical and empirical support, especially for developed countries (Cantwell, 1981, 1987; Dunning, 1993; Duran and Ubeda, 2001; Grubaugh, 1987; Kogut and Chang, 1991; Lall, 1980, 1996; Manolopoulos et al., 2007; Narula, 1996; Pearce, 1989; Pugel, 1981). However, in terms of developing countries, some studies find that the competitive advantages of emerging economies' MNEs tend to be based on price competitiveness rather than technology or brand (Gammeltoft et al., 2010). Salehizadeh (2007) also finds that some emerging economies' MNEs have access to "lower level" technologies and management practices that may be better suited to other emerging markets, thus enabling them to generate OFDI into similar economies.

In the case of China, over 30 years of fast economic growth saw China not only increase its income level but also improve its technological level. Although China's technologies in general are still less sophisticated than Western technologies, they are relatively advanced compared to those of other developing countries. It is reasonable to assume therefore that Chinese firms equipped with relatively advanced technologies have the motivations to exploit such technologies in other developing countries through OFDI. Therefore, we expect that provinces with higher level of technology would have higher level of OFDI flows. There are many proxies that can be used to measure innovative and technological capabilities, such as R&D expenditure, R&D personnel, technology balance payment and patent. However, due to data limitations at the province level, we use patent numbers as the proxy. Patent number as an indicator to represent the level of technology and innovative capabilities has been widely used in empirical studies (Archibugi and Pianta, 1996). In this study, the annual number of patents granted per 10,000 persons in each province is used to represent the innovative and technological capability of each province. We formulate the second hypothesis as follows:

Hypothesis 2: The level of provincial innovative and technological capability (PATP) has a positive impact on provincial OFDI flows.

Level of inward FDI

According to the OLI paradigm, foreign firms can compete locally with domestic firms, which would have the superior understanding of the market and environment, because they possess firm-specific ownership advantages. Since both foreign and domestic firms can imitate each other in the same market, domestic firms can benefit from FDI firms through knowledge spillovers (Caves, 1996; Dunning, 1993). These include imitation and learning-by-doing by local firms, technology spillovers through backward and forward industrial linkages, international experience through strategic alliances with FDI firms, information spillovers and competition. The IDP theory also postulates that inward FDI enhances OFDI. As a result of knowledge spillovers from FDI, local companies improve their ownership advantages and exploit these new ownership advantages through OFDI (Dunning, 1981, 1986, 1988; Duran and Ubeda, 2001; Stoian, 2013; Stoian and Filippaios,

2008). However, empirical findings on the existence of positive spillovers generated by FDI vary (Gorg and Greenaway, 2004). Despite the inconclusive evidence, we expect that inward FDI will have positive impact on OFDI if there are positive spillovers from FDI on domestic economy. We thus have the third hypothesis:

Hypothesis 3: The level of provincial inward FDI flows (INFDI) has a positive impact on provincial OFDI flows.

Level of international trade openness

The liberalization of a country's international trade is expected to influence positively OFDI (Dunning et al., 2001; Kyrkilis and Pantelidis, 2003). China's open policy on international trade and capital flows are likely to influence the patterns of Chinese OFDI (Buckley et al., 2007). The more a country is open to foreign economic transactions, the easier for domestic firms to access foreign markets, the easier for them to obtain information and experience and, therefore, the easier for them to invest abroad.

One of the motives for MNEs to conduct OFDI is market-seeking – to sustain or protect the existing foreign markets, or explore or promote new foreign markets (Dunning, 1993). Apart from directly setting up production bases abroad, establishing business centres and trading firms overseas to facilitate exports of the parent companies is an effective way to maintain existing foreign markets or explore new ones, especially when the home country still enjoys cost advantages. During the 1980s and 1990s, much of Chinese OFDI was directed at providing local support functions for Chinese exporters and to help them increase their hard currency earnings. Typically, such investments were small scale, with local subsidiaries providing information, import and export services, transportation and financial services to their parent companies and other Chinese firms (Gang, 1992; Zhan, 1995). After China's accession to the WTO and the implementation of the "go global" strategy in 2001, many Chinese companies, especially those of non-SOEs based in the coastal provinces that witnessed a rapid increase in exports like Guangdong, Zhejiang, Fujian and Jiangsu, established trading firms overseas to facilitate exports (MOFCOM, 2010). The ratio of export to GDP of a province captures the market orientation of that province's firms. Provinces with a higher export to GDP ratio would

have more incentives to invest abroad to facilitate their exports. Thus we have the following hypothesis:

Hypothesis 4: The level of provincial export to GDP ratio (EXGDP) has a positive impact on provincial OFDI flows.

Another motive for MNEs to conduct OFDI is resource-seeking – to obtain access to natural resources abroad then export them back to China (Dunning, 1993). In order to pursue long-term national interests and to secure supplies of strategic natural resources, Chinese companies have been very active in investing in natural resource sectors in recent years. The recent high-profile investments in Australia, Canada and the United States as well as developing countries in Asia and Africa put Chinese companies in the spotlight. Although most of the OFDI projects in natural resources are conducted by large central government-controlled SOEs through cross-border mergers and acquisitions (M&As), it is worth investigating whether provincial firms also have this motive in undertaking OFDI. If that is the case, then provinces with a higher level of import of resources would see a higher level of investment overseas in natural resource sectors. However, due to data limitation, we use provincial total imports and total OFDI as proxies for import of resources and OFDI in resource sectors respectively.⁸ Thus we have the following hypothesis:

Hypothesis 5: The level of provincial import to GDP ratio (IMGDP) has a positive impact on provincial OFDI flows.

Control variable

Drawing on existing literature, we control for provincial GDP. Despite the mixed evidence in the literature (Andreff, 2002; Chudnovski and Lopez, 2000; Wei and Alon, 2010), researchers have suggested that larger home markets lead to higher OFDI (Andreff, 2002; Buckley et al., 2007; Stoian, 2013) as these markets allow the firms to derive ownership advantages from economies of scale. However, firms can use

⁸ With fast economic growth, China's imports of primary products (mainly natural resources) have increased very rapidly. As a result, during the period 2003-2013, on average the imports of primary products accounted for 55.18 per cent of China's total ordinary imports.

the national market to realize economies of scale and scope. Therefore, provincial GDP may affect OFDI flows but this impact is not clear.

4. Empirical analysis and discussion

4.1. Variable specification and the model

The relationship between OFDI and the home-side variables of China's provinces is investigated over time and across provinces. Data for 30 provinces for the period from 2003 to 2012 are included.⁹ In this study, the dependent variable, denoted as $OFDI_{it}$, is the aggregate OFDI flows from China's province i in year t . There are nine missing values for OFDI flows (Hainan for years 2003-04, Chongqing for year 2003, Guizhou for years 2003-06, Qinghai for year 2004 and Ningxia for year 2003). So the total observations are 291. There are six independent variables which are summarized in Table 1.

We formulate the following model to test the determinants of provincial OFDI flows.

$$\ln OFDI_{it} = \beta_0 + \beta_1 \ln PGDP_{it-1} + \beta_2 \ln PATP_{it-1} + \beta_3 \ln INFDI_{it-2} + \beta_4 \ln EXGDP_{it-1} + \beta_5 \ln IMGDP_{it-1} + \beta_6 \ln GDP_{it-1} + v_i + \varepsilon_{it} \quad (1)$$

The ordinary least squares (OLS) regression can be applied to equation 1. But the OLS estimates may be biased if the independent variables are correlated with some province-specific and time-invariant unobserved factors in the error term. To eliminate the province-specific and time-invariant factors which may affect FDI outflows, we adopt the fixed-effects panel regression model to estimate equation 1.¹⁰ Another concern is the potential endogeneity problem. Without appropriate instruments, it may be difficult to control for possible endogeneity. For example, OFDI is not only affected by economic development and patents, but it may also boost economic growth and innovation and technological capability. However, as most Chinese FDI projects have started only recently, there is little reason to be seriously concerned about reverse causality running from outward FDI to parent firm characteristics (Wang et al., 2012a), thus to home province characteristics. Nevertheless, in order to mitigate the potential causality

⁹ Tibet is excluded from the test due to a lack of data.

¹⁰ The Hausman test results prefer the fixed-effects model.

Table 1. List of variables of provincial OFDI flow equation

| Variable name | Specification of variables | Sources |
|------------------------------|---|--|
| Dependent variable | | |
| OFDI _{it} | Aggregate OFDI flows from province i in year t. Million US dollars at 2000 constant prices. | Ministry of Commerce of China (2010, 2012), <i>Statistical Bulletin of China's Outward Foreign Investment</i> . |
| Independent variables | | |
| PGDP _{it} | Per capita GDP of province i in year t. <i>Renminbi</i> yuan per capita at 2000 constant prices. | National Bureau of Statistics of China (various issues), <i>China Statistical Yearbook</i> . |
| PATP _{it} | Patent granted per 10,000 persons of province i in year t | Same as above. |
| INFDI _{it} | FDI inflows into province i in year t. Million US dollars at 2000 constant prices. | Before 2005 (including 2005), National Bureau of Statistics of China (various issues), <i>China Statistical Yearbook</i> ; After 2005, Provincial Bureau of Statistics (various issues of each province), <i>Provincial National Economic and Social Development Statistics Bulletin</i> . |
| EXGDP _{it} | Export to GDP ratio of province i in year t. | National Bureau of Statistics of China (various issues), <i>China Statistical Yearbook</i> . |
| IMGDP _{it} | Import to GDP ratio of province i in year t. | Same as above. |
| GDP _{it} | Gross Domestic Product of province i in year t. <i>Renminbi</i> million yuan at 2000 constant prices. | Same as above. |

problem, following previous studies (e.g. Raff et al., 2009; Wang et al., 2012a), we lag all the independent variables by one year, except for the FDI inflow variable which is lagged 2 years.¹¹

4.2. Regression results and explanations

Table 2 reports the regression results of the fixed-effects model. Model 1 includes the three key variables of the IDP theory – the level of economic development (*PGDP*), technology and innovatory capabilities

¹¹ We assume that FDI will take a longer period of time to generate spillovers on domestic economy.

(*PATP*) and FDI inflows (*INFDI*). Model 2 includes the three key variables of the IDP theory and the two trade openness variables – export to GDP ratio (*EXGDP*) and import to GDP ratio (*IMGDP*). Finally Model 3 includes all independent and control variables.¹² The estimated results are robust throughout all 3 models. Therefore, despite shortcomings owing to the short span of available data, this study does present an initial insight into China’s provincial OFDI determinants in terms of home-provincial variables. The following explanations are based on Model 3 which includes all independent and control variables.

The regression results show that the level of economic development (*PGDP*), innovation and technology capability (*PATP*) and the export to GDP ratio (*EXGDP*) are positive and statistically significant determinants of OFDI flows from China’s provinces. However, the level of FDI inflows (*INFDI*), the import to GDP ratio (*IMGDP*) and the market size (*GDP*) are not statistically significant.

Table 2. Regression results of China’s provincial OFDI flows, fixed-effects 2003–2012
(Dependent variable: $\ln\text{OFDI}$)

| Variables | Model 1 | Model 2 | Model 3 |
|------------------------|----------------------|----------------------|----------------------|
| Constant | -26.70 (-8.56)*** | -29.71 (-9.47)*** | -32.84 (-6.19)*** |
| $\ln\text{PGDP}$ | 3.06 (8.47)*** | 3.26 (9.02)*** | 2.50 (2.30)** |
| $\ln\text{PATP}$ | 0.39 (2.16)** | 0.45 (2.50)** | 0.40 (2.07)** |
| $\ln\text{INFDI}$ | 0.14 (0.86) | 0.04 (0.23) | 0.03 (0.21) |
| $\ln\text{EXGDP}$ | | 0.85 (3.70)*** | 0.81 (3.45)*** |
| $\ln\text{IMGDP}$ | | -0.09 (-0.33) | -0.07 (-0.26) |
| $\ln\text{GDP}$ | | | 0.79 (0.73) |
| Number of observations | 291 | 291 | 291 |
| Number of groups | 30 | 30 | 30 |
| R ² Overall | 0.56 | 0.52 | 0.60 |
| F-statistics | 226.23*** | 146.06*** | 121.58*** |

Note: t-statistics are in parentheses.
 * Statistically significant at 0.10 level.
 ** Statistically significant at 0.05 level.
 *** Statistically significant at 0.01 level.

¹² A multicollinearity test is conducted for all independent and control variables. The mean VIF is 4.87, which is within the acceptance level.

More specifically, we find that the coefficient of per capita GDP is positive and statistically significant at the 5 per cent level; thus hypothesis 1 is supported. Consistent with the propositions of the IDP, provinces with a higher level of economic development generate more OFDI. This suggests that local firms have developed ownership advantages that they can exploit through investing abroad. These advantages may be a result of the development and accumulation of advanced technologies, production know-how, management and marketing skills and international business networks associated with a higher level of economic development.

We also find that the patent variable is positive and statistically significant at the 5 per cent level; thus hypothesis 2 is supported. This indicates that OFDI is associated with a higher level of technological development of the province. This also suggests that provincial firms that have accumulated and developed certain technologies have incentives to exploit their ownership advantages through investing abroad. This finding is consistent with the explanations of international business theories.

The motives for MNEs to conduct technology-exploiting OFDI can be either market-seeking – to sustain or protect existing markets or to explore or promote new markets; or efficiency-seeking – to use particular and specific resources (especially labour and raw materials) at a lower real cost (Dunning, 1993). For China's provincial firms, the main motive to invest abroad is market-seeking, given the pressure of increasing competition and the acceleration of industrial restructuring and upgrading at home, and facing increasing use of non-tariff trade barriers by China's trading partners. At the same time, facing the rapid increase in production costs at home (increasing costs of labour and raw materials), efficiency-seeking is an increasingly important motive for them to invest abroad. For example, some Chinese non-SOEs in the manufacturing industries, such as machinery, automobiles and home appliances, have established market-seeking and efficiency-seeking foreign subsidiaries through technology-exploiting OFDI mainly in developing countries. Notable examples include Sany Group, which established construction equipment plants in Brazil, Germany, India, Indonesia and the United States; Wanxiang Group, which has 25 foreign subsidiaries in production and distribution of auto parts; Zongshen Industrial Group, which established a motorcycle manufacturing

subsidiary in Viet Nam; and Haier Group which established fridge manufacturing subsidiaries in Asia (India, Indonesia, Jordan, Malaysia, Pakistan and the Philippines), in Africa (Algeria, Egypt, Nigeria, South Africa and Tunisia) and in the United States.

Some studies find that China's OFDI flows are negatively related to technology development.¹³ One possible explanation for such findings is that these studies used the aggregate Chinese OFDI data. As we discussed in the previous section, nearly 80 per cent of China's OFDI is carried out by central government-controlled SOEs. These large SOEs rely on various forms of government support, such as easy access to state-owned financial institutions, low interest loans and foreign currency reserves in exchange for implementing national long-term and strategic interests. Because of these favourable advantages granted by the Government, firm-specific ownership advantages are a less important factor in determining OFDI flows of large SOEs. Therefore, the motives of large SOEs to conduct OFDI abroad are mainly resource-seeking in resource rich countries and asset- and technology-seeking in developed countries (e.g. Buckley et al., 2007; Wei and Alon, 2010). In contrast to central government-controlled SOEs, provincial firms, especially non-SOEs, do not receive as much government support. Therefore, creating and developing their firm-specific ownership advantages are important for provincial firms to invest abroad. However, it should be noted that the ownership advantages of provincial firms may not be the most advanced technologies but matured technologies, production know-how, management skills and business and marketing networks that are most suited for emerging and developing countries. Therefore, the exploitation of ownership advantages is one of the main motives for China's provincial firms to conduct OFDI, which is consistent with the explanations of traditional international business theories.

Contrary to our expectations, we find that FDI inflows have no significant impact on OFDI from China's provinces; thus hypothesis 3 is not supported. Wang et al. (2012a) find that inward FDI even has a negative impact on outward FDI in China. This suggests that FDI in China has not yet generated sufficient positive spillovers on provincial firms to help them generate ownership advantages. Furthermore, foreign-funded enterprises (FfEs) in China, including enterprises funded by foreign investors and investors from Hong Kong (China), Macao (China)

¹³ For example, Wei and Alon (2010).

and Taiwan Province of China, have not been very active in conducting OFDI. By the end of 2010 the share of OFDI projects conducted by FFEs is only 5.2 per cent of China's total OFDI projects abroad (MOFCOM, 2010).

Consistent with our expectations, we find that the export to GDP ratio is positive and statistically significant at the 1 per cent level; thus hypothesis 4 is supported. The finding is consistent with conventional empirical findings that FDI follows exports.¹⁴ This finding is consistent with the view that one of the key motives of provincial firms to invest abroad is to promote and facilitate provincial exports.

Contrary to our expectations, we find that the import to GDP ratio is not significant; thus hypothesis 5 is not supported. The insignificance of the import to GDP ratio suggests that securing resource supplies through OFDI may not be an important motive for local provincial firms. This result could also be due to the relocation production from China to other developing countries. Imports of resources and intermediate products to China for processing and assembling and then re-exporting are reduced when Chinese firms relocate processing and assembling abroad via OFDI (Buckley et al., 2007).

This finding is very interesting and is different from other studies. For example, Wei and Alon (2010) find that imports have a positive and significant impact on China's OFDI flows; Buckley et al. (2007) find that natural resource-seeking is a main motive of Chinese OFDI. As we discussed earlier, the main reason for such results may be that these studies used the aggregate data of China's OFDI flows. It is well known that one of the important aspects of China's "go global" strategy is to encourage domestic firms to invest abroad to secure supplies of natural resources to assist long-term economic growth. Chinese companies invest overseas to access to resources mainly through cross-border M&As. However, most of these deals are carried out by central government-controlled SOEs, like China National Offshore Oil Corporation (CNOOC), PetroChina, China National Petroleum Corporation (CNPC), and Chinalco. Because of the dominance of large SOEs in the strategic resource sectors in China, provincial firms, especially non-SOEs, have effectively been excluded

¹⁴ For example, Buckley et al. (2007) find that export positively affects China's OFDI flows.

from those sectors. In addition, provincial non-SOEs have less support from government, lacking access to loans from state-owned banks and other financial institutions. As a result, provincial non-SOEs have less incentive and capabilities to engage in cross-border M&As to secure resource supplies.

Finally, we find that provincial GDP is insignificant in determining provincial firms' OFDI. This suggests that the size of the provincial economy may not influence provincial OFDI directly since firms can realize economy of scale and economy of scope by relying on the national market. It may also suggest that the larger the provincial economy, the greater the opportunity for firms serving domestic market and thus reducing the incentives for investing abroad.

5. Conclusion

Based on Dunning's OLI framework and the IDP theory, we investigated the home-province determinants affecting OFDI flows from China's provincial firms. The study finds that the province's level of economic development, innovation and technology capability and the export to GDP ratio are important determinants of OFDI by provincial firms. The results suggest that market-seeking is the main motive for provincial firms to invest abroad. In addition, facing the intense competition and rapid increase in production costs at home, efficiency-seeking is an increasingly important motive for provincial firms to invest abroad.

This study reveals the characteristics of OFDI from China's provincial firms. In contrast to OFDI of China's central government-controlled SOEs, which has been motivated primarily by the desire to secure supplies of key natural resources, circumvent host country trade barriers, penetrate new markets, acquire advanced technology and management expertise, and seek strategic assets (Wei and Alon, 2010), OFDI of China's provincial firms has been motivated not only by the desire to circumvent host country trade barriers, sustain and protect existing markets, and explore and promote new markets, but also by the desire to exploit ownership advantages, such as matured technology, know-how, management skills and business and marketing networks, and the pressure of intense competition and the acceleration of industrial restructuring and upgrading at home.

Given that OFDI brings benefits to the home economy through increased competitiveness, facilitating exports, industrial restructuring and upgrading and economic growth, provincial governments should consider implementing policies to encourage and facilitate OFDI. This includes policies to encourage R&D and technology development; policies to increase competition and to accelerate SOE reform and enterprise restructuring; policies to encourage the interaction between FFEs and domestic firms in order to enhance positive spillovers from FDI and increase the ownership advantages and the ability to generate OFDI of domestic firms.

We should, however, acknowledge the limitations of this study. Because the data on provincial OFDI flows do not include the information on destinations, we cannot test the patterns of OFDI and motives of local provincial firms in terms of location choice, risk taking and the motives of strategic and technological asset-seeking in the empirical model. Further work should pay more attention on these aspects by including the host country variables and bilateral variables in the empirical model in order to have a more comprehensive understanding of the determinants and motives of China's OFDI.

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The motives of Russian state-owned companies for outward foreign direct investment and its impact on state-company cooperation: observations concerning the energy sector*

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This paper analyses cooperation between state institutions and state-owned energy companies of the Russian Federation on the basis of three examples of outward foreign direct investments (OFDI): the acquisition by nuclear power company Atomstroyexport of Nukem Technologies in Germany; the gas giant Gazprom and its South Stream investment package in Hungary; and the oil company Zarubezhneft's acquisition of the Optima Group in Bosnia-Herzegovina. The research is based on the analyses of media reports, official state and company documents, and interviews conducted with representatives of the state-owned energy companies and state officials. The analysis suggests that Russian state-owned energy companies only initiate cooperation with state institutions when the circumstances require certain financial and diplomatic support to conduct OFDI. This paper reveals that, despite usually being portrayed as channels for Russian political influence, the drivers for the OFDI of Russian state-owned energy companies in fact represent a complex range of commercial considerations.

Key words: Russian Federation; state-owned TNCs; outward foreign direct investment (OFDI); state-TNC cooperation

1. Introduction

Due to the importance of the Russian energy sector, both as the main source of revenue for the state budget and as one of the main sources of energy supplies for Europe, the outward foreign direct investment (OFDI) of Russian energy companies has been the subject of a lively academic debate. The debate is whether these OFDI by Russian state-owned energy companies

* The views expressed in this article are solely those of the author and do not represent the views of the United Nations.

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are driven more by state interests of the Russian Federation or by the business interests of the companies themselves. The following quotation illustrates the way in which the motives of the energy companies are presented in the literature:

While Russia claims to pursue strictly economic interests in its energy policy, many outsiders – especially in the US – maintain that Russia is using energy provisions as a political tool. Some even claim that Russia is using energy provisions as part of a bargain to tie its neighbors and European partners into its orbit – just as the Soviet Union did when it sought to strengthen control over its Eastern European allies via the building of oil and gas pipelines. While the US is generally much more concerned about the political use of energy than the Europeans, some European governments also view dependency on Russia very negatively (Perovic, 2009, p.9).

At the same time, a number of studies about the domestic politics and economic transformation explicitly differentiate the Russian Federation's state/national interests from the interests of its energy companies and political elite (Shevtsova, 2005; Shevtsova, 2007; Treisman, 2011; Krastev and Holmes, 2012). For instance, Ivan Krastev and Stephen Holmes (2012) argue that the Russian political system has rather been a regime that ignores and pacifies the people "while amassing unbelievable riches from the sale of Russia's natural resources abroad" (p.40). This differentiation between the state/national interests and the individual interests of the political elite is important in the examination of OFDI from the Russian Federation. Equally important is the phenomenon of cooperation between Russian transnational companies (TNCs) and Russian state institutions abroad in the instances of OFDI (state-TNC cooperation), an aspect which is overlooked in the literature.

The objective of this paper, therefore, is twofold: first, it provides a constructivist account of state-TNC cooperation by looking closely at the processes of OFDI by three Russian state-owned energy companies, and the extent and nature of their contacts with Russian state institutions. Second, the paper explains under what circumstances and to what extent Russian state-owned energy companies follow the state/national interests, and to what extent these state interests are combined with other interests in instances of OFDI. The analysis of

OFDI by privately-owned Russian energy and non-energy companies, as well as of Russian state-owned non-energy companies, is therefore out of the scope of this paper. This paper's analysis relies on media reports, official Russian state documents, company websites, and interviews conducted with representatives of the Russian state-owned energy companies and of Russian state officials. Three Russian state-owned companies of different sizes that represent different industries in the Russian energy sector are analysed, namely, the large nuclear power producer Rosatom (and its subdivision Atomstroyexport), the gas giant Gazprom, and the relatively small state-owned oil company Zarubezhneft.

Clearly, it must be borne in mind that the information provided by these companies and their representatives may not accurately reveal their "true" motives. Nevertheless, the analysis demonstrates that, although the analysis demonstrates that, although usually presented in the debate as channels of state interests, the motives for OFDI by Russian state-owned energy companies in fact represent a complex range of business considerations. The paper will first analyse how Russian state interests and the interests and strategies of the three Russian energy companies are defined in the state and company official documents, followed by a discussion on the extent to which these interests and strategies are implemented in the actual OFDI by these three companies.

2. Motives for OFDI by Russian state-owned energy companies

The motives for OFDI by Russian state-owned energy companies vary depending on the size of the company as well as on the OFDI location (Liuhto 2006; Vahtra 2009; Poussenkova 2009; Kalotay 2006; Kalotay and Sulstarova, 2008). Still, scholars who analyze the motives for OFDI by Russian state-owned energy companies can be roughly divided into three groups. The first and largest group focuses on the meaning of Russian OFDI for its state/national interests (Liuhto and Vahtra 2004; Kuzio 2005; Nygren 2007; Liuhto 2008; Orban 2008; Orttung 2009; Closson 2009; Poussenkova 2010). For instance, Anita Orban (2008) examines Russian energy policy and investments in three of the four Visegrad group countries, and points out that "Russia's energy-centred foreign policy is not limited to the states of the former Soviet Union and is clearly designed to increase its leverage in key geostrategic theatres

and over U.S. allies, and to achieve a far-reaching foreign policy goal” (p.177). Similarly, Peeter Vahtra (2009) points out that Russian state-owned enterprises “make purchases that seem to serve the purposes of Russia’s foreign policy rather than commercial logic” (p.7).

In contrast, the second group of scholars concentrate on the business motives for OFDI by Russian state-owned energy companies (Johnson 2004; Kuznetsov 2007; Kuznetsov 2010; Filippov 2008; Kalotay and Sulstarova 2008; Panibratov and Kalotay 2009). According to this view, the motives of Russian energy companies for OFDI in Europe can be explained from a purely business point of view. Alexei Kuznetsov (2007), for example, points out that, by investing in European retail companies, Gazprom attempts to control the profits from the gas supplies and improve the stability of its business.

While not dismissing Russian state/national interests and business considerations as the motives for OFDI by Russian energy state-owned companies, the third group of scholars tend to focus attention on individual profit-seeking motives. For instance, Robert Ortung (2009) points out that “the main conflict among the individuals at the apex of Russian power is for control over the rents generated by the energy sector” (p.65). Similarly, Alexei Kuznetsov (2010) highlights that some of the top managers of Russian TNCs under state control pursue their own interests, ignoring Russian national interests as well as the economic objectives of the TNCs.

3. Description of concepts and actors

Overall, these insights suggest that the motives for OFDI by Russian state-owned energy companies can in fact be driven by the interests of two types of collective actors, i.e. the state and the companies, and two types of individual actors, i.e. politicians and managers.

The interests of the Russian state, the first type of collective actor, are set out in one of the most important official Russian documents, “National Security Strategy to 2020”, as “the aggregate of the internal and external needs of the state in ensuring the protection and stable development of the individual, society and the state” (National Security Strategy to 2020, 2009). Similarly, the Russian Foreign Policy Concept 2000 aimed to protect the interests of the individual and society and, within that framework, “ ... to achieve firm and prestigious positions in

the world community, most fully consistent with the interests of the Russian Federation as a great power, as one of the most influential centres of the modern world” (Russian Foreign Policy Concept, 2000). These principles of foreign policy include interrelated economic and security interests within the broader interests of society. The 2008 Concept adds the creation of “favorable external conditions for the modernization of Russia, transformation of its economy along innovation lines, ... rule of law and democratic institutions, ... and, as a consequence, ensuring the competitiveness of the country in a globalizing world” (Russian Foreign Policy Concept, 2008). This principle highlights the increasing importance of economic interests in Russian foreign policy. It also hints at the possible role of Russian TNCs in reaching economic goals abroad. Moreover, the Energy Strategy also reflects the power aspirations of the political elite, beginning with the claim that:

the objective of the energy policy of Russia is to maximize the effective use of natural energy resources and the potential of the energy sector to sustain economic growth, improve the quality of life of the population and promote the strengthening of foreign economic positions of the country (Energy Strategy of the Russian Federation by 2030, p.10).

All of these objectives, especially the last, are in line with the argument of Andrey Tsygankov’s (2006) that the post-Soviet Russian Federation largely inherited foreign policy aspirations of the USSR. According to Tsygankov, the post-Soviet government merely changed its foreign policy strategy to using soft power, or, as he puts it, taking “by banks” rather than “by tanks”. Therefore, one can assume that by investing abroad, Russian TNCs serve broader national interests, including economic ones. Moreover, the Russian Foreign Policy Concept 2013 states that, in order to achieve principal objectives in the area of international economic relations, meaning primarily the innovation-based development of the country and ensuring its equal standing in the modern system of international economic relations, the Russian Federation “provides state support to Russian enterprises and companies in gaining access to new markets and in the development of traditional ones while counteracting discrimination against Russian investors and exporters”.

Similarly, business interests of Russian energy companies, representing the second type of collective actor, can encompass a

variety of motives. Sergey Filippov (2008) outlines the most frequent business motives for OFDI by Russian companies in the following way: a resource-seeking motive refers to investments seeking to acquire natural resources or production assets; a market-seeking motive refers to investments which aim at either entering new markets or maintaining existing ones; efficiency-seeking investments aim to increase a company's efficiency by exploiting the economies of scale and scope, or common ownership; and asset-seeking FDI aims at the acquisition of technology and R&D-intensive units. Some of these motives are reflected in the official strategies of the three state-owned energy companies analysed in this paper.

Nevertheless, in their official discourse (which might be a part of public relations exercise), Russian state-owned energy companies put forward the fulfilment of the state/national interests as their main goals. For instance, nuclear producer Rosatom describes its mission as "maintaining national interests in defence, nuclear safety and nuclear power by achieving global leadership in advanced technologies, competencies and innovations" (Rosatom, 2014). Moreover, the company defines its international role as "...an official Russian Federation agency promoting international cooperation on peaceful uses of nuclear power. It is responsible for meeting Russia's commitments in the nuclear industry with a specific focus on the international nuclear non-proliferation effort" (Rosatom, 2014). In a similar vein, in its advertisements, Gazprom is represented as a "national patrimony" (*natsional'noe dostoyanie*). At the same time, Gazprom's mission and strategy are described primarily in commercial terms:

Gazprom views its mission as the reliable, efficient and balanced supply of natural gas, and other energy resources and their derivatives to consumers ... Gazprom's strategic goal is to become a leader among global energy companies by developing new markets, diversifying business activities and securing the reliability of supplies (Gazprom, 2014).

Similar to Rosatom, the smallest state-owned oil company, Zarubezhneft, describes its mission as "the development and strengthening of international economic relations of the Russian Federation, and the strengthening of the geopolitical position of Russia on the international market" (Zarubezhneft, 2014). It is stated that the company's strategy in foreign investment includes the "development

of innovation and technological potential by means of its own studies and acquisitions in the market of highly technological companies and technologies” and the “extension of the geography of strategic presence on the international market” (Zarubezhneft, 2014).

The interests of the third and fourth types of actors, i.e. individuals, can be defined as individual profit-seeking interests distinct from both the state/national interests and the business interests of a particular company. For instance, if an investment project is financed by the state, it is in the interest of both the company and the state to negotiate the lowest possible price. However, as the analysis in this paper will show, in some circumstances the cost of energy investment projects increases due to the rent-seeking behaviour of individuals who have control over the budget, by employing intermediaries in the process of implementation.

To sum up, the interests that drive OFDI by Russian state-owned energy companies are categorized as follows: a) state/national interests (both internal and external needs in ensuring the protection and stable development of the individual, society and the state), b) business interests (resource-, market-, efficiency-, or/and asset-seeking), and c) individual interests (undeclared and unrelated to national or/and business interests). These concepts are summarized in Table 1.

Table 1. Russian state-owned energy companies’ declared interests for OFDI

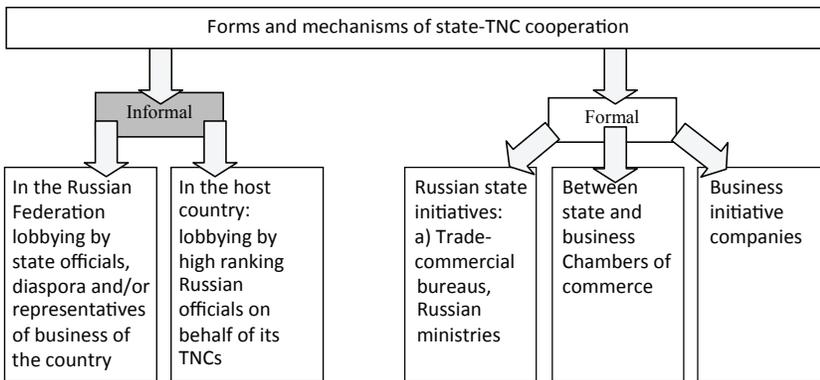
| Company | Types of interests for OFDI | |
|--------------------------|--|--|
| | State/national interests | Business interests |
| Rosatom-Atomstroy export | “...to maintain national interests in defence, nuclear safety...” | “...achieving global leadership in advanced technologies, competencies and innovations...” |
| Gazprom | “National patrimony” | “...to become a leader among global energy companies by developing new markets...” |
| Zarubezhneft | “...strengthening of the geopolitical position of Russia on the international market...” | “...development of innovation and technological potential by means of... acquisitions on the market of highly technological companies” |

Source: Rosatom, Gazprom, and Zarubezhneft websites.

It is, therefore, expected that these companies that declare serving Russia's state/national interests as part of their mission and strategies do so by means of their investments abroad.

In the following sections, this paper will analyse cooperation with Russian state institutions abroad and the extent to which Russian state-owned energy companies follow their declared missions and strategies in three concrete examples of OFDI. Cooperation between Russian companies and state institutions (state-TNC cooperation) is broadly defined as the contact between Russian companies and Russian state institutions abroad regarding OFDI. The forms and mechanisms of this contact is presented in graph form in Figure 1 below.

Figure 1. Forms and mechanisms of Russian state-TNC cooperation



TNC-state cooperation can be defined as *high* when cooperation exists at both company and state levels and is both formal and informal, as represented in Figure 1; TNC-state cooperation is defined as *medium* when cooperation exists at some but not all levels and is formal and/or informal; it is defined as *low* when it is limited to one level and is either formal or informal.

4. Description of the research strategy

The data were collected in two distinct phases. The first phase was dedicated to mapping the views of Russian officials regarding the cooperation between Russian state institutions and Russian state-owned energy companies in instances of OFDI, as well as their

experience of this cooperation. The second phase was dedicated to mapping the views of the Russian state-owned energy companies and Russian economic institutions (such as Chambers of Commerce) regarding the cooperation between Russian state institutions and the Russian state-owned energy companies in these three instances of OFDI, and their experiences and perceptions of specific challenges in conducting OFDI. These views were mapped in two ways. First, mass media reports regarding the OFDI projects by the Russian state-owned energy companies were monitored both in the Russian Federation and in the host countries. Second, the author conducted interviews with representatives of the Russian state-owned energy companies, Russian state institutions, and with some representatives of business circles in the host countries. The interviewees were chosen on the basis of their position which allows them to have first-hand information on the internal policy decision-making of the state-owned energy companies and state institutions regarding relations with Russian companies abroad (all answers are treated anonymously and names replaced by the approximate positions held by the respondents). The questions were structured in such a way to allow detailed answers. For instance, the questions posed to the representatives of the Russian state-owned energy companies included the following: *To what extent does your company cooperate with Russian state institutions when conducting OFDI? Which side, if any, initiates this cooperation?* Similarly, the questions posed to the representatives of Russian state institutions included: *To what extent does the state institution that you represent cooperate with Russian state-owned energy companies in their instances of OFDI? If so, who initiates the cooperation?*

The data were thus gathered from interviews with representatives of the Russian, German, Hungarian and Bosnian business and state officials and representatives of non-state institutions. The questions were organized in two groups: a) the relations between the company/subsidiary and the Russian state institutions in Germany, Hungary, and Bosnia-Herzegovina; b) Russian-German/Hungarian/Bosnia-Herzegovina relations regarding specific investments. The interviews used in this paper were conducted with representatives of the Russian state-owned energy companies (Russian and German citizens), representatives of Russian state institutions (from Russian ministries, from the Russian embassies in Hungary and Bosnia-Herzegovina, and from the trade representative office in Germany), and representatives

of the host country's business community (Chamber of Commerce of the Republic of Srpska, Bosnia-Herzegovina).

The interviews were conducted in one of three forms: personal conversations, telephone interviews, and answers in written form sent by e-mail. Some respondents opted for telephone or Skype conversations which were electronically recorded. A smaller number of respondents preferred to answer in written form. Some respondents agreed to electronically recorded interviews during personal meetings, and the remainder preferred to provide information only in the form of a personal conversation with the author taking written notes.

Furthermore, as natural-resource-based firms account for four-fifths of the foreign assets of the top twenty-five Russian TNCs (Sauvant, Maschek, and McAllister, 2009, p.16), and oil and gas in particular are the top outward- investing industries from the Russian Federation, it is crucial to analyse Russian OFDI in the energy sector. It is also important to analyze Russian OFDI in Europe because the largest proportion of Russian OFDI is in non-CIS (Commonwealth of Independent States) Europe, as shown in Table 2 below:

Table 2. Russian OFDI flows, total and in Europe (excluding CIS), 2007–2012
(Millions of dollars and per cent)

| Year | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|--|--------|--------|--------|--------|--------|--------|
| Russian OFDI Total | 44,801 | 55,663 | 43,281 | 52,616 | 66,851 | 48,822 |
| Russian OFDI in Europe (excluding CIS) | 34,594 | 35,941 | 32,255 | 36,559 | 44,930 | 32,283 |
| Percentage of total Russian OFDI in Europe (excluding CIS) | 77% | 64.6% | 74.5% | 69.5% | 67.2% | 66.1% |

Source: Central Bank of Russia (2014), author's calculations.

It is important to note here that this paper is based on an entirely qualitative analysis of three cases of OFDI by Russian state-owned energy companies, and hence cannot claim significance in the same terms as a statistical analysis would. However, the cases were selected in such a way to allow the findings to be extrapolated to other instances

of OFDI by Russian state-owned energy companies. The paper analyses examples of OFDI by three state-owned energy companies.¹ They are of different sizes, represent different industries within the energy sector, and invested or planned to invest in three different European countries. A large nuclear power producer, Rosatom (and its subdivision Atomstroyexport), invested in the European Union's largest economy, Germany. The gas giant Gazprom planned a package of investment projects in a relatively small and new EU member state, Hungary. The smaller state-owned oil company Zarubezhneft invested in the small non-EU member country Bosnia-Herzegovina.

5. State-TNC cooperation in three examples of OFDI

5.1. Atomstroyexport's acquisition of Nukem Technologies in Germany

In August 2006, United States private equity group Advent International put up for sale the German uranium trader Nukem GmbH and its subdivision Nukem Technologies, a leading European engineering company that specializes in the dismantling and decommissioning of nuclear power stations. Atomstroyexport, a subdivision of the Russian state-owned holding company Rosatom, immediately expressed its interest in Nukem Technologies and began to negotiate its acquisition. The initial price for the two assets was approximately €70 billion. However, as Nukem GmbH and Nukem Technologies represent two very different business profiles, there was little interest in the acquisition of both companies. Negotiations between Rosatom and Advent International lasted three years and in December 2009 they agreed on Atomstroyexport's acquisition of Nukem Technologies for €23.5 billion (Gileva, 2009). According to Atomstroyexport's vice-president, Alexander Glukhov, during the negotiations Advent International requested banking guarantees of approximately €500 million, in accordance with German law. Nevertheless, Atomstroyexport negotiated a guarantee of only €66 million for operational responsibilities.

Nevertheless, it seems that the acquisition was mutually beneficial. Alexander Glukhov stated that by acquiring Nukem

¹ In the Russian Federation, there are eight state-owned energy companies, including large corporations Rosatom, Gazprom, Rusnano, Rosneft, Transneft, and RosGidro (the remnant of electricity giant RAO UES)

Technologies, Atomstroyexport gained access to the unique technology for the dismantling and decommissioning of nuclear power stations, which at the time of the acquisition did not exist in the Russian Federation (Gileva, 2009). Moreover, according to Rosatom's director of nuclear security Oleg Krukov, as Nukem Technologies was a relatively well-known company in Europe, the acquisition was expected to provide Rosatom with new contracts in the European market (Vedomosti, 2013). Similarly, Nukem Technologies' managing director Ulf Kutscher pointed out that with Atomstroyexport, Nukem Technologies obtained a strategic investor who perfectly understood the company's business and would develop it further: "I am convinced that we can extend the activities and therefore also the employment situation at NUKEM Technologies" (Nukem Technologies Website, 2009).

According to Alexander Glukhov, Atomstroyexport cooperated with several Russian banks: in cooperation with VneshtorgBank, Atomstroyexport provided guarantees to Commerzbank for Nukem Technologies' responsibilities in existing contracts. Similarly, Atomstroyexport employed the Russian GazpromBank as its financial consultant in the acquisition (Gileva, 2009). These forms of cooperation among Russian state-owned commercial organizations suggest that, by following primarily its business interests, Atomstroyexport also considered Russian economic state/national interests. Nevertheless, Atomstroyexport collaborated not only with the Russian partners, but also non-Russian companies Norton Rose and KPMG for law and taxation consultations.

Interviews with other participants in the acquisition process suggest a dominance of business interests in Atomstroyexport's decision making. For instance, Nukem Technologies' Communication Director pointed out that the roles of the Governments of the Russian Federation and Germany were limited to technical contacts, as all negotiations were conducted directly between the companies, and that this pattern has not changed since the acquisition. "Due to the fact that Nukem is active worldwide, we don't cooperate with Russian institutions any more than with other foreign institutions, besides some technical contacts like applying for visas for colleagues travelling to Russia" (online interview, 12th July 2012). Russian state officials working at the diplomatic mission in Germany confirm that there is little cooperation between Russian state institutions in Germany and

Russian investors, stating that Russian state institutions abroad provide support for Russian companies only when they receive a directive to do so from Moscow. Otherwise, companies, including state-owned energy companies in general and Atomstroyexport in particular, act independently.

In Soviet times, the state had the power to say what amount of production the organizations should export to Germany. Now, we have a market economy and all we can do is establish the contacts and support Russian business abroad, when required. However, we have no tools to make them useful for Russia itself (Deputy of Russian Trade and Commercial Bureau in Berlin, personal interview, December 13th 2011).

Moreover, according to the director of Communications at Nukem Technologies, even after acquisition by the Russian state-owned energy company, Nukem Technologies continued to be recognized as a German rather than Russian company.

More than 90 % of our staff is German; the majority of the remaining 10 % [are] international colleagues but no[t] Russians. Only two Russians (from about 250 employees) started working at Nukem after the acquisition by Atomstryexport. Only recently [was] our Management Board expanded [to include] the Russian Managing Director (online interview, 12th July 2012).

These observations suggest that, when acquiring Nukem Technologies, Atomstryexport did not encounter any political obstacles and thus did not need political and diplomatic support from the Russian state. Therefore, it can be argued that in this particular example of OFDI, Russian state-TNC cooperation was very low and that it took place in the Russian Federation mainly among various state-owned commercial structures. Moreover, the willingness of the management of Atomstroyexport to endure a lengthy negotiation to obtain a significantly lower price suggests that the acquisition was driven primarily by business motives (rather than state/national or personal) of the company (as a collective actor). These business motives, namely access to new technologies and access to new markets, only coincidentally turned out to be economically beneficial for the Russian Federation's broader state/national interests.

5.2. Gazprom's South Stream project in Hungary

The instance of Gazprom's investment in the Hungarian section of the South Stream project represents an almost opposite picture of Russian state-TNC cooperation to Atomstroyexport's acquisition of Nukem Technologies. At 2,400 kilometer long, South Stream represented one of Gazprom's largest international pipeline projects (Gazprom, 2013).² Its aim was the diversification of the gas supply routes from the Russian Federation to Europe in view of the disputes with Ukraine in 2006 and 2009 which led to gas cut-offs (Marson, 2013). The total cost of the project was forecast to be about €56 billion, of which €46 billion was to be financed by Gazprom (€31 billion domestically, and €15 internationally), and the rest by its European partners (Korchemkin, 2013).

The pipeline was to cross the territories of Bulgaria, Serbia, Hungary and Slovenia before terminating in Italy (Pinchuk, 2013). An alternative trajectory bypassing Slovenia and reaching Italy through Austria was also considered. The Hungarian section of South Stream was a relatively small 229 kilometres and the cost of investment was estimated at €600 million (Marnitz, 2012). The participation of Hungary in the South Stream project seemed to be a high priority for the Hungarian government as it gave the project the status of national importance (Gazprom, 2012).

Negotiations about Hungary's participation in the South Stream project started in 2007 and were finalized at the end of 2013. As the project itself was infrastructural and international, it required an active involvement of the governments of all the participating countries, including the Russian Federation. According to a representative of the Russian Ministry of Energy, the foreign economic interests of the Russian state coincide with Gazprom's business interests to invest in Europe because the Russian state budget receives most of its revenues from the energy sector, thus the cooperation between Gazprom and Russian state institutions abroad is usually relatively intensive.

Our relations with state-owned energy companies should be analysed within the context of Russia's Energy Strategy up to

² In December 2014, the Russian government officially abandoned the South Stream pipeline, citing EU objections, and instead named Turkey as its preferred partner for an alternative pipeline.

2030, which is part of the broader Strategy for Russia's Economic Development. ... Energy is the leading sector of Russia's economy. Therefore, Russia's state budget to a large extent depends on the revenues of state-owned energy companies. In order to increase these revenues, and consequently to increase the state budget, not only our Ministry but other ministries also have to support our energy companies, both in Russia and abroad. (Representative of the Russian Ministry of Energy, telephone interview, August 5th 2011).

In a similar vein, Gazprom sees the role of Russian state institutions as the provider of political and diplomatic support when required. "As we are a majority state-owned company, it is logical that the state has the same interests as we do, and, therefore, Russian state institutions provide help if Gazprom needs it" (Gazprom official, telephone interview, May 20th 2012). Moreover, according to the Gazprom official interviewed, the role of all Gazprom's European subsidiaries and joint-stock companies is primarily commercial:

Similarly to other countries which participate in the South Stream pipeline project, in Hungary we established a joint venture with our Hungarian partners. ... Our partnerships are based on simple mutual interests: the goal of all our foreign partners is to secure gas supplies, and our goal is to reach our final consumers in Europe and to increase revenues (Gazprom official, telephone interview, May 20th 2012).

The CEO of Gazprom's Hungarian partner company MVM, Csaba Bajo, shared a similar view, pointing out that the Hungarian stretch of the pipeline would have had the capacity to fulfil domestic needs (Marnitz, 2012). At the same time, an official from the Russian Ministry of Foreign Affairs (MFA) pointed out that the state interests were not always taken into consideration when cooperating with Russian TNCs abroad:

Although we are a political institution and, consequently, our tasks are exclusively political, we are obliged to provide support to Russian business in the form of favourable political conditions and in order to avoid discrimination against Russian companies. ... Unfortunately, companies hardly consider Russian state and

national interests in their activities abroad (Expert on Russian-Hungarian relations from the Russian Ministry of Foreign Affairs, personal interview, July 23rd 2011).

In general, it can be argued that the South Stream project would have been commercially beneficial for Gazprom and also for the Russian budget. However, some analyses indicate that the observation of the official at the Ministry of Foreign Affairs (mentioned above) could also be applied to the South Stream project: “this investment will increase the gas transmission costs and reduce the profits of Gazprom shareholders. ... The high cost of the Southern Corridor pipelines cannot be explained by climatic, geographic or terrain conditions of Southern European Russia” (Korchemkin, 2013). Thus, it seems that the rationale behind this Gazprom project can partly be explained by “the maximization of profits of pipeline contractors and intermediaries” (Korchemkin, 2012).

In summary, while planning investments related to the South Stream project in Hungary, Gazprom enjoyed extensive support from Russian state institutions, in particular from the Ministry of Energy and the Russian Embassy in Hungary. It is also possible that, while Gazprom’s business interests that drove its investments in Hungary coincided with the economic interests of the Russian state, this project was, to some extent, driven by the individual interests of the decision-makers.

5.3. Zarubezhneft’s acquisitions of oil capacities in the Republic of Srpska³, Bosnia-Herzegovina

The smallest wholly state-owned oil company and the oldest Russian foreign economic enterprise (founded in 1967), Zarubezhneft has become one of the largest investors in Bosnia-Herzegovina. By using credit from the Russian VneshTorgBank (literally, the Bank of Foreign Trade), Zarubezhneft’s affiliate in the Republic of Srpska, NeftgazInkor, provides an important example in the analysis of Russian state-TNC cooperation. According to a former Zarubezhneft official, the main motive for investment in oil capacities in Bosnia-Herzegovina was the company’s easier access to customers in the EU markets.

³ Bosnia-Herzegovina emerged in its current form in 1995, based on the Dayton Peace Accord. Since then Bosnia-Herzegovina has been divided into two entities: Bosnia-Herzegovina Federation composed of Bosniak and Croat ethnic counties; and the Serb entity Republic of Srpska, with its own government and local governing bodies.

Bosnia-Herzegovina is geographically close to the EU and as a potential EU member it has more favourable conditions for trade with the EU than Russia. Our main goal is to gain access to the EU markets not only for crude oil but for refined oil products. However, we are too small a company to invest directly in the EU as the competition there is much greater than in Bosnia (former Zarubezhneft official, personal conversation, October 15th 2011).

This comment explains Zarubezhneft's choice to locate its Bosnian office as close to the Western European markets as possible. As a result, NeftegazInKor was established in Banja Luka (located only 30 kilometres from the Bosnian-Croatian border) in 2007 (when Croatia's prospects for EU membership were already confirmed). Largely destroyed during the Bosnian war and out of use since 1992, the Oil Refinery Bosanski Brod became NeftegazInKor's first purchased capacity. The purchase of Refinery for Oil Derivatives in Modrica followed soon after. The responses from both a Zarubezhneft representative and their hosts in Bosnia-Herzegovina indicate that the conditions of purchase were favourable for both contractors. On the one hand, Zarubezhneft's investments had a positive effect on Bosnia-Herzegovina's economy: during 2007–2011, the sale of assets to Zarubezhneft raised €120 million. As a result, the credit rating of the country increased for the first time in the post-war period. On the other hand, the Zarubezhneft representative recognizes Bosnia-Herzegovina's advantages as an FDI destination:

The investment climate in the Republic of Srpska is quite favourable: we pay only property tax to the local government, which is only 0,03% of the revenues. ... The labour force is also cheaper than in neighbouring countries (former Zarubezhneft official, personal conversation, October 15th 2011).

The management of the refineries in the Republic of Srpska and the entity's government tried to find an investor for the deteriorating oil capacities by using all possible networks around the world. Finally, in 2005 the representatives of the former-Yugoslav business diaspora in the Russian Federation succeeded in attracting the attention of state-owned Zarubezhneft. Negotiations lasted until the end of 2007 when the first official contracts were signed in Moscow. These contracts were

an official guarantee that Zarubezhneft henceforth had all rights on decision-making regarding Bosnian oil capacities.

After receiving these guarantees, the company's top management decided to apply for state credit to conduct the acquisition. According to the former Zarubezhneft official, this application resulted in uneasy negotiations in the Kremlin and even in disputes between various Kremlin factions and their members in the ministries over the next two years. Resistance to Zarubezhneft's application came from the politicians considered to represent the Kremlin's liberal wing.

In spite of the widely shared view in the Ministry of Energy that this acquisition could be useful for the state's oil sector, there was strong resistance to providing the credit on the part of the Ministry of Finance, and Minister Alexei Kudrin in particular, who was responsible for the state budget. The former Minister of Economic Development, German Gref, supported Kudrin. In their view, Bosnian and other Western Balkan markets were too small and too poor to be attractive for Russian investment (former Zarubezhneft official, personal conversation, October 11th 2011).

According to the former Zarubezhneft official, the management of Zarubezhneft realized that the only way to receive credit for the planned acquisition in Bosnia-Herzegovina was to bypass the ministerial level. Personal networks in the Kremlin were the main means of lobbying for the credit. Some managers used personal friendships with some of the most influential decision-makers in VneshEkonomBank. Others used personal relations with representatives of the presidential administration and with President Putin himself. The final agreement was reached by the representatives of the presidential administration, VneshEkonomBank and the company when they recognized that they all had a mutual interest in the deal, whether that be commercial or as individuals. As a result of these two years of non-transparent negotiations and disputes among the factions, VneshEkonombank granted the credit to Zarubezhneft and the acquisition was finalized in 2009. An official explanation for the decision was again ascribed to Russian foreign policy interests in the Balkans.

After Zarubezhneft's intention to acquire the oil capacities in Bosnia became the top business story in both the Russian and Balkan media, it became a matter of pride and dignity for the

state to finalize the project. We received the credit and finalized the acquisition in 2009 (former Zarubezhneft official, personal conversation, October 11th 2011).

For the local economy Zarubezhneft's investments were more than simply beneficial. According to a representative of the Republic of Srpska Chamber of Commerce, once Zarubezhneft re-activated the Brod refinery, former workers finally received their long-awaited salaries and in only two months 200 cars were bought in the town of Brod. "The small and medium enterprises for technical and cleaning services and restaurants appeared, and life came back to Brod" (representative of the Republic of Srpska Chamber of Commerce, personal interview, December 6th 2012).

In terms of the cooperation between the Russian state and Zarubezhneft, apart from using the above-mentioned informal personal contacts to gain financial support directly from the Russian state budget, Zarubezhneft's cooperation with Russian state institutions in Bosnia-Herzegovina has been limited to official formalities unrelated to investment.

There are about 100 Russian citizens in Banja Luka, which represents a kind of Russian business community. When there were elections, we organized a polling station in Banja Luka for them (Russian Embassy official in Bosnia-Herzegovina, personal interview, December 2nd 2012).

Since conducting this major acquisition in Bosnia-Herzegovina, Zarubezhneft has needed the state's support only once, when the company experienced certain problems with the importation of its oil through the territory of neighbouring Croatia. According to an economic expert in the Fourth European Department of the Russian Ministry of Foreign Affairs, officials at the Russian Embassy in Bosnia immediately contacted their colleagues at the Russian Embassy in Croatia for support.

The price for the importation of Zarubezhneft's oil was considerably higher than that for the Croatian company INA. In turn, the Russian Embassy in Croatia contacted the Croatian government and negotiated a lower price for oil importation for Zarubezhneft (Economic expert in the Fourth European

Department of the Russian MFA, personal interview, July 20th 2011).

Overall, in the case of Zarubezhneft's investment in Bosnia-Herzegovina, the initiative came from the host country's diaspora in the Russian Federation. This initiative triggered negotiations between Zarubezhneft and Russian state institutions. In its initial phase, state-TNC cooperation consisted of informal personal contacts between Zarubezhneft's management and very high-ranking Russian state officials, where the business and individual commercial interests were drivers for the particular investment transactions. Abroad, Zarubezhneft initiated cooperation with Russian state institutions regarding its investment activities only when it experienced difficulties with the importation of its oil through Croatian territory, while within Bosnia-Herzegovina the company's contacts with the Russian Embassy have been limited to official formalities unrelated to Zarubezhneft's investment activities. To summarize, the case of Zarubezhneft's investments in Bosnia-Herzegovina demonstrates first that the initiative for OFDI can come from the host country. Second, it shows that what constitutes economic interests of the state is sometimes disputed among factions within Russia's political elite.

6. What are the drivers for OFDI by these three Russian state-owned energy companies?

While all three companies analysed above declare to various extents that the state interests are a priority in their official missions and strategies (Gazprom in its advertisements, and Rosatom and Zarubezhneft in their missions and strategies), the analysis of the processes of their investments abroad shows that drivers of their OFDI are much more diverse and complex. The motive of Atomstroyexport for its acquisition of Nukem Technologies was relatively close to its declared mission "to maintain national interests in defence, nuclear safety and nuclear power". Nevertheless, any possible long-term benefits for the Russian Federation are coincidental rather than Atomstroyexport's main intentions, as the process of the acquisition indicates. The negotiation regarding the acquisition as well as the forms and mechanisms of cooperation with Russian state institutions and other commercial state-owned institutions reflect the dominance of the company's business interests.

The case of Gazprom's planned investment in the Hungarian section of the South Stream project suggests that the size of the company matters when Russian state support is in question. As the largest Russian company, Gazprom enjoys state support in all stages of its foreign investment projects. While the company's declared goals are mainly commercial, its importance for the Russian economy is very significant, creating a situation in which the state interests coincide with Gazprom's business interests. However, the South Stream project in its later stages no longer seemed commercially beneficial for Gazprom; rather the beneficiaries would have been – in Mikhail Korchemkin's words – the contractors and intermediaries, i.e. the individuals who control the company or the powers of the state.

Similarly, Zarubezhneft's OFDI in Bosnia-Herzegovina was driven by the company's business interests, while the personal network of its top managers was a decisive factor in receiving financial support from the Russian state. Both the business interests and the individual interests resulted in cooperation between Zarubezhneft and state institutions being of an informal nature. Moreover, despite the fact that the Russian Foreign Policy Concept declared that there was a state obligation to support Russian companies in their investment activities abroad, smaller Russian companies cannot always count on this support even if it is wholly owned by the state. Thus, the extent and pattern of the state's support to Zarubezhneft's acquisitions in Bosnia-Herzegovina confirms that the size of the company matters when it comes to Russian state support. A summary of these findings is presented in Table 3.

6.1. Possible explanatory factors

So far, the analysis has shown that there is no single Russian government strategy vis-à-vis OFDI by state-owned energy companies. At the same time, the differences in the three cases of OFDI by Russian state-owned energy companies with regard to conformity between Russian state interests, the declared missions and strategies of the companies, and state-TNC cooperation can best be explained by the differences between the three host countries and the characteristics of their markets. The destination for Rosatom's foreign expansion, Germany, is the largest European economy and an established member of the European Union (EU). Thus, Germany represents one of the

most attractive markets for foreign investors in general and for Russian energy companies in particular for three major reasons: the first is the size of the German market (about eighty million people); the second reason is the high market sophistication, with GDP per capita of about \$39,100 in 2012 against Russia's GDP per capita of \$17,700 in the same year (indexmundi.com, 2013); and lastly, there are strict regulations of FDI, which provide low political and economic risks.

Table 3. Conformity between Russian state-owned energy companies' declared and demonstrated interests for international expansion
(based on the state-TNC cooperation)

| Company | Conformity between declared and demonstrated interests for outward foreign direct investment (OFDI) | | Driving interests for OFDI |
|-------------------------|---|--------------------|--|
| | State/national interests | Business interests | Individual profit-seeking interests |
| Rosatom-Atomstroyexport | Potential (long-term) conformity | Conformity | Not declared in the company's official policy; not found in case study; there is conformity between declared and demonstrated interests for OFDI |
| Gazprom | Potential (long-term) conformity | Conformity | Not declared in the company's official policy; found in case study; there is non-conformity between declared and demonstrated interests for OFDI |
| Zarubezhneft | Conforms with regional state interests, and contradicts economic ones | Conformity | Not declared in the company's official policy; not found in case study; there is conformity between declared and demonstrated interests for OFDI |

In contrast, Hungary is considered part of the Central and Eastern Europe (both for historical and geographical reasons). It represents a less significant market to Russian energy companies for three reasons: first, the Hungarian market is relatively small in size (about ten million people); second, it has a medium level of GDP per capita at \$19,800 GDP in 2012 (accounting for less than one percent of total EU GDP); and third, its regulations of FDI are less rigorously enforced with limited political and economic risks. The latter is, as Bohle and Greskovits (2012) point out, due to attempts to attract TNCs by adopting generous incentive packages, creating investment promotion agencies, and

launching expensive infrastructure development programs” while keeping in place “relatively generous systems of social protection”, which resulted in “contested and ineffective institutions of macroeconomic coordination” (Bohle and Greskovits, 2012, p.138).

In contrast to both these countries, Bosnia-Herzegovina is a small non-EU member state (of approximately only three million people) with the GDP per capita of only \$8,300 in 2012. There are also lax FDI regulations resulting in high political and economic risks. Nevertheless, the near absence of competition by other foreign investors has attracted a limited number of Russian companies to invest in Bosnia-Herzegovina.

These differences between these three countries are also reflected in the Russian Foreign Policy Concept. For instance, according to the Russian Foreign Policy Concept 2013, Russia’s foreign policy interests also include a geographical dimension in which relations with the EU are second only to the Commonwealth of Independent States on the list of regional priorities. However, while most of the older EU countries are specifically named in the Concept as states of high economic and political importance to the Russian Federation (namely, Germany, Italy, the United Kingdom, France, and the Netherlands), the newer EU member states of in the Central and East Europe are merely mentioned under the title “other European states” and are important only in the sense that they provide a buffer with Western Europe. “Southeast Europe” and in particular the Balkan states are depicted as a region of a “great strategic importance to Russia” (2013), but no mention is made of their economic importance.

The three examples of OFDI by Russian state-owned energy companies analysed in this paper reflect to varying extents this dimension of the state interests abroad. In Atomstroyexport’s acquisition of Nukem Technologies, business interests coincide with Russia’s state interests in terms of security. It also coincides with the state interests from a geographical point of view: the Russian Foreign Policy Concept names the EU as its second regional priority and Germany as the most important partner in the EU. At the same time, it is clear that for the South Stream project Hungary was important as a transit route rather than as a target market. Thus, Gazprom’s investment in the South Stream section in Hungary shows that the country was

more important to Gazprom's business considerations than to Russia's state interests. Finally, while Bosnia-Herzegovina has no particular economic importance for Russia's state interests abroad, it is located in a region of a "great strategic importance to Russia" as stated in the Russian Foreign Policy Concept 2013. In that sense, the process of negotiations and cooperation between Zarubezhneft and Russian state institutions regarding the company's acquisitions in Republic of Srpska, Bosnia-Herzegovina, reveals certain inconsistency between Russia's geostrategic and economic state/national interests. Zarubezhneft's acquisitions to some extent comprise some geostrategic Russian state/national interests, but not necessary its economic interests. Nevertheless, the analysis above shows that conformity between Zarubezhneft's acquisition and Russian geopolitical state interests is largely unintentional.

Overall, the analysis of the OFDI processes and cooperation between Russian state institutions and state-owned energy companies in the three instances of OFDI discussed above implies that the most typical relationships between the four types of actors and their interests in OFDI by Russian state-owned energy companies can be summarized as follows. Both managers and politicians pursuing their individual interests usually portray them as the interests of collective actors, either as the business interests of the Russian state-owned energy companies or the state/national interests. At the same time, Russian state-owned energy companies also often purport their business interests as being Russian state/national interests. Thus, the business interests of Russian state-owned energy companies and the individual profit-seeking interests of the managers and of some Russian politicians are often interrelated, and all are usually presented as being state interests.

7. Conclusions

By reconstructing the processes of OFDI by Russian state-owned energy companies through the analysis of Russian state-TNC cooperation in three examples of OFDI by Russian state-owned energy companies in Germany, Hungary and Bosnia-Herzegovina, this paper demonstrates that the motives for OFDI by Russian state-owned energy TNCs is a much more nuanced phenomenon than the existing literature would imply. Moreover, the analysis presented in this paper provides

four more general conclusions about the motives that drive OFDI by Russian state-owned energy companies. First, the three analysed cases show that the motives of Russian state-owned energy companies vary depending on the location. In developed countries – represented here by Atomstroyexport’s investment in Germany – they expand to gain access to markets and new technologies. In less developed countries, such as Zarubezhneft’s acquisitions in Bosnia-Herzegovina, they attempt to take advantage of relatively cheap labour and the absence of other foreign investors. This finding confirms the claim by Alexei Kuznetsov (2007) that Russian energy companies’ motives for OFDI do not differ from those of multinationals from developed countries. At the same time, this finding contradicts Peeter Vahtra and Kari Liuhto’s claim (2004) that OFDI decisions of Russian energy companies are based on political goals rather than on a business rationale.

Second, this paper reveals that Russian state-TNC cooperation in these three instances of OFDI by Russian state-owned energy companies was always initiated by the companies. This finding implies that the primary drivers for OFDI by Russian state-owned energy companies are business interests. More specifically, the cases analysed in this paper suggest that Russian state-owned energy companies act predominantly according to their business interests rather than official Russian foreign policy, which reflects broader state interests. Therefore, the findings of the present paper supports Olga Oliker et al. (2009), who point out that most large Russian energy TNCs act in their own business interests, which do not necessarily coincide with Russian national interests.

Third, this paper reveals that the motives for OFDI by Russian state-owned energy companies also depend on the host countries. As the analysis of Zarubezhneft’s acquisition of the oil capacities in Bosnia-Herzegovina indicates, the main trigger for this investment was the initiative by the Bosnian diaspora in the Russian Federation. The other two cases of Russian investments discussed in this paper also confirm this finding.

The fourth conclusion is that the motives for OFDI by Russian state-owned energy companies are case specific. As the case of Zarubezhneft’s OFDI in Bosnia-Herzegovina demonstrates, Russian politicians and the top managers of the state-owned TNCs can act as individuals, and instead of following national interests and business

motives, they pursue their individual interests. Each of these four types of actors' interests can be combined with those of the other three types of actors. In all three cases, business interests were evident. In the cases of Gazprom and Zarubezhneft, business interests were also combined with individual interests. Andreas Wenger (2009) confirms this view by pointing out that "while the state has attempted to formulate a long-term energy strategy, its energy politics remain dominated by short-term personal gains and by the interests of competing elites, rather than by the long-term interests of the Russian people" (p.228). Finally, this paper demonstrates that in OFDI by Russian state-owned energy companies, Russian state interests may well be fulfilled in the long run, but largely as an unintentional outcome.

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POLICY NOTES

Reform of investor-state dispute settlement: in search of a roadmap

UNCTAD Secretariat

Challenges posed by today's investor-State dispute settlement (ISDS) regime create momentum for its reform. Concerns with the current ISDS system relate, among others things, to a perceived deficit of legitimacy and transparency; contradictions between arbitral awards; difficulties in correcting erroneous arbitral decisions; questions about the independence and impartiality of arbitrators, and concerns relating to the costs and time of arbitral procedures. This note outlines five main reform paths.

- Promoting alternative dispute resolution;
- Tailoring the existing system through individual IIAs;
- Limiting investor access to ISDS;
- Introducing an appeals facility;
- Creating a standing international investment court.

Each of the five reform options comes with its specific advantages and disadvantages and responds to the main concerns in a distinctive way. Some of the options can be implemented through actions by individual governments and others require joint action by a larger group. The options that require collective action from a larger number of States would go further in addressing the existing problems, but would also face more difficulties in implementation. Collective efforts at the multilateral level can help to develop a consensus about the preferred course for reform and ways to put it into action

The proliferation of ISDS under international investment agreements (IIAs) shows the importance this mechanism has gained. But it also increasingly reveals that there are a number of problems. This note summarizes the main concerns relating to the current ISDS regime, and sketches out the main possible avenues for reform. The note rests upon UNCTAD's *Investment Policy Framework for Sustainable*

*Development (IPFSD)*¹ which places the objectives of inclusive growth and sustainable development at the core of national and international investment policies.

I. Main concerns about the current ISDS regime

As documented by UNCTAD’s annual update, ISDS cases have proliferated in the past 10-15 years, with the overall number of known treaty-based arbitrations reaching 514 by the end of 2012 (see figure 1). Since most arbitration forums do not maintain a public registry of claims, the total number of cases is likely to be higher.²

Figure 1. Known ISDS cases, annual and cumulative, 1987-2014



Source: UNCTAD.

In light of the increasing number of ISDS cases, the debate about the pros and cons of the ISDS mechanism has been gaining momentum, especially in those countries and regions where ISDS is on the agenda of IIA negotiations and/or which have faced investor claims that have attracted public attention.

¹ UNCTAD (2012), *Investment Policy Framework for Sustainable Development*, available at http://unctad.org/en/PublicationsLibrary/webdiaepcb2012d6_en.pdf.

² UNCTAD (2013), *Recent Developments in Investor-State Dispute Settlement*, available at http://unctad.org/en/PublicationsLibrary/webdiaepcb2013d3_en.pdf.

The ISDS mechanism was designed for depoliticizing investment disputes and creating a forum that would offer investors a fair hearing before an independent, neutral and qualified tribunal. It was seen as a mechanism for rendering final and enforceable decisions through a swift, cheap, and flexible process, over which disputing parties would have considerable control.³

Given that investor complaints relate to the conduct of sovereign States, taking these disputes out of the domestic sphere of the State concerned was seen as providing aggrieved investors with an important guarantee that their claims will be adjudicated in an independent and impartial manner.

However, the actual functioning of ISDS under investment treaties has led to concerns about systemic deficiencies in the regime. They have been well documented in literature and need only be summarized here.⁴

1. Legitimacy and transparency

In many cases foreign investors have used ISDS claims to challenge measures adopted by States in the public interest (for example, policies to promote social equity, foster environmental protection or protect public health). Questions have been raised whether three individuals, appointed on an ad hoc basis, can be seen by the public at large as having sufficient legitimacy to assess the validity of States' acts, particularly if the dispute involves sensitive public policy issues.

³ For a discussion of the key features of ISDS, see also, UNCTAD, *Investor-State Dispute Settlement: A Sequel*, UNCTAD Series on Issues in IIAs II (forthcoming).

⁴ Michael Waibel et al. (eds.), *The Backlash against Investment Arbitration: Perceptions and Reality* (Kluwer Law International, 2010); D. Gaukrodger and K. Gordon, "Investor-State Dispute Settlement: A Scoping Paper for the Investment Policy Community", OECD Working Papers on International Investment, No. 2012/3; P. Eberhardt and C. Olivet, "Profiting from Injustice: How Law Firms, Arbitrators and Financiers are Fuelling an Investment Arbitration Boom" (Corporate Europe Observatory and Transnational Institute, 2012), available at <http://corporateeurope.org/sites/default/files/publications/profitting-from-injustice.pdf>.

Host countries have faced ISDS claims of up to \$114 billion⁵ and awards of up to \$1.77 billion.⁶ Although in most cases the amounts claimed and awarded are lower than that, they can still exert significant pressures on public finances and create potential disincentives for public-interest regulation, posing obstacles to countries' sustainable economic development.

In addition, even though the transparency of the system has improved since the early 2000s,⁷ ISDS proceedings can still be kept fully confidential – if both disputing parties so wish – even in cases where the dispute involves matters of public interest.⁸

Further concerns relate to so-called “nationality planning”, whereby investors structure their investments through intermediary countries with the sole purpose of benefitting from IIAs, including their ISDS mechanism.

2. *Arbitral decisions: problems of consistency and erroneous decisions*

Those arbitral decisions that have entered into the public domain have exposed recurring episodes of inconsistent findings. These have included divergent legal interpretations of identical or similar treaty provisions as well as differences in the assessment of the merits

⁵ This figure is the aggregate amount of compensation sought by the three claimants constituting the majority shareholders of the former Yukos Oil Company in the ongoing arbitration proceedings against Russia. See *Hulley Enterprises Limited (Cyprus) v. The Russian Federation*, PCA Case No. AA 226; *Yukos Universal Limited (Isle of Man) v. The Russian Federation*, PCA Case No. AA 227; *Veteran Petroleum Limited (Cyprus) v. The Russian Federation*, PCA Case No. AA 228.

⁶ *Occidental Petroleum Corporation and Occidental Exploration and Production Company v. The Republic of Ecuador*, ICSID Case No. ARB/06/11, Award, 5 October 2012.

⁷ See for example, the 2006 amendments to the ICSID Arbitration Rules and the 2013 agreement reached by an UNCITRAL Working Group regarding transparency in ISDS proceedings. In the case of UNCITRAL, the new rules have a limited effect in that they are designed to apply not to all future arbitrations but only to arbitrations under future IIAs.

⁸ This applies to cases brought under arbitration rules other than ICSID (only ICSID keeps a public registry of arbitrations). It is indicative that of the 85 cases under the UNCITRAL Arbitration Rules administered by the Permanent Court of Arbitration (PCA), only 18 were public (as of end 2012). Source: the Permanent Court of Arbitration International Bureau. See further UNCTAD, *Transparency: A Sequel, Series on Issues in IIAs II* (New York and Geneva, 2012), available at [http://unctad.org/en/Pages/DIAE/International%20Investment%20Agreements%20\(IIA\)/International-Investment-Agreements-\(IIAs\).aspx](http://unctad.org/en/Pages/DIAE/International%20Investment%20Agreements%20(IIA)/International-Investment-Agreements-(IIAs).aspx)

of cases involving the same facts. Inconsistent interpretations have led to uncertainty about the meaning of key treaty obligations and lack of predictability of how they will be applied in future cases.⁹

Erroneous decisions are another concern: arbitrators decide important questions of law without a possibility of effective review. Existing review mechanisms, namely the ICSID annulment process or national-court review at the seat of arbitration (for non-ICSID cases), operate within narrow jurisdictional limits. It is noteworthy that an ICSID annulment committee may find itself unable to annul or correct an award, even after having identified “manifest errors of law”.¹⁰ Furthermore, given that annulment committees – like arbitral tribunals – are created on an ad hoc basis for the purpose of a single dispute, they may also arrive (and have arrived) at inconsistent conclusions, thus further undermining predictability of international investment law.

3. *Arbitrators: Concerns about party appointments and due incentives*

Arbitrators’ independence and impartiality. An increasing number of challenges to arbitrators may indicate that disputing parties perceive them as biased or predisposed. Particular concerns have arisen from a perceived tendency of each disputing party to appoint individuals sympathetic to their case. Arbitrators’ interest in being re-appointed in future cases and their frequent “changing of hats” (serving as arbitrators in some cases and counsel in others) amplify these concerns.¹¹

4. *Cost- and time-intensity of arbitrations*

Actual ISDS practice has put into doubt the oft-quoted notion that arbitration represents a speedy and low-cost method of dispute

⁹ Sometimes, divergent outcomes can be explained by the differences in wording of a specific IIA applicable in a particular case; however, often they represent the differences in the views of individual arbitrators.

¹⁰ See *CMS Gas Transmission Company v. The Republic of Argentina*, ICSID Case No. ARB/01/8, Decision of the ad hoc Committee on the application for annulment, 25 September 2007, paras. 97, 127, 136, 150, 157-159. Article 52(1) of the ICSID Convention enumerates the following grounds for annulment: (a) improper constitution of the arbitral Tribunal; (b) manifest excess of power by the arbitral Tribunal; (c) corruption of a member of the arbitral Tribunal; (d) serious departure from a fundamental rule of procedure; or (e) absence of a statement of reasons in the arbitral award.

¹¹ For further details, see Gaukrodger and Gordon (2012 : 43-51). *Ibid.*, p. 19.

resolution. On average, costs, including legal fees (which on average amount to approximately 82% of total costs) and tribunal expenses, have exceeded \$8 million per party per case.¹² For any country, but especially for poorer ones, this is a significant burden on public finances. Even if the government wins the case, tribunals have mostly refrained from ordering the claimant investor to pay the respondent's costs. At the same time, high costs are also a concern for investors, especially those with limited resources.

Large law firms, who dominate the field, tend to mobilise a team of attorneys for each case who charge high rates and employ expensive litigation techniques, which include intensive research on each arbitrator candidate, far-reaching and burdensome document discovery and lengthy arguments about minutest case details.¹³ The fact that many legal issues remain unsettled contributes to the need to invest extensive resources to develop a legal position by closely studying numerous previous arbitral awards. Some of the same reasons are also responsible for the long duration of arbitrations, most of which take several years to conclude.

II. Mapping five broad paths towards reform

These challenges have prompted a discourse about the challenges and opportunities of ISDS. This discourse has been developing through relevant literature, academic/ practitioner conferences and the advocacy work of civil society organisations. It has also been carried forward under the auspices of UNCTAD's Investment Commission and Expert Meetings, its multi-stakeholder World Investment Forum (WIF)¹⁴ and a series of informal conversations it has organized,¹⁵ as well as the OECD's Freedom- of-Investment Roundtables.¹⁶

¹² Lawyers' fees may reach \$1,000 per hour for senior partners in top-tier law firms. *Ibid.*, pp. 19-21.

¹³ <http://unctad-worldinvestmentforum.org/>

¹⁴ During 2010 and 2011 seven informal conversations were organized or co-organized by UNCTAD, taking the form of small- group, informal discussions among various stakeholders about possible improvements to the ISDS system. These conversations were oriented towards generating concrete outputs on possible improvements to the ISDS system.

¹⁵ See e.g., OECD, "Government perspectives on investor-state dispute settlement: a progress report", Freedom of Investment

¹⁶ Roundtable, 14 December 2012, available at: <http://www.oecd.org/daf/inv/investment-policy/foi.htm>.

Five broad paths for reform have emerged from these discussions:

1. Promoting alternative dispute resolution
2. Tailoring the existing system through individual IIAs
3. Limiting investor access to ISDS
4. Introducing an appeals facility
5. Creating a standing international investment court

1. Promoting alternative dispute resolution

This approach advocates for increasing resort to so-called alternative dispute resolution (ADR) methods and dispute prevention policies (DPPs), both of which have formed part of UNCTAD's technical assistance and advisory services on IIAs. ADR can be either enshrined in IIAs or implemented at the domestic level, without specific references in the IIA.

Compared to arbitration, non-binding ADR methods, such as conciliation and mediation,¹⁷ place less emphasis on legal rights and obligations. They involve a neutral third party whose main objective is not the strict application of the law but finding a solution that would be recognized as fair by the disputing parties. ADR methods can help to save time and money, find a mutually acceptable solution, prevent escalation of the dispute and preserve a workable relationship between the disputing parties. However, there is no guarantee that an ADR procedure will lead to resolution of the dispute; an unsuccessful procedure would simply increase the costs involved. Also, depending on the nature of a State act challenged by an investor (e.g., a law of general application), ADR may not always be acceptable to the government.

ADR could go hand in hand with the strengthening of dispute prevention and management policies at the national level. Such policies aim to create effective channels of communication and improve institutional arrangements between investors and respective agencies

¹⁷ Mediation is an informal and flexible procedure: a mediator's role can vary from shaping a productive process of interaction between the parties to effectively proposing and arranging a workable settlement to the dispute. It is often referred to as "assisted negotiations". Conciliation procedures follow formal rules. At the end of the procedure, conciliators usually draw up terms of an agreement that, in their view, represent a just compromise to a dispute (non-binding to the parties involved). Because of its higher level of formality, some call conciliation a "non-binding arbitration".

(for example, investment aftercare policies) and between different ministries dealing with investment-related issues. An investment ombudsman office, or a specifically assigned agency that takes the lead should a conflict with an investor arise, can help resolve investment disputes early on, as well as assess the prospects of, and, if necessary, prepare for international arbitration.¹⁸

In terms of implementation, this approach is relatively straightforward, and much has already been done by some countries. Importantly, given that most ADR and DPP efforts are implemented at the national level, individual countries can proceed without the need for their treaty partners to agree. However, ADR and DPPs do not solve key ISDS-related challenges. The most they can do is to reduce the number of fully-fledged legal disputes, which would render this reform path a complementary rather than standalone avenue for ISDS reform.

2. Tailoring the existing system

This option implies that the main features of the existing system would be preserved and that individual countries would apply tailored modifications to selected aspects of the ISDS system in their new IIAs. A number of countries have already embarked on this course of action.¹⁹ Procedural innovations, many of which also appear in UNCTAD's IPFSD, have included:²⁰

- *Setting time limits for bringing claims*; for example, three years from the events giving rise to the claim, in order to limit State exposure and prevent the resurrection of "old" claims;²¹

¹⁸ See further UNCTAD, *Investor-State Disputes: Prevention and Alternatives to Arbitration* (United Nations, New York and Geneva, 2010); UNCTAD, *How to Prevent and Manage Investor-State Disputes: Lessons from Peru*, Best Practices in Investment for Development Series (United Nations, New York and Geneva, 2011).

¹⁹ In particular, Canada, Colombia, Mexico, the United States and some others. Reportedly, the European Union is also considering this approach. See N. Bernasconi-Osterwalder, "Analysis of the European Commission's Draft Text on Investor-State Dispute Settlement for EU Agreements", *Investment Treaty News*, 19 July 2012, available at: <http://www.iisd.org/itn/2012/07/19/analysis-of-the-european-commissions-draft-text-on-investor-state-dispute-settlement-for-eu-agreements/>.

²⁰ Policy options for individual ISDS elements are further analyzed in UNCTAD, *Investor-State Dispute Settlement: A Sequel*—(forthcoming).

²¹ See e.g., NAFTA Articles 1116(2) and 1117(2); see also Article 15(11) of the China-Japan-Republic of Korea investment agreement.

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- *Increasing the contracting parties' role in interpreting the treaty* in order to avoid legal interpretations that go against their intentions; for example, through providing for binding joint party interpretations, requiring tribunals to refer certain issues for determination by the treaty parties and facilitating interventions by the non-disputing contracting parties;²²
 - *Establishing a mechanism for consolidation of related claims*, which can help to deal with the problem of related proceedings, contribute to the uniform application of the law, thereby increasing the coherence and consistency of awards, and help to reduce the cost of proceedings.²³
 - *Providing for more transparency in ISDS*; for example, by granting public access to arbitration documents and arbitral hearings as well as allowing the participation of interested non-disputing parties such as civil society organisations;²⁴
 - *Including a mechanism for an early discharge of frivolous (unmeritorious) claims*, in order to avoid wasting resources on full-length proceedings.²⁵

To these, add changes in the wording of IIAs' substantive provisions, introduced by a number of countries. These innovations seek to clarify the agreements' content and reach, thereby enhancing the certainty of the legal norms and reducing the margin of discretion of arbitrators.²⁶

The approach whereby countries provide focused modifications through their IIAs allows for individually tailored solutions and

²² On various means that can be - and have been - used by States, see UNCTAD, Interpretation of IIAs: What States Can Do, IIA Issues Note, No.3, December 2011. Two issues merit attention with respect to such authoritative interpretations. First, the borderline between interpretation and amendment can sometimes be blurred; second, if issued during an ongoing proceeding, a joint party interpretation may raise due-process related concerns.

²³ See e.g., NAFTA Article 1126; see also Article 26 of the Canada-China BIT.

²⁴ See e.g. Article 28 of the Canada-China BIT; see also NAFTA Article 1137(4) and Annex 1137.4.

²⁵ See e.g., Article 41(5) ICSID Arbitration Rules (2006); Article 28 United States-Uruguay BIT.

²⁶ UNCTAD, World Investment Report 2010, available at: http://unctad.org/en/Docs/wir2010_en.pdf. See also UNCTAD's Pink Series Sequels on Scope and Definition, MFN, Expropriation, FET and Transparency, available at: <http://investmentpolicyhub.unctad.org/Views/Public/IndexPublications.aspx>

numerous variations. For example, in their IIAs, specific countries may choose to address those issues and concerns that appear most relevant to them. At the same time, this option cannot address all ISDS-related concerns.

Mechanisms that facilitate high-quality legal defense to developing countries at an affordable price can also play a role. This idea stood at the origin of a 2009 initiative when UNCTAD, together with the Academia de Centroamerica, the Organization of American States (OAS) and the Inter-American Development Bank (IADB), were invited to pursue the possibility of establishing an Advisory Facility on International Investment Law and ISDS. This resulted in a series of meetings that addressed technical issues, including what should be the type of services such a Facility should offer, what could be its membership (open to all countries and organizations or limited to specific countries) and how it should be financed.

Implementation of this “tailored modification” option is relatively straightforward given that only two treaty parties (or several – in case of a plurilateral treaty) need to agree. However, the approach is limited in effectiveness: unless the new treaty is a renegotiation of an old one, the modifications are applied only to newly concluded IIAs while the large number of “old” ones remain unaffected. Moreover, one of the key advantages of this approach, namely, that countries can choose whether and which issues to address, is also one of its key disadvantages, as it turns this reform option into a piecemeal approach that stops short of offering a comprehensive and integrated way forward.

3. Limiting investor access to ISDS

This option envisages narrowing down the range of situations in which investors may resort to ISDS. This could be done in numerous ways, including: (i) by reducing the subject-matter scope for ISDS claims; (ii) by restricting the range of investors who qualify to benefit from the treaty, and (iii) by introducing the requirement to exhaust local remedies before resorting to international arbitration. A far-reaching version of this approach would be to abandon ISDS as a means of dispute resolution altogether and returns to State-State arbitration proceedings, as some recent treaties have done.²⁷

²⁷ Recent examples of IIAs without ISDS provisions are the Japan-Philippines

Some countries have adopted policies of the first kind, for example, by excluding certain types of claims from the scope of arbitral review.²⁸ In the past, some countries used this approach to limit jurisdiction of arbitral tribunals in a more pronounced way, for example, by allowing ISDS only with respect to expropriation disputes.²⁹

To restrict the range of covered investors, one approach is to include additional requirements in the definition of “investor” and/or to use denial-of-benefits provisions.³⁰ Among other things, this approach can address concerns arising from “nationality planning”/“treaty shopping” by investors and ensure that they have a genuine link to the putative home State.

Requiring investors to exhaust local remedies, or alternatively, to demonstrate the manifest ineffectiveness/bias of domestic courts, would make ISDS an exceptional remedy of last resort. While in general international law, the duty to exhaust local remedies is a mandatory prerequisite for gaining access to international judicial forums,³¹ most

Economic Partnership Agreement (2006), the Australia-United States FTA (2004) and the Australia-Malaysia FTA (2012). In April 2011, the Australian Government issued a trade policy statement announcing that it would stop including ISDS clauses in its future IIAs as doing so imposes significant constraints on Australia’s ability to regulate public policy matters: see Gillard Government Trade Policy Statement: Trading Our Way to More Jobs and Prosperity, April 2011, available at: <http://www.dfat.gov.au/publications/trade/trading-our-way-to-more-jobs-and-prosperity.pdf>.

²⁸ For example, claims relating to real estate (Cameroon-Turkey BIT); claims concerning financial institutions (Canada-Jordan BIT; claims relating to intellectual property rights and to prudential measures regarding financial services (China-Japan-Republic of Korea investment agreement); claims relating to establishment and acquisition of investments (Japan-Mexico Free Trade Agreement); claims concerning specific treaty obligations such as national treatment and performance requirements (Malaysia- Pakistan Closer Economic Partnership Agreement); and claims arising out of measures to protect national security interests (India-Malaysia Comprehensive Economic Cooperation Agreement). For further analysis, see UNCTAD, *Investor-State Dispute Settlement - A Sequel* (forthcoming).

²⁹ For example, some BITs concluded in the 1980s and early 1990s, particularly by China and Eastern European countries provided investors access to international arbitration only with respect to disputes relating to the amount of compensation following an investment expropriation (for example, Albania-China (1993), Bulgaria-China (1989), Belgium-Poland BIT (1987)).

³⁰ Denial of benefits clauses authorize States to deny treaty protection to investors who do not have substantial business activities in their alleged home State and who are owned and/or controlled by nationals or entities of the denying State or of a State who is not a party to the treaty.

³¹ Mummery, D. “The content of the duty to exhaust local judicial remedies”, *The American Journal of International Law*, Vol. 58. No2 (April 1964).

IAs dispense with this duty.³² Instead, they allow foreign investors to resort directly to international arbitration without first going through the domestic judicial system. Some see this as an important positive feature and argue that reinstating the requirement to exhaust domestic remedies could undermine the effectiveness of ISDS.

These options for limiting investor access to ISDS can help to slow down the proliferation of ISDS proceedings, reduce States' financial liabilities arising from ISDS awards and save resources. Additional benefits may be derived from these options if they are combined with assistance to strengthen the rule of law and domestic legal/judicial systems. To some extent, this approach would be a return to the earlier system, in which investors could lodge their claims only in the domestic courts of the host State, negotiate arbitration clauses in specific investor-State contracts or apply for diplomatic protection by their home State.

In terms of implementation – like the options described earlier – this alternative does not require coordinated action by a large number of countries and can be put in practice by parties to individual treaties. Implementation is straightforward for future IAs; past treaties would require amendments, renegotiation or unilateral termination.³³ Similar to the “tailored modification” option, however, this alternative results in a piecemeal approach towards reform.

4. Introducing an appeals facility³⁴

An appeals facility implies a standing body with a competence to undertake substantive review of awards rendered by arbitral tribunals. It has been proposed as a means to improve consistency among arbitral awards, correct erroneous decisions of first-level tribunals and enhance

³² Some IAs require investors to pursue local remedies in the host State for a certain period of time (e.g., Belgium/Luxembourg- Botswana BIT and Argentina-Republic of Korea BIT). A small number of agreements require the investor to exhaust the host State's administrative remedies before submitting the dispute to arbitration (e.g., China-Côte d'Ivoire BIT).

³³ Termination of IAs is complicated by “survival” clauses that provide for the continued application of treaties, typically for 10 or 15 years after their termination.

³⁴ In 2004, the ICSID Secretariat mooted the idea of an appeals facility but at that time the idea failed to garner sufficient State support. See ICSID, “Possible Improvements of the Framework for ICSID Arbitration”, Discussion paper, 22 October 2004, Part VI and Annex “Possible Features of an ICSID Appeals Facility”. In the eight years that have passed since, the views of many governments may have evolved.

the predictability of the law.³⁵ This option has been contemplated by some countries.³⁶ If constituted of permanent members, appointed by States from a pool of the most reputable jurists, an appeals facility has a potential to become an authoritative body capable of delivering consistent – and balanced – opinions, which would rectify some of the legitimacy concerns about the current ISDS regime.³⁷

Authoritative pronouncements by an appeals facility on issues of law would guide both the disputing parties (when assessing the strength of their respective cases) and arbitrators adjudicating disputes. Even if the process for constituting first-level arbitral tribunals remained unchanged, concerns would be alleviated through their effective supervision at the appellate level. In a word, an appeals facility would add direction and order to the existing decentralized, non-hierarchical and ad hoc regime.

At the same time, absolute consistency and certainty would not be achievable in a legal system that consists of more than 3,000 legal texts; different outcomes may still be warranted by the language of specific applicable treaties. Also, the introduction of an appellate stage would further add to the time and cost of the proceedings, although that could be controlled by putting in place tight timelines, as has been done for the WTO Appellate Body.³⁸

In terms of implementation, for the appeals option to be meaningful, it would need to be supported by a significant number

³⁵ For the relevant discussion see, e.g., C. Tams, “An Appealing Option? A Debate about an ICSID Appellate Structure”, *Essays in Transnational Economic Law*, No.57, 2006.

³⁶ Several IIAs concluded by the United States have addressed the potential establishment of a standing body to hear appeals from investor-State arbitrations. The Chile-US FTA was the first one to establish a “socket” in the agreement into which an appellate mechanism could be inserted should one be established under a separate multilateral agreement (Article 10.19(10)). The Dominican Republic-Central America-US FTA (CAFTA) (2004) went further, and required the establishment of a negotiating group to develop an appellate body or similar mechanism (Annex 10-F). Notwithstanding these provisions, there has been no announcement of any such negotiations and no text regarding the establishment of any appellate body.

³⁷ An alternative solution would be a system of preliminary rulings, whereby tribunals in ongoing proceedings would be enabled or required to refer unclear questions of law to a certain central body. This option, even though it does not grant a right of appeal, may help improve consistency in arbitral decision making. See e.g., C. Schreuer, “Preliminary Rulings in Investment Arbitration”, in K. Sauvart (ed.), *Appeals Mechanism in International Investment Disputes* (OUP, 2008).

³⁸ At the WTO, the appeals procedure is limited to 90 days.

of countries. In addition to an in-principle agreement, a number of important choices would need to be made: Would the facility be limited to the ICSID system or be expanded to other arbitration rules?³⁹ Who would elect its members and how? How would it be financed? Would the appeal be limited to the points of law or also encompass questions of fact? How to ensure the coverage of earlier-concluded IIAs by the new appeals structure?⁴⁰ In sum, this reform option into one that is likely to face significant, although not insurmountable, practical challenges.

5. *Creating a standing international investment court*

This option implies the replacement of the current system of ad hoc arbitral tribunals with a new institutional structure, namely a standing international court. The latter would consist of judges appointed or elected by States on a permanent basis, for example, for a fixed term. It could also have an appeals chamber.

This approach rests on the theory that investment treaty arbitration is analogous to domestic judicial review in public law because “it involves an adjudicative body having the competence to determine, in response to a claim by an individual, the legality of the use of sovereign authority, and to award a remedy for unlawful State conduct.”⁴¹ Under this view, a private model of adjudication (arbitration) is inappropriate for matters that deal with public law. The latter requires objective guarantees of independence and impartiality of judges which can be provided only by a security of tenure – to insulate the judge from outside interests such as an interest in repeat appointments and in maintaining the arbitration industry. Only a court

³⁹ It has been suggested that the application of an appeals facility to ICSID disputes would require an amendment to the ICSID Convention, which in turn, may be hard to achieve.

⁴⁰ Some further questions include: Would it have the power to correct decisions or only a right of remand to the original tribunal? Would the establishment of an appellate review mechanism imply the phase-out of the ICSID annulment mechanism and national-court review?

⁴¹ G. Van Harten, “A Case for International Investment Court”, Inaugural Conference of the Society for International Economic Law, 16 July 2008, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1153424.

with tenured judges, the argument goes, would establish a fair system widely regarded to be free of perceived bias.⁴²

A standing investment court would be an institutional public good serving the interests of investors, States and other stakeholders. The court would address most of the problems outlined above: it would go a long way to ensure the legitimacy and transparency of the system, facilitate consistency and curacy of decisions and ensure independence and impartiality of adjudicators.⁴³

However, this solution would also be the most difficult to implement as it would require a complete overhaul of the current regime through a coordinated action by a large number of States. Yet, the consensus would not need to be universal. A standing investment court may well start as a plurilateral initiative, with an opt-in mechanism for those States that will wish to join.

Finally, it is questionable whether a new court would be fit for a fragmented regime that consists of a huge number of mostly bilateral IIAs. It has been argued that this option would work best in a system with a unified body of applicable law.⁴⁴ Nonetheless, even if the current diversity of IIAs is preserved, a standing investment court would likely be much more consistent and coherent in its approach to the interpretation and application of treaty norms, compared with numerous ad hoc tribunals.

III. Concluding remarks

Given the numerous challenges arising from the current ISDS regime, it is timely for States to assess the current system, weigh options for reform, and then decide upon the most appropriate route.

Among the five options outlined here, some imply individual actions by governments and others require joint action by a significant number of countries. Most of the options would benefit from being

⁴² Ibid.

⁴³ A system where judges are assigned to the case, as opposed to being appointed by the disputing parties, would also save significant resources currently spent on researching arbitrator profiles.

⁴⁴ Similarly to the European Court of Human Rights that adjudicates claims brought under the European Convention for the Protection of Human Rights and Fundamental Freedoms.

accompanied by comprehensive training and capacity-building to enhance awareness and understanding of ISDS related- issues.⁴⁵

While the collective action options would go further in addressing the problems posed by today's ISDS regime, they would face more difficulties in implementation and require agreement between a larger number of States. Collective efforts at the multilateral level can help develop a consensus about the preferred course for reform and ways to put it into action.

An important point to bear in mind is that ISDS is a system of application of the law. Therefore, improvements to the ISDS system should go hand in hand with progressive development of substantive international investment law itself. UNCTAD's Investment Policy Framework for Sustainable Development (IPFSD) offers policy options in this regard.

⁴⁵ Such capacity building activities are, being carried out by UNCTAD, among others, (together with different partner organizations). Latin American countries, for example, have benefitted from UNCTAD's advanced regional training courses on ISDS on an annual basis since 2005: see [http://unctad.org/en/Pages/DIAE/International%20Investment%20Agreements%20\(IIA\)/IIA-Technical-Cooperation.aspx](http://unctad.org/en/Pages/DIAE/International%20Investment%20Agreements%20(IIA)/IIA-Technical-Cooperation.aspx).

International investment policymaking in transition: challenges and opportunities of treaty renewal

UNCTAD Secretariat

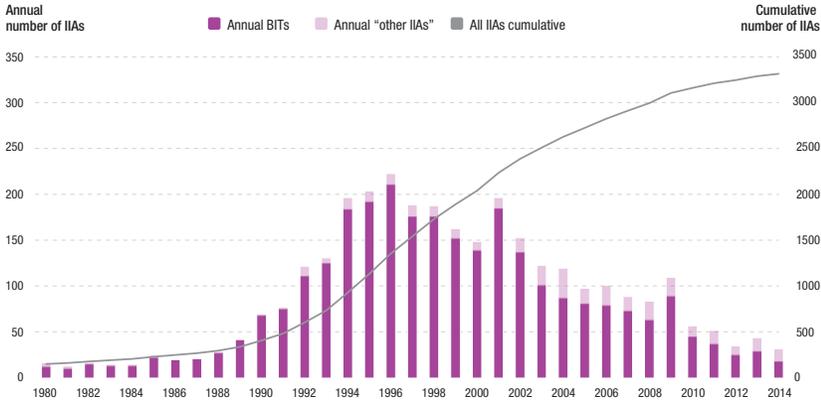
Today, the international investment regime consists of more than 3,200 agreements, which includes over 2,926 bilateral investment treaties (BITs). The international investment regime poses a series of systemic, capacity and development challenges. Countries are taking actions to address these challenges, including through clarifying the meaning of treaty provisions (e.g. through authoritative interpretations), revising treaties (e.g. through amendments), replacing older treaties (e.g. through renegotiation), or terminating/consolidating treaties (either unilaterally or by mutual consent). According to an UNCTAD analysis, by the end of 2013, more than 1,300 bilateral treaties were at the stage where they could be terminated or renegotiated at any time. Furthermore, between 2014 and 2018, at least 350 bilateral treaties will reach the end of their initial duration. Treaty expiration creates a window of opportunity to address inconsistencies and overlaps in the multi-faceted and multi-layered regime of international investment treaties, and to update the investment regime in light of development paradigm shifts.

Today, the international investment regime consists of more than 3,200 agreements, which includes over 2,926 bilateral investment treaties (BITs) and over 340 “other international investment agreements” (e.g. free trade agreements (FTAs), economic partnership agreements (EPAs) or framework agreements with an investment dimension) (Figure 1).

The international investment regime poses a series of systemic capacity and development challenges. Systemic challenges arise from the gaps, overlaps and inconsistencies resulting from the multi-faceted and multi-layered regime of international investment treaties and deficiencies in investor-State dispute settlement (ISDS). Capacity challenges manifest themselves as countries and firms find

it increasingly difficult to navigate through a highly fragmented treaty regime. Development challenges include how to preserve appropriate regulatory space for host countries, and how to balance the rights and obligations of States and investors.

Figure 1. Trends in IIAs, 1980–2014



Countries are taking actions to address these challenges, including through clarifying the meaning of treaty provisions (e.g. through authoritative interpretations), revising treaties (e.g. through amendments), replacing older treaties (e.g. through renegotiation), or terminating/consolidating treaties (either unilaterally or by mutual consent). Depending on the depth of change they wish to achieve, countries choose between different avenues for improving the international investment regime.

The expiration of treaties provides opportunities for several of the above options. According to an UNCTAD analysis, by the end of 2013, more than 1,300 bilateral treaties were at the stage where they could be terminated or renegotiated at any time. Furthermore, between 2014 and 2018, at least 350 bilateral treaties will reach the end of their initial duration.

Treaty expiration creates a window of opportunity to address inconsistencies and overlaps in the multi-faceted and multi-layered regime of international investment treaties, and to update the investment regime in light of development paradigm shifts. In taking

such actions, countries need to weigh the pros and cons in the context of their investment climate and their overall development strategies.

1. *Options to improve the IIA regime*

Many countries have accumulated a stock of older bilateral treaties that were concluded in the 1990s, before the rise of investor-State dispute cases prompted a more cautious approach. The risks exposed by this growing number of disputes, together with countries' desire to harness the sustainable development contribution of foreign investment, has led to the emergence of "new generation" agreements (*World Investment Report 2012, WIR12*). The desire to move towards a more sustainable regime has precipitated a debate about possible ways to reform the IIA regime.

Countries have several avenues for taking pre-emptive or corrective action, depending on the depth of change they wish to achieve:

Interpretation. As drafters and masters of their treaties, States retain interpretive authority over them. While it is the task of arbitral tribunals to rule on investors' claims and interpret and apply international investment agreements to this end, the contracting States retain the power to *clarify* the meaning of treaty provisions through authoritative interpretations – stopping short, however, of attaching a new or *different* meaning to treaty provisions that would amount to their amendment.¹ The interpretative statement issued by the NAFTA Free Trade Commission (clarifying, among other things, the "minimum standard of treatment") is an example of this approach.²

Revision. Revision can be pursued through amendments that are used to modify or suppress existing provisions in a treaty or to add new ones. Amendments are employed when the envisaged changes do not affect the overall design and philosophy of the treaty and, usually, are limited in number and length. Amendments require the consent of all contracting parties, often take the form of a protocol to the

¹ On various interpretative tools that can be used by States, see UNCTAD, "Interpretation of IIAs: What States Can Do", IIA Issues Note, No.3, December 2011.

² "Notes of Interpretation of Certain NAFTA Chapter 11 Provisions", NAFTA Free Trade Commission, 31 July 2001. Available at http://www.sice.oas.org/tpd/nafta/Commission/CH11understanding_e.asp.

treaty and typically require domestic ratification. An example is the amendment of 21 bilateral investment treaties by the Czech Republic, following its accession to the EU in May 2004, which was aimed at ensuring consistency between those treaties and EU law with regard to exceptions to the free transfer-of-payments provision.

Replacement/consolidation. Replacement can be done in two ways. First, a treaty might be replaced by a new one as a result of a renegotiation (i.e. conclusion of a new treaty between the same two parties).³ Second, one or several bilateral treaties can be replaced through the conclusion of a new plurilateral/regional agreement. The latter case leads to the consolidation of the IIA network if one new treaty replaces several old ones, entailing a reduction in the overall number of existing treaties. One of the few examples of this second approach is the Central America–Mexico FTA, which provides for the replacement of a number of FTAs: i.e. the FTAs between Mexico and Costa Rica (1994); Mexico and El Salvador, Guatemala and Honduras (2000); and Mexico and Nicaragua (1997) (see IIA Issues Note No. 3, June 2013).

Termination. A treaty can be terminated unilaterally or by mutual consent. The Vienna Convention allows parties to terminate their agreements by mutual consent at any time.⁴ Rules for unilateral treaty termination are typically set out in the BIT itself.⁵ Treaty termination may result from a renegotiation (replacing the old BIT with a new one). It can also be done with the intent to relieve respective States of their treaty commitments (eliminating the treaty). Furthermore, a notice of termination can be an attempt to bring the other contracting party back to the negotiation table. Countries that have terminated their bilateral investment treaties include the Bolivarian Republic of Venezuela (denouncing its BIT with the Netherlands in 2008), Ecuador (denouncing nine of its bilateral investment treaties in 2008),⁶ the

³ As opposed to amendments, renegotiations are used when the parties wish to make extensive modifications to the treaty.

⁴ Article 54(b) of the Vienna Convention on the Law of Treaties.

⁵ If not, and if needed, in addition to the rules set out in the treaty, the rules of the Vienna Convention on the Law of Treaties apply.

⁶ These were BITs with Cuba, the Dominican Republic, El Salvador, Guatemala, Honduras, Nicaragua, Paraguay, Romania and Uruguay. Subsequently, on 9 March 2013, Ecuador announced its intent to terminate all remaining IIAs and that the legislative assembly would work on the requisite measures to that effect from 15 May 2013

Plurinational State of Bolivia (denouncing its bilateral investment treaty with the United States in 2011) and South Africa (denouncing one BIT in 2012). Countries wishing to unilaterally terminate their international investment agreements – for whatever reason – need to have a clear understanding of the relevant treaty provisions (Box 1), as well as the implications of such actions.

Depending on their IIA strategy (see section E.1. of the Investment Policy Framework for Sustainable Development (IPFSD)) and the degree of change they wish to achieve, countries may wish to carefully consider the options that are appropriate to reach their particular policy goals and accordingly adapt tools to implement them. To the extent that contracting parties embark on changes by mutual consent, the range of options is vast and straightforward. The situation becomes more complex, however, if only one party to an IIA wishes to amend, renegotiate or terminate the treaty.

2. *Treaty expirations*

The conclusion of bilateral investment treaties peaked in the 1990s. Fifteen years later, the inclination to enter into such treaties has decreased. This has brought the international investment regime to a juncture that provides a window of opportunity to undertake systemic improvement.⁷ As agreements reach their expiry date, a treaty partner can opt for automatic prolongation of the treaty or notify its wish to revoke a treaty.⁸ The latter option gives treaty partners an opportunity to revisit their agreements, with a view to addressing inconsistencies and overlaps in the multi-faceted and multi-layered investment treaty regime. Moreover, it presents an opportunity to strengthen the regime's development dimension.

onward. See Declaration by the President of Ecuador Rafael Correa, ENLACE Nro 312 desde Piquiucho - Carchi, published 10 March 2013. Available at <http://www.youtube.com/watch?v=CkC5i4gW15E> (at 2:37:00).

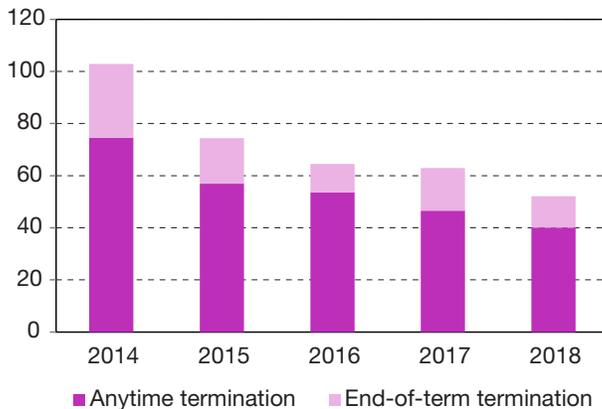
⁷ This section is limited to BITs and does not apply to "other IIAs" as the latter raise a different set of issues. Importantly, an investment chapter in a broad economic agreement such as an FTA cannot be terminated separately, without terminating the whole treaty.

⁸ In accordance with general international law, a treaty may also be terminated by consent of the contracting parties at any time, regardless of whether the treaty has reached the end of its initial fixed term (Article 54(b) of the Vienna Convention on the Law of Treaties).

For example, in September 2012, South Africa informed the Belgo–Luxembourg Economic Union, through a notice of termination, that it would not renew the existing bilateral investment treaty, which was set to expire in March 2013. South Africa further stated its intent to revoke its treaties with other European partners, as most of these treaties were reaching their time-bound window for termination which, if not used, would trigger the automatic extension of these agreements for 10 years or more.⁹

The significant number of expired or soon-to-expired bilateral investment treaties creates distinct opportunities for updating and improving the international investment regime. Between 2014 and 2018, at least 350 bilateral treaties reach the end of their initial duration. In 2014 alone, the initial fixed term of 103 bilateral treaties will expire (figure 2). After reaching the end of the initial fixed term, most BITs can be unilaterally terminated at any time by giving notice (“anytime termination”); the minority of BITs – if not terminated at the end of the initial term – are extended for subsequent fixed terms and can be unilaterally terminated only at the end of each subsequent term (“end-of-term termination”).

Figure 2. BITs reaching the end of their initial term, 2014–2018



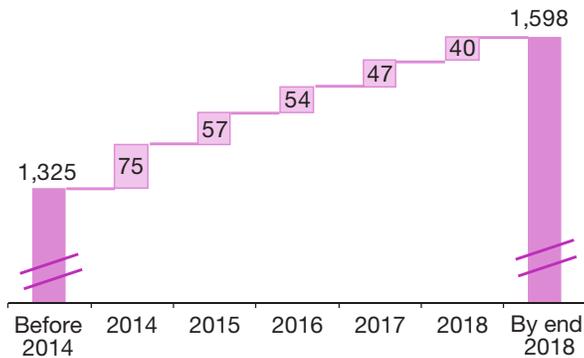
Source: UNCTAD.

Methodology: Data for BITs in force; derived from an examination of BITs for which texts were available, extrapolated to BITs for which texts were unavailable. Extrapolation parameters were obtained on the basis of a representative sample of more than 300 BITs.

⁹ Publication by a spokesman of South Africa’s Department of Trade and Industry. Available at <http://www.bdlive.co.za/opinion/letters/2012/10/01/letter-critical-issues-ignored>.

The great majority of bilateral investment treaties set the initial treaty term at 10 years or 15 years, and about 80 per cent of all bilateral investment treaties provide for the “anytime termination” approach after the end of the initial term. Given that a large proportion of the existing bilateral treaties were signed in the 1990s and that most of them have reached the end of their initial period, the overall number of bilateral investment treaties that can be terminated by a party at any time is estimated to have exceeded 1,300 by the end of 2013. This number will continue to grow as bilateral investment treaties with the “anytime termination” option reach their expiry dates (Figures 2 and 3).

Figure 3. Cumulative number of BITs that can be terminated or renegotiated at any time



Source: UNCTAD.

Methodology: Data for BITs in force; derived from an examination of BITs for which texts were available, extrapolated to BITs for which texts were unavailable. Extrapolation parameters were obtained on the basis of a representative sample of more than 300 BITs.

Using treaty expirations to instigate change in the international investment regime is not a straightforward endeavour. First, there is a need to understand how treaty termination work, so as to identify when opportunities arise and what procedural steps are required.

A second challenge originates from the “survival clause”, contained in most treaties, which prevents unilateral termination of the treaty with immediate effect. It prolongs the exposure of the host State to international responsibility by extending the treaty’s application for a further period, typically 10 or 15 years.¹⁰

¹⁰ It is an open question whether the survival clause becomes operative only in cases of unilateral treaty termination or also applies in situations where the treaty

The “anytime termination” model provides the most flexibility for review as the parties are not tied to a particular date by which they must notify the other party of their wish to terminate the BIT. The “end-of-period” model, in contrast, provides opportunities to terminate the treaty only once every few years. Failure to notify the intention to terminate within a specified notification period (usually either 6 or 12 months prior to the expiry date) will lock the parties into another multi-year period during which the treaty cannot be unilaterally terminated.

Third, renegotiation efforts aimed at reducing or rebalancing treaty obligations can be rendered futile by the most favoured nation treatment (MFN) obligation. If the scope of the MFN clause in the new treaty is not limited, it can result in the unanticipated incorporation of stronger investor rights from international investment agreements with third countries into an IIA. Hence, in case of amendments and/ or renegotiations that reduce investors’s rights, negotiators may wish to formulate MFN provisions that preclude the importation of substantive provisions from other agreements.¹¹

In addition, countries need to analyse the pros and cons of treaty termination and its implication for the overall investment climate (and foreign investors’ perception of it), their own investors abroad, and their overall development strategies.

* * *

is terminated by mutual consent by the contracting parties. This may depend on the wording of the specific clause and other interpretative factors.

¹¹ This will not automatically solve the issue of those older treaties that were not renegotiated; but it will gradually form a new basis on which negotiators can build a more balanced network.

Towards a new generation of international investment policies: UNCTAD's fresh approach to multilateral investment policy-making

UNCTAD Secretariat

In response to changing economic realities and multiple crises, investment policy-making is experiencing a paradigm shift. As a result, inclusive growth and sustainable development have emerged as key policy objectives.

At the international level, policy-making faces multiple challenges. The most pertinent of these are how to strengthen the sustainability dimension of international investment agreements (IIAs); how to preserve appropriate regulatory space for host countries; how to deal with the complexity of a fragmented treaty regime characterised by overlaps and incoherence; and how to address serious deficiencies in investor-State dispute settlement (ISDS).

UNCTAD, and its recently launched Investment Policy Framework for Sustainable Development (IPFSD) offer a two pronged approach for addressing these challenges.

- First, IPFSD offers expert guidance for the future formulation of investment policies. Through its eleven core principles, its guidelines on national policy making and its options for IIA clauses, IPFSD provides direction for every level of investment policy-making.
- Second, UNCTAD complements this expert-led guidance with a universal, inclusive and transparent policy dialogue. Given its multi-stakeholder nature, UNCTAD offers a forum for a diverse set of actors ranging from civil society, business and academia to working- and high-level representatives and policy-makers from countries at all levels of development.

The two prongs are not only mutually re-enforcing each other, but also complemented by UNCTAD's world-wide recognition of being the United Nations' focal point for issues related to investment and sustainable development.

Recent changes in the global political and economic environment, including a series of crises in finance, food security and the environment, are leading to a new generation of foreign investment policies that place inclusive growth and sustainable development at the heart of efforts to attract and benefit from investment.

On the international plane, made up of over 3,200 international investment agreements (IIAs), the pressing policy challenges include:

- strengthening the development dimension of the investment policy regime;
- ensuring sufficient policy space for host countries by balancing public and private interests;
- addressing serious deficiencies of the current system of investor-State dispute settlement (ISDS); and
- resolving issues stemming from the increasing complexity of the international investment policy regime.

These challenges would be best solved through coordinated efforts. UNCTAD's experience in this area, most recently embodied in its *Investment Policy Framework for Sustainable Development*, can serve as a foundation for future consensus-building on international investment policies.

This note (A) provides an overview of the relevant changes in the economic and policy environment; (B) discusses the key trends and pressing challenges in international investment policy making; and (C) puts forward the idea of multilateral consensus-building as a way to deal with existing challenges and sets out some considerations with regard to this process.

A. The evolving context for IIAs

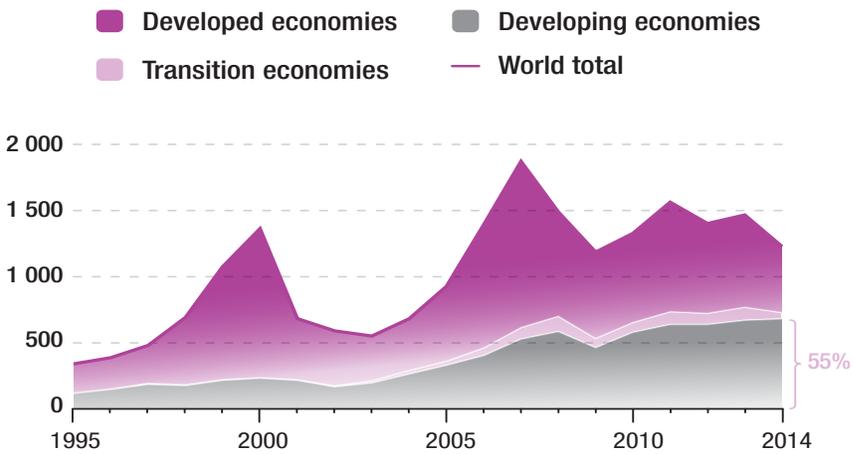
1. Changing investment landscape

The investment and investor landscape has undergone fundamental changes in recent years (figure 1). Since 2010, developing and transition economies have absorbed more than half of global FDI inflows.

Developing economies have not only become important recipients of FDI, they are increasingly large investors themselves, with their share

in world outflows reaching a record of 35 per cent (*WIR 2015*). While these countries might previously have been more concerned with the pressure they faced to provide protection for investments made by others, they now also have to consider the security and treatment of their own investors' interests abroad.

Figure 1. FDI inflows, global and by group of economies, 1995-2014
(Billions of US dollars)



Source: UNCTAD.

Today, transnational corporations (TNCs) and their international production networks play a significant role, with foreign affiliates' economic activity having increased in 2014 across all major indicators of international production (sales, value added, assets, exports and employment) (table 1). In that year, foreign affiliates employed an estimated 75 million people, who generated US\$ 36 trillion in sales and US\$ 7.9 trillion in value added.

2. Policy development

A series of crises in finance, energy, food security and the environment have revealed persistent global imbalances and social challenges, especially with regard to poverty alleviation. These crises and challenges are having profound effects on the way policy is shaped at the global level. First, current crises have accentuated a longer-

term shift in economic weight from developed countries to emerging markets. Second, the financial crisis in particular has strengthened the role of governments in the economy, in both the developed and the developing world. Third, the nature of the challenges, which no country can address in isolation, makes international coordination imperative. And fourth, the global political and economic context and the challenges that need to be addressed – with social and environmental concerns taking centre stage – are leading policymakers to reflect on an emerging new development paradigm that places inclusive and sustainable development goals on the same footing as economic growth.

Table 1. Selected indicators of FDI and international production, 1990, 2014

| Item | Value at current prices (Billions of dollars) | |
|---|--|---------|
| | 1990 | 2014 |
| FDI inward stock | 2 198 | 26 039 |
| Income on inward FDI | 82 | 1 575 |
| <i>Rate of return on inward FDI (per cent)</i> | 4.4 | 6.4 |
| Income on outward FDI | 128 | 1 486 |
| <i>Rate of return on outward FDI (per cent)</i> | 5.9 | 5.9 |
| Sales of foreign affiliates | 4 723 | 36 356 |
| Value-added (product) of foreign affiliates | 881 | 7 882 |
| Total assets of foreign affiliates | 3 893 | 102 040 |
| Exports of foreign affiliates | 1 444 | 7 803 |
| Employment by foreign affiliates (thousands) | 20 625 | 75 075 |

Source: UNCTAD.

One important policy trend is that governments have become more active in economic policies. More and more governments are moving away from a “hands-off” approach to economic growth and development that had prevailed previously.

Industrial policies and industrial development strategies are proliferating in developing and developed countries alike. This trend reflects, in part, a renewed realism about the economic and social costs of unregulated market forces. A stronger role of the State also manifests itself with regard to other sustainability issues. New social and environmental regulations are being introduced or existing rules

reinforced; governments are increasing efforts to promote actively the move towards sustainable development, for example through the encouragement of low- carbon FDI (*WIR 2010*, *WIR 2011*, *WIR 2012*, *WIR 2013*).

As a result, a “new generation” of investment policies is emerging, pursuing a broader and more intricate development policy agenda. Broadly, “new generation” investment policies are characterized by (i) a recognition of the role of investment as a primary driver of economic growth and development, and the consequent realization that investment policies are a central part of development strategies; and (ii) a desire to pursue sustainable development through responsible investment, placing social and environmental goals on the same footing as economic growth and development objectives (*WIR 2012*).

B. International investment policy making: current trends and challenges

1. Key trends in IIA rulemaking

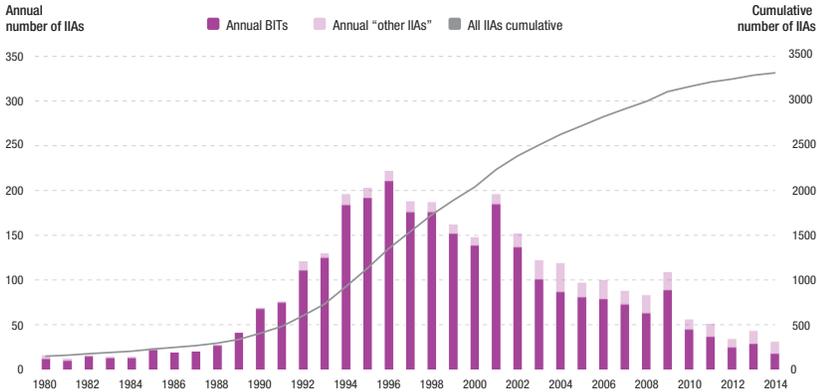
By the end of 2014, the overall number of IIAs reached 3,271 agreements, including close to 2,926 BITs and some 345 “other IIAs”¹ (figure 2). Almost every country is party to one or more IIAs. This treaty network offers protection to approximately two-thirds² of global FDI stock and covers one-fifth of possible bilateral investment relationships (*WIR 2011*).

In today’s spaghetti bowl of IIAs, bilateral agreements constitute the overwhelming majority. However, in terms of economic significance, there has been a gradual shift towards regionalism. This is particularly the case with respect to current negotiations, where most prominent developments are the ongoing negotiation of the Trans-Pacific Partnership Agreement (TPP) (the combined economic weight of the participating States amounts to 35 percent of the global GDP), and the European Union’s new investment treaty-making powers (any agreement concluded by the EU as a bloc will bring together at least 27+1 countries). Other regional groupings, such as ASEAN or Central

¹ “Other IIAs” include agreements such as free trade agreements (FTAs) or economic partnership agreements, and usually fall in one of three categories: (i) IIAs including obligations commonly found in BITs; (ii) agreements with limited investment-related provisions; and (iii) IIAs focusing on investment cooperation and/or providing for a negotiating mandate on investment (*WIR 2011*, *WIR 2012*).

America, have also emerged as regional investment actors. In most cases, regional treaties are at the same time FTAs and address trade and investment in a comprehensive manner (*WIR 2012*).

Figure 2. Trends in IIAs signed, 1980–2014



Source: UNCTAD. Data for 2012 are preliminary.

The shift to regionalism can bring about the consolidation and harmonization of investment rules and represent a step towards multilateralism. However, where new regional treaties do not entail the phase-out of old bilateral ones, the result can be the opposite: instead of simplification and growing consistency, regionalization may lead to a multiplication of treaty layers, making the IIA network even more complex and prone to overlaps and inconsistencies. Nevertheless, current regional IIA negotiations present a window of opportunity to consolidate the existing network of BITs. Nine selected regional negotiations currently under way may potentially overlap with close to 270 BITs, which constitute nearly 10 per cent of the global BIT network (*WIR 2013*).

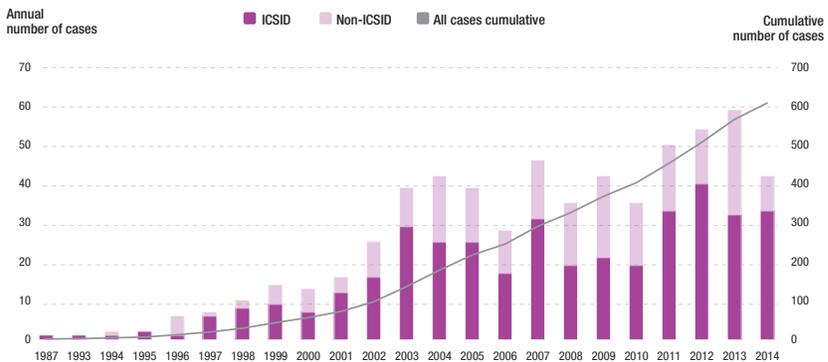
Sustainability considerations have been gaining prominence in the negotiation of IIAs. Although many of the recently concluded IIAs follow the traditional BIT model that focuses solely on investment protection, others include innovations. Several of the new features are meant to ensure that the treaty does not interfere with, but instead contributes to, countries' sustainable development strategies that focus on inclusive economic growth, supports policies for industrial

development, and addresses the environmental and social impacts of investment (*WIR 2012, WIR 2013*).

Another notable trend has been the ongoing reassessment by numerous countries of their IIAs. Governments have approached this in a different manner, including (i) revising their model BITs, (ii) renegotiating “old” BITs to replace them with “modern” ones, (iii) putting on hold the conclusion of any new agreements, and (iv) sometimes terminating existing BITs and denouncing the ICSID Convention (*WIR 2010*). At the same time, the IIA regime is reaching a juncture as 1,300 BITs will be at the stage where they could be terminated or renegotiated at any time hence offering an opportunity for treaty partners to revisit their agreements, with a view to addressing inconsistencies and overlaps in the multi-faceted and multi-layered IIA regime and to strengthen its development dimension (*WIR 2013*).

These actions have been taken largely in response to an increasing number of international investor-State claims that often touch upon sensitive public policy issues, may lead to unexpected interpretation of IIA provisions and/or entail a heavy financial toll on State budgets. There has been a steady growth of investment arbitration cases against host countries: by the end of 2014, the total number of known treaty-based disputes reached 608 (figure 3) and the total number of countries that have responded to one or more investment treaty claim increased to 95.

Figure 3. Known ISDS cases, annual and cumulative, 1987-2014



Source: UNCTAD.

2. Key challenges for international investment policy making

The above-mentioned policy developments have brought to light a number of demanding challenges.

First, policymakers in some countries, especially those seeking to implement industrial development strategies or adjust regulatory frameworks, have found that IIAs can unduly constrain domestic policy space. Many policymakers have observed that IIAs are focused almost exclusively on protecting investors and do not do enough to promote investment for development. While IIAs – implicitly or explicitly

– recognize the sovereign right of host countries to regulate foreign investment in their territory, questions about the “right” balance between private and public interests in IIAs, and how to achieve it in technical terms, remain an important subject for discussion. Similarly, while IIAs – by ensuring stability of the legal regime

– can play a role in stemming protectionist tendencies, it is also important that IIAs grant sufficient regulatory flexibility to respond to changing circumstances.

The second challenge involves adjusting the balance between the rights and obligations of States and investors. This means that in addition to the IIAs’ goal of protecting foreign investments, more attention should be given to the corresponding responsibilities of investors. Further to investors’ obligation to respect the laws of the host country, IIAs should give more prominence to the issue of corporate social responsibility.

The third challenge is to resolve issues stemming from the increasing complexity of the international investment regime. The current regime consists of thousands of treaties (mostly BITs, FTAs with investment provisions, and regional agreements). This construct has a number of systemic deficiencies, including gaps, overlaps and inconsistencies in coverage and content. Also, the “interconnect” between international investment policies and other policy areas such as trade, finance, competition or environmental (e.g. climate change) policies, is absent.

The fourth challenge stems from the shortcomings of the ISDS system. Concerns include (i) an expansive use of IIAs by investors that reaches beyond what was originally intended; (ii) contradictory interpretations of key IIA provisions by ad hoc tribunals, leading to uncertainty about their meaning; (iii) the inadequacy of ICSID's annulment or national judicial review mechanisms to correct substantive mistakes of arbitration tribunals; (iv) the emergence of a "club" of individuals who serve as counsel in some cases and arbitrators in others, often obtaining repeated appointments; (v) the practice of nominating arbitrators who are likely to support the position of the party appointing him/her; (vi) the secrecy of many proceedings; (vii) the high costs and considerable length of arbitration proceedings; and (viii) overall concerns about the legitimacy and equity of the arbitration system. These challenges have prompted a debate about the challenges and opportunities of ISDS. This discourse has been developing through relevant literature, academic/ practitioner conferences and the advocacy work of civil society organizations. It has also been carried forward under the auspices of UNCTAD's Investment Commission and Expert Meetings, its multi-stakeholder World Investment Forum (*WIF*) and a series of informal conversations it has organized, as well as the OECD's Freedom-of-Investment Roundtables (*WIR 2012*, *WIR 2013*).

As its most recent contribution to this debate, UNCTAD has identified five broad path for reform:

1. Promoting alternative dispute resolution
2. Tailoring the existing system through individual IIAs
3. Limiting investors' access to ISDS
4. Introducing an appeals facility
5. Creating a standing investment tribunal

IIA stakeholders are prompted to assess the current system, with the available options and embark on concrete steps for reform. Collective efforts at the multilateral level can help develop a consensus about the preferred course of reform and ways to put it into action (*WIR 2013*).

C. UNCTAD's approach to multilateral investment policy-making

There is currently no appetite for negotiating a binding multilateral framework for investment. But there is a compelling need for a multilateral mechanism that deals with today's investment policy-making challenges at different levels.

In fact, UNCTAD has long been providing such a mechanism, as it has been – widely and firmly – recognized as the focal point of the United Nations system for dealing with IIA-related issues. Over the past years, UNCTAD has taken a two pronged approach, providing comprehensive expert-led guidance for investment policy-making and establishing a multilateral, multi-stakeholder forum for an inclusive dialogue for investment and sustainable development issues.

The approach advocated by UNCTAD has its origins in the 2008 “Accra Accord” which encouraged work in the form of interactive expert meetings with practical and actionable outcomes “*such as inventories of best practices, checklists, indicative guidelines, sets of criteria or principles, and model frameworks*”.²

In this spirit, UNCTAD's Division on Investment and Enterprise launched in 2012 its *Investment Policy Framework for Sustainable Development (IPFSD)*. The Framework is a comprehensive embodiment of UNCTAD's experience in the area of investment policy-making developed in line with the objectives of inclusive growth and sustainable development and through a process that involved top experts and a wide range of stakeholders. It is designed to serve as a key point of reference for investment policymakers and to become the basis for UNCTAD's capacity-building and technical cooperation in this area.

It is complemented by other aspects of UNCTAD's work relevant to multilateral consensus building, e.g. the Entrepreneurship Policy Framework, the Principles for Responsible Agricultural Investment (PRAI), contributions to various G20 work streams (such as those on long-term investment, corporate social responsibility, “green growth”, global value chains, private investment and job creation, and investment

² UNCTAD, Accra Accord, 25 April 2008, para. 207.

policy monitoring), and the Division's inputs to various summits (such as G8, G20, ASEAN and APEC).

Currently, the IPFSD is at the stage of wide dissemination and pilot use. The next stage will involve its review in light of the feedback received and lessons learnt. The Framework was designed as a "living document" that can be discussed and updated continuously.

The remainder of this section discusses how the IPFSD-based process can, on the one hand, serve as a model, and on the other hand, feed into multilateral consensus-building on investment. To this end, it addresses the following aspects of the potential multilateral consensus-building, as inspired by the IPFSD: objectives, substance, process and end-use.

1. *Objectives*

In light of the challenges identified in section B above, the objectives of multilateral consensus-building include:

- strengthening the sustainable-development dimension of the international investment policy regime;
- preserving sufficient regulatory space for host countries through a better balancing of public and private interests;
- addressing serious deficiencies of the current system of ISDS; and
- resolving issues stemming from the increasing complexity of the international investment policy regime.

In addition, there is a need to increase synergy between investment policies and other policies at both national and international levels.

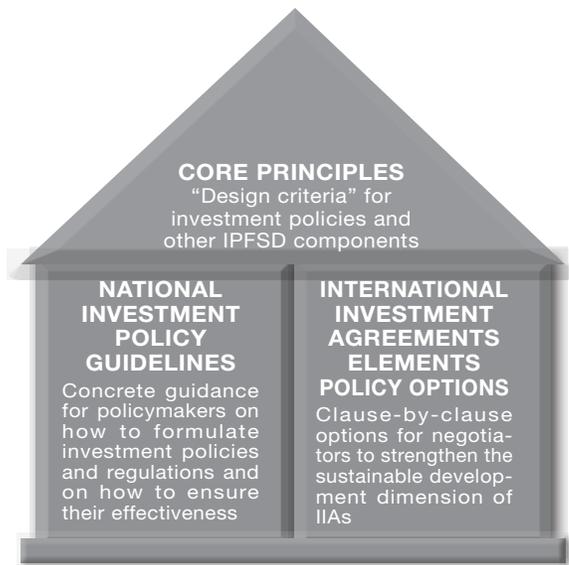
Multilateral consensus-building can bring important benefits. It can help identify areas of broad agreement and disagreement. This in itself can facilitate discussions directed at resolving potential disagreements. At a minimum, clarification of the extent of consensus in the IIA universe serves the interest of transparency and predictability. By improving – where possible – coherence between agreements, consensus-building can also further the clarity, stability and transparency of the IIA system. This work can gradually establish a development-friendly foundation for a possible future multilaterally binding investment regime.

2. Substance

The IPFSD is designed as a holistic, comprehensive and synergistic policy tool. It is holistic as it views investment not in isolation but as part of a broader agenda and countries' overall development strategies. It is comprehensive as it addresses all aspects of investment policies and does so with respect to both national and international policy-making. It is synergistic as it recognizes and embraces interactions with related policy areas ranging from taxation to trade to environmental and labour market policies. Throughout the IPFSD, inclusive growth and sustainable development serve as its main guiding principles.

The IPFSD consists of three parts (figure 4): (i) core principles, which are the basis for subsequent specific (ii) guidelines for national investment policies, and (iii) policy options for IIAs.

Figure 4. IPFSD's structure and components



IPFSD's Core principles. The eleven Core Principles aim to guide the development of investment policies, both national and international (table 2). They are a set of “design criteria” for investment policies that aim to mainstream sustainable development in investment policymaking, while confirming the basic principles of sound development-oriented

investment policies, in a balanced approach. The principles should be read as a package, because interaction between them is fundamental.

The IPFSD's national investment policy guidelines argue for policy action at different levels: at the strategic level, the guidelines suggest that policymakers should ground investment policy in a broad road map for economic growth and sustainable development; at the normative level, they propose that through the setting of rules and regulations on investment and in a range of other policy areas - such as trade, taxation, labour and environmental regulations, and intellectual property policies - policymakers should promote sustainable development, and at the administrative level, they call for reviewing and monitoring the effectiveness of investment policies.

IPFSD's guidance on IIAs. The objective of the IPFSD's IIA part is to assist policymakers in search for an optimal investment treaty design. It addresses all principal IIA elements including treaty scope, substantive obligations, dispute settlement and others. With respect to each element and sub-element, it sets out a menu of options, from which negotiators can pick and choose, adopt and adapt as per their needs. The accompanying commentaries discuss policy options in light of the Core Principles and are meant to help IIA negotiators identify those drafting options that best suit their countries' needs, preferences and objectives.

Taking from there, multilateral consensus-building can lead to a number of possible outcomes including, amongst others, a checklist for IIA negotiators, a collection of best practices, guidance notes for interpreting IIA provisions, a set of multilaterally agreed principles, model provisions or a model agreement.

3. *Process*

The process of developing the IPFSD, based on the engagement of top experts and stakeholders, allowed for content-focused and issue-specific exchanges of views. Such a process appears to be more appropriate for the area of investment which (i) does not readily lend itself to a "give and take"-like bargaining process and (ii) is not ripe for conventional intergovernmental negotiations.

The dynamic nature of investment policymaking and the continuous need to respond to newly emerging challenges makes it mandatory to review and, where necessary, modify the guidelines from time to time. Hence, the IPFSD was designed as a “living” document that will allow for updates and improvements. UNCTAD has established a platform for further consultation and discussion with all investment stakeholders. Using UNCTAD’s Investment-policy-hub, experts and all relevant stakeholders can analyze the implications of particular policy options, voice concerns and exchange views.

This approach to developing the IPFSD will also guide the further evolution of the IPFSD as an expert-driven, rather than a negotiator-driven, consensus- building process that uses UNCTAD’s intergovernmental machinery in all its facets (ranging from expert meetings, to the Investment, Enterprise and Development Commission, the Trade and Development Board and the quadrennial Conferences) and that involves multi-disciplinary expertise (legal, economic, business), and multi- stakeholder engagement (from public and private sector, and from developed, developing and transition economies).

This will also guarantee the inclusiveness and universality of the process, with participation open to all investment-development stakeholders at all levels – from Heads of States to grassroots civil society organizations, from CEOs of global companies to executives of small and medium-sized enterprises in developing countries; and with multi-stakeholder engagement at multiple levels of platforms for consensus building, including the World Investment Forum, events with regional organizations, national workshops, etc. Together, this and the open-source nature of the web-based policy hub for feedback, debates and best practices exchanges will ensure the “living” character of this instrument for regular update and reality check.

4. *End-use*

The IPFSD is meant to provide guidance for policy making in the investment field. It offers a “policy at a glance” for politicians (the Core Principles), a handbook for national policy makers (the national investment policy guidelines), and a “checklist of options” for treaty negotiators (the policy options for IIAs). The Framework also serves as a tool for technical cooperation and capacity-building in the area of

Table 2. Core Principles for investment policymaking

| Area | Core Principles |
|--|--|
| 1. Investment for sustainable development | <ul style="list-style-type: none"> The overarching objective of investment policymaking is to promote investment for inclusive growth and sustainable development. |
| 2. Policy coherence | <ul style="list-style-type: none"> Investment policies should be grounded in a country's overall development strategy. All policies that impact on investment should be coherent and synergetic at both the national and international levels. |
| 3. Public governance and institutions | <ul style="list-style-type: none"> Investment policies should be developed involving all stakeholders, and embedded in an institutional framework based on the rule of law that adheres to high standards of public governance and ensures predictable, efficient and transparent procedures for investors. |
| 4. Dynamic policymaking | <ul style="list-style-type: none"> Investment policies should be regularly reviewed for effectiveness and relevance and adapted to changing development dynamics. |
| 5. Balanced rights and obligations | <ul style="list-style-type: none"> Investment policies should be balanced in setting out rights and obligations of States and investors in the interest of development for all. |
| 6. Right to regulate | <ul style="list-style-type: none"> Each country has the sovereign right to establish entry and operational conditions for foreign investment, subject to international commitments, in the interest of the public good and to minimize potential negative effects. |
| 7. Openness to investment | <ul style="list-style-type: none"> In line with each country's development strategy, investment policy should establish open, stable and predictable entry conditions for investment. |
| 8. Investment protection and treatment | <ul style="list-style-type: none"> Investment policies should provide adequate protection to established investors. The treatment of established investors should be non-discriminatory. |
| 9. Investment promotion and facilitation | <ul style="list-style-type: none"> Policies for investment promotion and facilitation should be aligned with sustainable development goals and designed to minimize the risk of harmful competition for investment. |
| 10. Corporate governance and responsibility | <ul style="list-style-type: none"> Investment policies should promote and facilitate the adoption of and compliance with best international practices of corporate social responsibility and good corporate governance. |
| 11. International cooperation | <ul style="list-style-type: none"> The international community should cooperate to address shared investment-for-development policy challenges, particularly in least developed countries. Collective efforts should also be made to avoid investment protectionism. |

making investment work for development. It provides the framework for UNCTAD's *Investment Policy Reviews* (IPRs); it is the basis for updating national regulatory regimes; and it is used as a menu for training workshops and a handbook for general advisory services.

Ultimately, this process should contribute to a broad multilateral understanding of key issues and, in turn, make the existing system of international investment rules more coherent and conducive to inclusive growth and sustainable development.

In the longer term, the IPFSD could become a stepping stone for formulating common denominators for future multilateral investment rules.

Conclusions

International investment rule-making in the 21st century is a dynamic process that has resulted in an increasingly complex IIA universe. An equally dynamic process of dispute settlement, with a growing number of cases, and sometimes conflicting or unanticipated arbitral decisions, adds an additional layer of complexity. As a result, the IIA universe is under pressure from capacity and content challenges.

Among the most pressing challenges for IIA negotiators are to strengthen the development dimension of the international investment policy regime; to ensure sufficient policy space for host countries by balancing public and private interests; to address deficiencies in the ISDS system; and to resolve issues stemming from the increasing complexity of the international investment policy regime, all of which with a view to achieving sustainable development objectives.

There are significant benefits associated with multilateral consensus-building on investment policies. UNCTAD advocates an inclusive, transparent and structured debate on key issues, to which the IPFSD and the *Investment-policy-hub* can provide a foundation. Through proper staging and sequencing, multilateral consensus-building can move from loose to closer forms of international cooperation, yielding practical outcomes along the way.

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