LSE Enterprise

*TO THE DEPARTMENT FOR BUSINESS INNOVATION AND SKILLS:*

# COSTS AND BENEFITS OF AN EU-CHINA INVESTMENT PROTECTION TREATY

**Version: April 2013**


**On behalf of LSE Enterprise:**

**LAUGE N. SKOVGAARD POULSEN**
UNIVERSITY OF OXFORD

**JONATHAN BONNITCHA**
LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

**JASON WEBB YACKEE**
UNIVERSITY OF WISCONSIN

## INTRODUCTION

This report assesses the likely costs and benefits for the United Kingdom (UK) of an investment protection treaty between the European Union (EU) and the People's Republic of China (China). Our cost-benefit assessment involves a comparison of the likely situation if an EU-China investment treaty were adopted to a continuation of the legal status quo. Two relevant characteristics of the status quo are that the UK already has a bilateral investment treaty (BIT) with China, albeit one that lacks full consent to investor-state arbitration, and that the UK already has a BIT with Hong Kong. Ultimately, these characteristics of the status quo play an important role in driving our conclusions. We do not compare the costs and benefits of an EU-China investment treaty to other hypothetical scenarios, such as the strengthening of the UK-China BIT, or the abrogation of the UK-China and UK-Hong Kong BITs.

Our assessment throughout is based on the approach articulated in our Analytical Framework report. The conceptual discussion in the Analytical Framework report provides the basic structure for this report, as well as identifying more specific questions that inform our analysis. We assume that readers will have read the Analytical Framework report before turning to this document.

Throughout this report the term 'China' is understood as including Mainland China and the special administrative regions (SAR) of Hong Kong and Macau. Thus, the concept of 'Chinese investment in the UK' includes investment from Hong Kong in the UK. This is consistent with the likely provisions of an EU-China investment treaty and with existing Chinese treaty practice. Modern Chinese investment treaties protect foreign investors of the partner state investing in Hong Kong and Macau, as well as foreign investors of the partner state investing in Mainland China. Equally, Chinese investment treaties protect investors from Hong Kong and Macau, as well as investors from Mainland China, when they invest in the partner state.[1]

[1] Gallagher and Shan 2009, 96; *Tza Yap Shum v The Republic of Peru* ICSID Case No ARB/07/6, Award on Jurisdiction, 19 June 2009.

# 1. UK-CHINA INVESTMENT RELATIONS

In this section we provide a brief overview of the UK-China investment relationship, focusing on the amount and composition of investment stocks and flows between the two countries. At the outset we caution that comprehensive data on UK-China investment relationship is relatively difficult to obtain. For example, there are significant discrepancies between Chinese foreign direct investment (FDI) data as reported by Chinese authorities and as compiled by Eurostat.[2] The UK Office of National Statistics (ONS) has drafted a detailed analysis of UK inward and outward FDI,[3] but the ONS analysis contains important gaps, especially in reporting the sectoral composition of UK-China FDI.

Much of the available data focuses specifically on FDI. It should also be noted these statistics may, depending on how 'FDI' is defined by those compiling the data, exclude equity investments involving the acquisition of high-value but low-percentage stakes in foreign companies. For example, a Chinese investor recently purchased an 8.6% stake in UK utility Thames Water, a deal worth an estimated £500 million. But the Chinese investment in Thames Water would probably not be reflected in official tabulations of Chinese foreign investment because the investor's holdings of Thames Water shares is below the 10% threshold typically used to distinguish FDI from "portfolio" investment. Similarly, the multi-billion dollar Chinese investment in British Petroleum (BP) would not be counted as foreign *direct* investment because the stake amounts to only approximately 1 per cent of BP's shares, and is not sufficient to give the Chinese investor "control" over BP. This is a significant point, because investment treaties are typically drafted to cover both direct *and* portfolio investment, and the costs and benefits of an investment treaty will flow from their coverage of both kinds of investment.

A further difficulty is that FDI statistics typically fail to provide information on the original source of inward FDI or the ultimate destination of outward FDI. If a foreign investor routes its investment from the 'home' state to the 'host' state via a subsidiary incorporated in a third state (perhaps for tax purposes) this investment would show up twice in FDI data, both as an

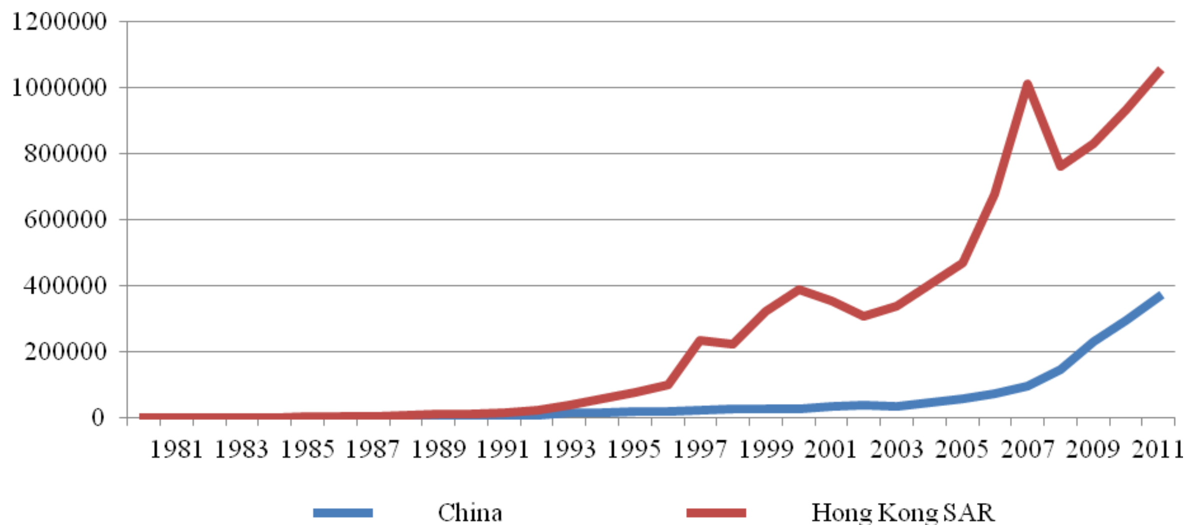
[2] Hanemann and Rosen 2012, 34 (referred to in text as "Rhodium Group report").
[3] ONS 2012.

investment of the home state in the third state and as an investment of the third state in the host state. It would not, however, show up in FDI data as an investment from the home state in the host state, making it difficult to determine how much FDI in a host state is indirectly owned by investors of the home state. This, too, is important as a significant amount of Chinese investment in the UK is routed through third states. For example, it appears that Chinese sovereign wealth funds have invested in the UK through Singapore-based subsidiaries.[4] More generally, a large proportion of Chinese outward FDI is routed through Caribbean islands.[5] Given the probability that some meaningful portion of Chinese FDI in the UK is routed through third states, official FDI statistics will understate the amount of FDI in the UK that is of Chinese origin. (The majority of outward Mainland Chinese investment is routed via Hong Kong but, for present purposes, this is less of a problem as Hong Kong is part of China.) We are, however, not aware of any data source that would allow the analyst to estimate the amount of Chinese investment in the UK that has been routed through third states.

## CHINESE INVESTMENT IN THE UK

Figure 1, below, illustrates the growth in Mainland Chinese and Hong Kong investment stock worldwide, using data compiled by UNCTAD. Given the statistical and other issues with FDI data discussed above, the Figure is useful largely as an indicator of general trends. We see that the value of Mainland Chinese investments abroad has increased greatly over the past several years, from approximately 28 billion USD in 2000 to over 350 billion USD in 2010. But the value of Hong Kong investments abroad is significantly greater—over 1 trillion USD in 2011. (Outward investment from Macau is comparatively slight, and we do not include it in the figures below in order to aid readability).

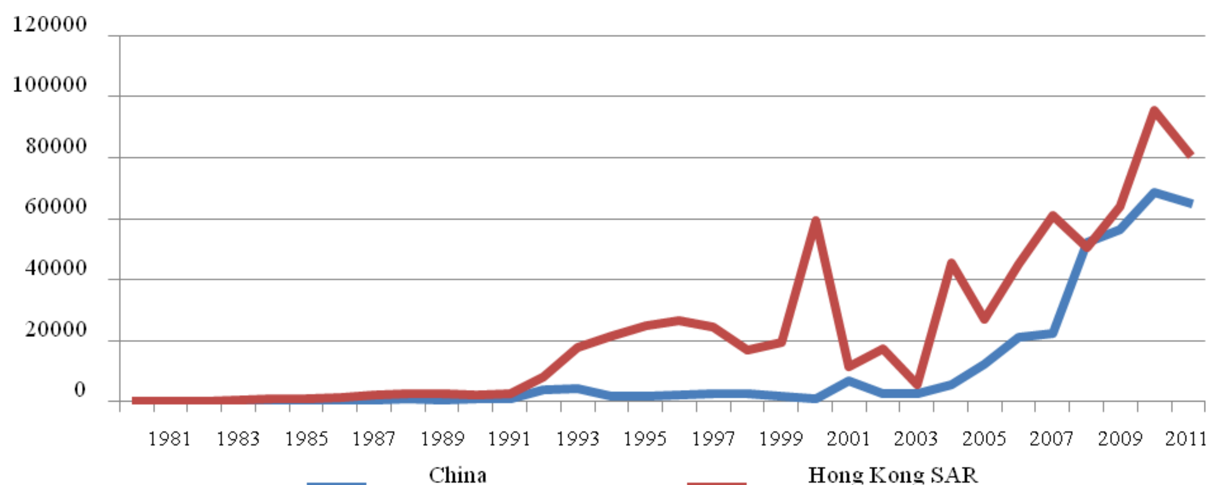
[4] McMahon and Wei 2013.
[5] See Table 2, below.




**Source:** UNCTAD FDI Database

FIGURE 1. OUTWARD CHINESE INVESTMENT STOCK (MILLIONS OF CURRENT USD)

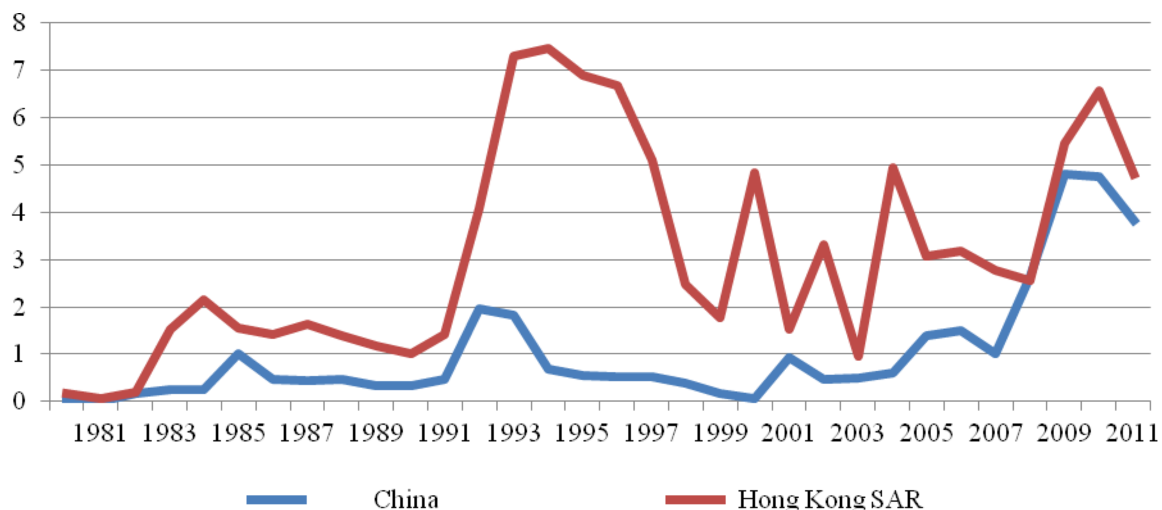
Figure 2 provides an equivalent graph of Mainland Chinese and Hong Kong FDI outflows, using data from UNCTAD. We see a dramatic increase in Mainland Chinese FDI outflows in recent years, from less than 1 billion USD in 2000 to approximately 65 billion USD in 2011. Outflows from Hong Kong have been consistently greater than outflows from the mainland, but in recent years the gap appears to have narrowed significantly.




**Source:** UNCTAD FDI Database

FIGURE 2. OUTWARD CHINESE INVESTMENT FLOWS (MILLIONS OF CURRENT USD)

Figure 3 displays the same underlying data as Figure 2 (Chinese FDI outflows), but expressed as a per cent of total world FDI outflows. We see that outflows from Mainland China have historically remained relatively low compared to world outflows—in most years, under two per cent. However, in the most recent years the relative importance of Chinese FDI outflows has increased significantly, to about four per cent of world totals – or approximately 10 per cent when combined.




**Source:** UNCTAD FDI Database

FIGURE 3. OUTWARD CHINESE INVESTMENT FLOWS (% OF WORLD FDI OUTFLOWS)

The trends of substantial increases in global Chinese outward investment illustrated above are reflected in Chinese investments flows to the EU. A recent analysis by a private consultancy, the Rhodium Group, on Chinese FDI in the EU reports roughly 1 billion USD in Chinese FDI transactions in the EU in 2003, and nearly 10 billion USD in 2011—a ten-fold increase.[6] Despite this increase, Chinese investments in the EU appear to remain a relatively small percentage of overall foreign investment in the EU, estimated in one study at just four per cent of total EU FDI inflows in 2011.[7] (The Rhodium data appears to count only Mainland Chinese outward FDI, but this is not clear from their report.)

[6] Hanemann and Rosen 2012, 35, Figure 17.
[7] Hanemann and Rosen 2012, 35.

ONS provides data on the net Chinese FDI position in the UK.[8] This data is commonly referred to as the 'stock' of Chinese investment in the UK.[9] However, it is important to note that ONS data on net Chinese FDI position in the UK does not correspond precisely to stock of investment that would be protected by an EU-China investment treaty. For one, as with other sources of FDI data, the ONS net FDI stock data excludes portfolio investment, which would also be entitled to the protection of an EU-China investment treaty. Perhaps more significantly, the net inward FDI position data is compiled by aggregating net inflows of investment from China, rather than by valuing the assets in the UK owned by Chinese investors. This means that the net inward FDI position data does not include investments owned by foreign investors but funded by capital raised within the UK.[10] For example, if a UK subsidiary of a Chinese parent company took out a loan from a UK bank to fund the construction of a factory in the UK, the factory would not show up as net FDI in the ONS data. In contrast, the factory would constitute an additional asset in the UK owned by a Chinese investor and this asset would be subject to the protection of an EU-China investment treaty.

Notwithstanding these caveats, the ONS data on the net FDI investment position of Chinese investors in the UK is the most reliable indicator of trends in the value of Chinese investment in the UK that would be protected by an EU-China investment treaty. Throughout the remainder of this paper we use ONS data on net Chinese FDI position in the UK as a proxy for the value of Chinese investments in the UK that would be protected by an EU-China investment treaty. We refer to this data as the ONS 'stock' data.

[8] ONS 2013.
[9] ONS 2013 (background notes).
[10] Ibid.

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|---|
| **MAINLAND CHINA** | | | | | | | | | | |
| **Outward** | 3212 | 1809 | 1882 | 2685 | 2228 | 2719 | 4571 | 4446 | 5760 | 6373 |
| **Inward** | 42 | 102 | 119 | 111 | 99 | 202 | 427 | 618 | 378 | 765 |
| **HONG KONG** | | | | | | | | | | |
| **Outward** | 5872 | 17221 | 19165 | 20432 | 22256 | 25517 | 28666 | 24342 | 27675 | 33289 |
| **Inward** | .. | .. | .. | .. | .. | .. | .. | 6641 | 9579 | 20504 |
| **ASIA** | | | | | | | | | | |
| **Outward** | 28914 | 43118 | 47311 | 54919 | 54377 | 60887 | 77412 | 80647 | 105706 | 123621 |
| **Inward** | 20323 | 19869 | 24800 | 24101 | 39436 | 53166 | 50419 | 42521 | 54791 | 66009 |
| **WORLD** | | | | | | | | | | |
| **Outward** | 616786 | 665123 | 645744 | 696113 | 741163 | 916261 | 1073613 | 981481 | 1046098 | 1098177 |
| **Inward** | 324680 | 339641 | 363422 | 488212 | 580313 | 620419 | 660373 | 681273 | 725557 | 766166 |

**Source:** ONS

TABLE 1. UK NET FDI INTERNATIONAL INVESTMENT POSITIONS (MILLIONS OF CURRENT GBP)

Table 1 shows that, as of 2011, total (world) stock of inward FDI in the UK was £766,166 million. Of this, £21,269 million – or roughly 2.7% – is Chinese investment. (The ONS stock data, like other sources such as UNCTAD, counts investment from Mainland China and investment from Hong Kong separately, so the two figures must be combined to arrive at total Chinese investment position in the UK.) Table 1 also shows that the vast majority of Chinese investment in the UK – over 95% of the current stock – is made from Hong Kong. This is an important observation, as inward investment in the UK made from or via Hong Kong is already protected by the UK-Hong Kong BIT. Notwithstanding this observation, Figure 1 shows that growth in the outward stock of Mainland Chinese investment is accelerating faster than growth in the outward stock of Hong Kong investment. If this trend continues, the proportion of the stock of Chinese investment in the UK arriving directly from Mainland China is likely to rise.

The ONS provides a further sectoral breakdown of Chinese FDI in the UK, though unfortunately the ONS data series is far from complete making it difficult to draw definitive conclusions. Yet, the ONS data do suggest that in recent years the bulk of Mainland Chinese FDI in the UK resides (as stock) in three principle sectors: financial services, other services,

and retail and wholesale trade.[11] The ONS sector-level data on Hong Kong is too sparse to interpret.

The Rhodium Group provides an alternative estimate of Chinese investment in the UK, using the consultancy's proprietary FDI database. (As mentioned, it is not clear whether the Rhodium Group database is recording only Mainland Chinese FDI or Chinese FDI including Hong Kong and Macau). Their analysis suggests a greater degree of diversification by Chinese investors in the UK than is reflected in the ONS data and concludes that the 'sectoral breadth of these [FDI] deals demonstrates that Chinese interests are broad, not limited to a handful of niches.'[12]

In terms of the UK's relative performance at attracting Chinese investment, the UK appears to perform well when compared to its EU partners. The Rhodium Group reports that over the years 2003-2011, the UK has received the second-most amount of Chinese FDI out of the EU27 (in terms of the total dollar value of investment deals recorded), behind only France.[13] Other studies have also confirmed that the UK is among the most, or is the most, attractive destination for Chinese investors in the EU.[14]

Notwithstanding the UK's relatively strong performance compared to other EU Member States as a destination for outward Chinese FDI, states beyond Europe have amassed much larger stocks of Chinese investment. Table 2 illustrates Mainland Chinese outward investment stocks as measured by MOFCOM. For reference, we have indicated whether each country has an investment treaty in force with China and distinguished between treaties with and without a comprehensive consent to investor state arbitration.

[11] Percentage figures are derived by the authors from ONS 2013, table 6.3.
[12] Hanemann and Rosen 2012, 45. See also Figure 20 in the same report.
[13] Hanemann and Rosen 2012, 36. In the Rhodium Group analysis, France edged out the UK only because of an unusually large transaction involving a Chinese investment in French utility GDF-Suez.
[14] See, for example, IBM Belgium 2010.

| Country | Outward stock, 2010 (Millions current USD) | Investment protection treaty |
|---|---|---|
| Hong Kong | 199055,57 | - |
| British Virgin Islands | 23242,76 | - |
| Cayman Islands | 17256,27 | - |
| Australia | 7867,75 | 1988 BIT* |
| Singapore | 6069,10 | 1985 BIT*, 2009 ASEAN-China PTIA |
| Luxembourg | 5786,75 | 2005 BIT |
| United States | 4873,99 | - |
| South Africa | 4152,98 | 1997 BIT |
| Russia | 2787,56 | 2006 BIT |
| Canada | 2602,6 | 2012 BIT |
| Macau | 2229,29 | - |
| Myanmar | 1946,75 | 2001 BIT |
| Pakistan | 1828,01 | 2006 PTIA |
| Kazakhstan | 1590,54 | 1992* BIT |
| Germany | 1502,29 | 2003 BIT |
| Sweden | 1479,12 | 2004 BIT |
| Mongolia | 1435,52 | 1991* BIT |
| **United Kingdom** | **1358,35** | **1986* BIT** |
| Nigeria | 1210,85 | 2001 BIT |
| Indonesia | 1150,44 | 1994* BIT, 2009 ASEAN-China PTIA |

* Investment treaty does not contain comprehensive investor-state dispute settlement.

**Source:** Mofcom

TABLE 2. MAINLAND CHINESE OUTWARD INVESTMENT STOCK AND INVESTMENT TREATIES

Table 2 suggests developing countries such as Myanmar, Pakistan and Kazakhstan have larger stocks of inward Chinese investment than either the UK or Germany. This is most likely misleading. Over half of Mainland China's total outward stock of investment goes to Hong Kong, but much of that investment continues to other destinations as routing investments via Hong Kong allow Chinese investors to avoid capital controls in Mainland China.[15] And recall from the ONS stock data in Table 1 that over 95% of the total outward Chinese FDI stock in the UK enters the UK from Hong Kong. Note also that the Caribbean tax havens of the British Virgin Islands and the Cayman Islands are the second and third most popular destinations for outward Chinese investment. These states are almost certainly intermediary, as opposed to final, destinations for Mainland Chinese investment. So, if China's very large investments in the jurisdiction of Hong Kong and other 'pass-through' states were traced to their final

[15] Hanemann and Rosen 2012, 94.

destinations, it is very likely that the UK would be one of the most important investment destinations for Chinese outward investment.

A further observation that can be made from Table 2 is that there is no obvious correlation between the existence of a 'strong' investment treaty – one that provides full consent to investor-state arbitration – and the ability of a state to attract outward Chinese investment. Even ignoring the three 'pass-through' jurisdictions that account for the majority of Mainland Chinese outward investment, the state that attracts the most Mainland Chinese investment is Australia. Australia has only a 'weak' investment treaty China, which is broadly equivalent to the UK-China BIT. The US has no investment treaty with China.

Finally, we turn to another important characteristic of outward Chinese investment, which is important for our cost benefit analysis, and that is the close relationship between Chinese outward investors and the Chinese state. Almost all of China's largest outward investors are state-owned enterprises (SOEs) or sovereign wealth funds (SWFs). Of the thirty largest Chinese multinational corporations, the only privately owned company is Huawei Technologies.[16] The remaining twenty-nine are SOEs. With respect to SWFs, Table 3 lists the largest funds worldwide by assets under management. There are four Chinese SWFs in the top nine: SAFE, CIC, the Hong Kong Monetary Authority Investment Portfolio, and the China National Social Security Fund. Their combined assets are greater than the assets managed by Norway's government pension fund, or indeed, greater than the assets held by any other government's SWFs. Detailed data on the investment activities of China's SWFs is scarce. However, it appears that China's SWFs are beginning to make important portfolio investments in the UK. For example, the Sovereign Wealth Fund Institute estimates that SAFE has made around 6 billion USD in investments in FTSE 100 companies.[17]

[16] Shapiro and Globerman 2013. Shapiro and Globerman uses three metrics to measure size of Chinese multinationals: foreign revenue; outward FDI stock; and total foreign assets.
[17] www.swfinstitute.org/swfs/safe-investment-company.

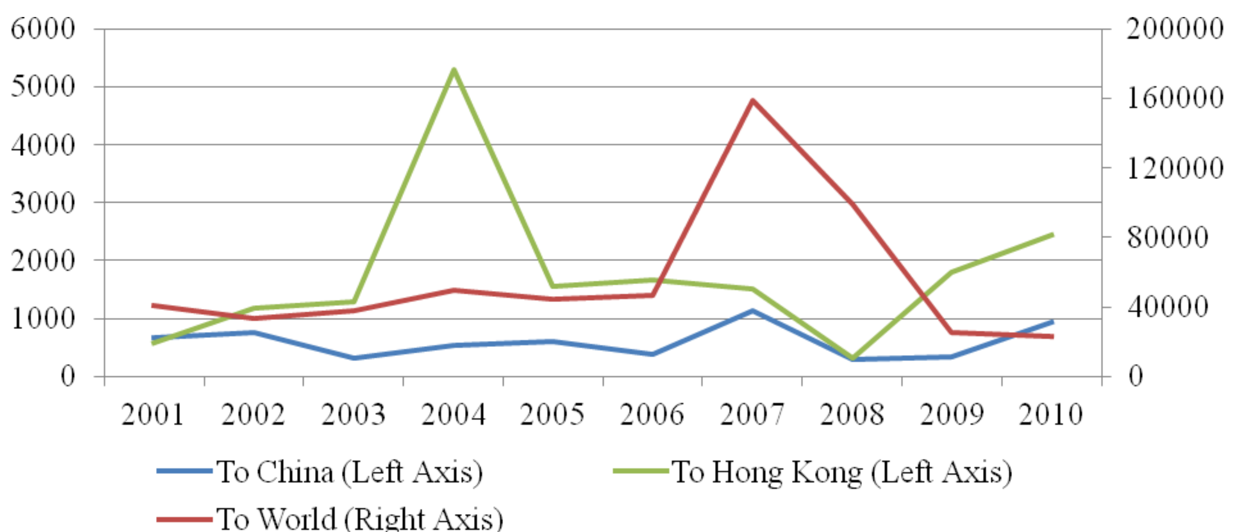
| Rank | Country | Fund Name | Assets (bn. USD) |
|---|---|---|---|
| 1 | Norway | Government Pension Fund – Global | 715.9 |
| 2 | UEA-Abu Dhabi | Abu Dhabi Investment Authority | 627 |
| 3 | China | State Administration of Foreign Investment Company (SAFE) | 567.9 (estimated) |
| 4 | Saudi Arabia | SAMA Foreign Holdings | 532.8 |
| 5 | China | China Investment Corporation (CIC) | 482 |
| 6 | China-Hong Kong | Hong Kong Monetary Authority Investment Portfolio | 298.7 |
| .. | .. | .. | .. |
| 9 | China | National Social Security Fund | 160.6 |

**Source:** SWF Institute

TABLE 3. LARGEST SWFS BY ASSETS UNDER MANAGEMENT, FEBRUARY 2013

## UK INVESTMENTS IN CHINA

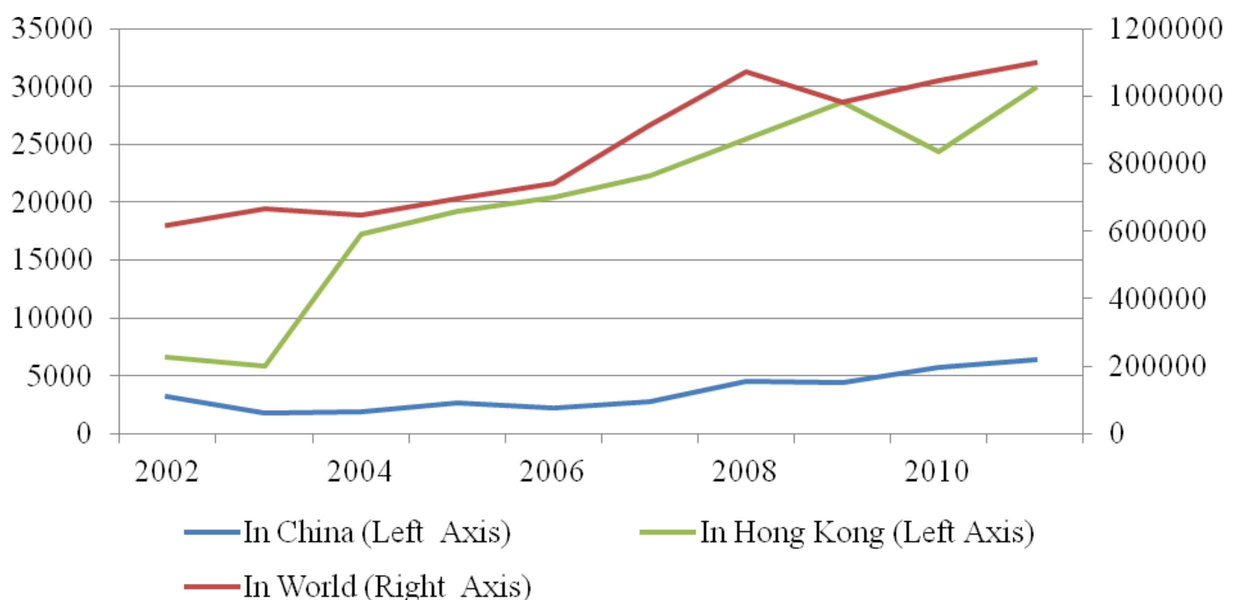
ONS provides our primary source of data on UK FDI in China. Figure 4, below, illustrates the flow of UK FDI to Mainland China and to Hong Kong over the previous decade. Figures are reported in millions of pounds. For reference, the figure also shows UK FDI flows to the entire world, scaled to the right-hand axis. We see that UK FDI flows to Hong Kong consistently exceed UK FDI outflows to Mainland China, though in some recent years (e.g. 2008) flows to Hong Kong approximately equalled flows to Mainland China. It should be noted that UK FDI flows to China appear to be a relatively small proportion of total UK FDI outflows: in 2002, approximately 2.25%, and in 2011 just under 2%.




**Source:** ONS 2012, Table 2.1.

FIGURE 4. UK FDI OUTWARD FDI FLOWS (MILLIONS OF CURRENT GBP)

Figure 5, below, shows UK FDI position (stock) in Mainland China, Hong Kong, and the world, calculated from ONS data. By 2011 (the last year of data) UK FDI stock has nearly doubled from its 2002 level. However, UK investment stock in China is a small proportion of UK investment stock worldwide: approximately one half of one per cent (0.52%) in 2002, and marginally higher in 2011 (0.58%). Note also that the UK's investment position in Hong Kong is, in recent years, roughly five times its position in Mainland China. As with outward Chinese investment, this partly reflects the fact that many British investors have found it beneficial to route their investment into Mainland China via Hong Kong (as well as Singapore). With the recent double-taxation treaty between China and the UK, the incentive to invest directly into Mainland China rather than routing via an intermediate company in a 'pass-through' state should increase.

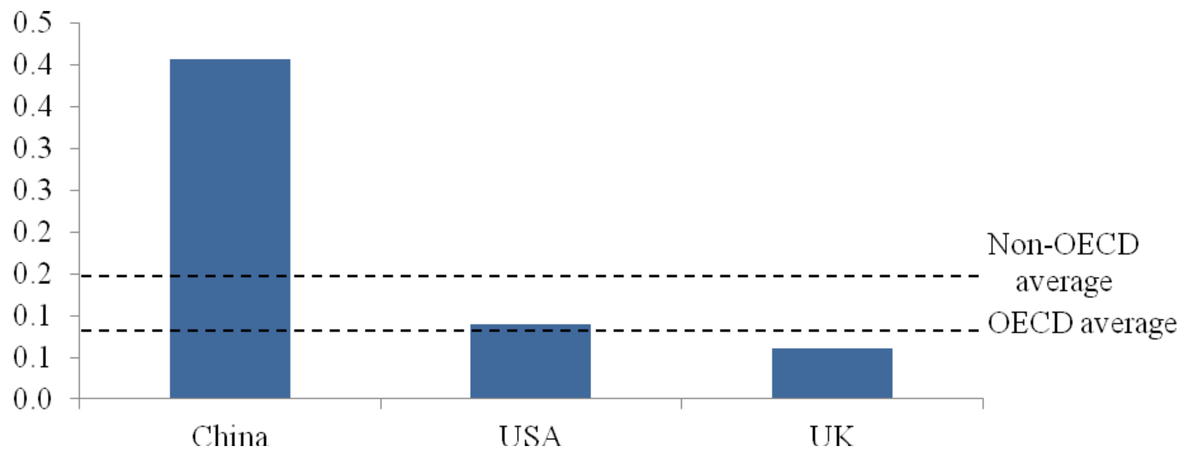



**Source:** ONS 2012, Table 3.1.

FIGURE 5. UK FDI OUTWARD FDI POSITION (MILLION CURRENT GBP)

It is beyond the scope of this report to analyse the determinants of UK investment abroad. It is worthwhile to note, however, that UK investors have committed capital in China despite China's restrictive FDI regime that discourages inward investment flows in many sectors of the economy. Figure 6, below, shows China's ranking on the OECD "FDI regulatory restrictiveness index". The index ranges from 1 (closed) to 0 (open). For reference, we have included the index ratings for the UK and the USA, and indicated OECD and world averages.

China is rated as the most FDI-restrictive state among all states rated by the OECD. We assume that the OECD's ranking is driven by the restrictions on inward investment flows into Mainland China.




**Note:** Index ranges from 0 (open) to 1 (closed)
**Source:** OECD

FIGURE 6. OECD FDI REGULATORY RESTRICTIVENESS INDEX, 2012

*To summarize, while considerable measurement problems and the issue of transhipment make it difficult to clearly identify the sectoral composition and value of investments flowing between the UK and China, it is clear that China is becoming an ever more important investment partner for the UK. Not only is China bound to become an increasingly important destination for British investors as the Chinese economy continues to develop, the stock of Chinese investment in the UK is likely to continue its growth as well. Much of the investment from China is likely to come from state-owned or controlled entities.*

## 2. TREATY PROVISIONS: UK-CHINA AND EU-CHINA INVESTMENT TREATIES COMPARED

Assessing the costs and benefits for the UK of an EU-wide investment treaty with China requires a comparison of the status quo. The most important characteristics of the status quo are the 1986 UK-China BIT and that the UK already has a BIT with Hong Kong.

## THE 1998 UK-HONG KONG BIT

The 1998 UK-Hong Kong BIT is typical of modern BITs signed by Western European states. It contains the full range of substantive protections common to BITs, including guarantees of national treatment, most favoured nation treatment (MFN), full protection and security, fair and equitable treatment, compensation for expropriation and free repatriation of capital and profits.[18] The protection of the treaty applies to a broad range of investments – 'every kind of asset' of an investor.[19] The protections of the treaty can be invoked by any company incorporated or constituted in Hong Kong that invests in the UK, and vice versa.[20] In other words, a company incorporated in Hong Kong that invests in the UK can invoke the protection of the UK-Hong Kong BIT, regardless of whether the origin of that company's capital is Hong Kong, Mainland China or a third state. The treaty provides full consent to investor-state arbitration of disputes arising under the BIT.[21]

The protection provided by the UK-Hong Kong BIT is essentially identical to that which would be provided by an EU-China investment treaty (see below), with one obvious exception. The UK-Hong Kong BIT applies only to the territory of Hong Kong SAR.[22] The treaty protects UK investment in Hong Kong, but not UK investment in Mainland China; the treaty protects Hong Kong investment in the UK, but not Mainland Chinese investment in the UK (unless, Mainland Chinese investment in the UK is routed via a Hong Kong incorporated entity, a point we discuss below). As the UK-Hong Kong BIT is essentially identical to a prospective EU-China investment treaty in its substantive terms, we note below that an EU-China investment treaty would in our view not meaningfully alter the legal regime governing the UK-Hong Kong investment relationship.

[18] UK-Hong Kong BIT, 1998, arts 2(2), 3(1), 5, 6.
[19] Ibid, art. 1 e).
[20] Ibid,art. 1 f).
[21] Ibid,art. 8.
[22] Ibid,art. 1 a) i).

## THE 1986 UK-CHINA BIT

The 1986 UK-China BIT shares many of the protections enshrined in the BIT with Hong Kong. It, too, provides guarantees of fair and equitable treatment, constant protection and security, MFN treatment, compensation for 'direct' or 'indirect' expropriation, as well as protections against restrictions on monetary transfers.[23] But it is nevertheless substantially different from the Hong Kong BIT (as well as recent Chinese and UK BIT practise) in two important respects. After outlining these differences below we discuss the possibility for both British and Chinese investors to rely on protections in other BITs when operating in China and the UK, respectively. Particular reference will be made to the UK-Hong Kong BIT.

### *Limited national treatment obligation*

Prior to 1998, China had a policy of *not* including unqualified national treatment provisions in its investment treaties. Instead, the UK BIT includes what can best be described as a 'best-effort' provision:

> … either Contracting Party shall *to the extent possible*, accord treatment *in accordance with the stipulations of its laws and regulations* to the investment of nationals or companies of the other Contracting Party the same treatment as that accorded to its own nationals or companies.[24]

The qualifications that national treatment should only be 'to the extent possible' and that it is subject to national laws and regulations mean this provision is merely hortatory. It does not require either China or the UK to eliminate discriminatory measures, nor does it block new discrimination, so long as that discrimination is authorised by national laws and regulations.[25]

In later treaties, China has reduced its limitations on national treatment provisions. For instance, 'grand-fathering' clauses are included in the 2003 BITs with the Netherlands and Germany. These clauses allow China, and only China, to preserve legislation or regulation that is inconsistent with the national treatment obligation. However, changing existing or introducing new legislation or regulation that increase the extent of discrimination is not

[23] For more complete analyses of the 1986 UK-China BIT, see Denza and Brooks 1987, 915-922; Gallagher and Shan 2009.
[24] UK-China BIT, 1986, art. 3(3) emphasis added.
[25] Gallagher and Shan 2009, 167.

allowed. Without considering the MFN clause (see below), this means Dutch and German investors are governed by more generous national treatment provisions than British investors. Finally, China has in one BIT – the 2007 treaty with the Seychelles – refrained from making *any* reservations to the national treatment provision. The provision reads:

> Each Contracting Party shall apply on its territory to the investors of the other Party, with respect to their investments and activities related to the investments, a treatment not less favourable than that granted to its investors, or the treatment granted to the investors of the most favoured nation, if the latter is more favourable.[26]

That China has not retained a right to discriminate between investors from China and investors from the Seychelles becomes particularly relevant when considering the importance of the MFN clause in the UK-China BIT. We discuss this point further below.

***Limited recourse to investor-state arbitration***

Since 1998, China has included comprehensive investor-state arbitration provisions in almost all its BITs. Under modern Chinese BITs, an investor may file an international arbitration claim against China after an initial 'cooling off' period of six months.[27] Not so in the earlier BITs, including the 1986 UK-China BIT. During the 1980s and early 1990s, China insisted that since 'a foreign investor - individual or company - does not have the same status as a state, the investor's recourse to arbitration should remain much more limited.'[28] In the BIT with the UK, recourse for British and Chinese investors to investor-state arbitration is therefore on a very limited basis. The relevant provision reads:

> A dispute between a national or company of one Contracting Party and the other Contracting Party *concerning an amount of compensation* which has not been amicably settled after a period of six months from written notification of that dispute shall be submitted to international arbitration.[29]

There is uncertainty as to what this provision implies. Similar provisions have been interpreted by some tribunals to mean that investors only have recourse to arbitration for

[26] Seychelles-China BIT, 2007, art. 5.
[27] Gallagher and Shan 2009, ch. 8.
[28] Denza and Brooks 1987.
[29] UK-China BIT, 1986, art. 7(1) emphasis added

disputes revolving around the amount of compensation, and not as to related issues, such as the question of whether an expropriation has occurred.[30] In those decisions, questions of liability are considered to be reserved for domestic courts to decide. Other tribunals have taken a broader view. In *Tza Yap Shum v Peru,* the first known investor-state dispute based on a Chinese BIT, the tribunal interpreted the arbitration provision (similar to that in the 1986 UK-China treaty) as follows:

> …it includes not only the mere determination of the amount but also any other issues normally inherent to an expropriation, including whether the property was actually expropriated in accordance with the BIT provisions and requirements.[31]

This reasoning has been followed by two other arbitral tribunals as well,[32] and is at the time of writing being argued by a Chinese investor in a claim against Lao.[33] This leaves some uncertainty about just how wide a consent has been granted to investor-state arbitration in the UK-China BIT. In either case, however, investor-state arbitration under the 1986 UK-China BIT is solely limited to expropriation disputes. These significant limits on the availability of investor-state arbitration, dramatically reduces the ability of investors to enforce substantive rights granted by the treaty and decrease the likelihood of investor-state claims.

***Possibilities to rely on other investment treaties via the MFN clause***

Although the UK-China BIT grants less wide-reaching protections than other investment treaties entered into by the UK and China, Chinese and British investors can rely on its MFN-clause to 'import' more favourable substantive provisions from the parties' investment treaties with third countries. The relevant parts of the provision read:

> (1) Neither Contracting Party shall in its territory subject investments or returns of nationals or companies of the other Contracting Party to treatment less favourable than that which it accords to investments or returns of nationals or companies of any third State.

[30] *Berschader v The Russian Federation*, SCC Case No. 080/2004, Award, 21 April, 2006, par. 153; *RosInvest UK Ltd v The Russian Federation*, SCC Case No. V070/2005, Award, October 2007, par. 115.
[31], ICSID Case No. ARB/07/6, Award on Jurisdiction, 19 June, 2009, par. 188. Unofficial translation.
[32] *Telenor Mobile Communications AS v Hungary,* ICSID Case No. ARB/04/15, Award on Jurisdiction, 13 September, 2006; *Saipem v Bangladesh,* ICSID Case No. ARB/05/07, Award on Jurisdiction, 21 March, 2007.
[33] Hepburn and Peterson 2012.

> (2) Neither Contracting Party shall in its territory subject nationals or companies of the other Contracting Party as regards their management, use, enjoyment or disposal of their investments, to treatment less favourable than that which it accords to nationals or companies of any third State.[34]

This means that Chinese and British investors are, in theory, entitled to the substantive rights included in investment treaties that the UK and China have entered into with third states. Here the existence of the Seychelles-China BIT is relevant. As mentioned above, in this treaty China accepted an obligation to accord full, unconditional post-establishment national treatment to investors from the Seychelles. This right could be invoked by UK investors via the MFN clause of the UK-China BIT.[35] (Whether they are capable of enforcing these rights in the absence of full consent to investor-state dispute settlement under the UK-China BIT is another question.)

Whether the ability to import rights from other treaties via the MFN-clause also extends to arbitration provisions is uncertain and much debated in the academic literature.[36] It is beyond the scope of this report to review the extensive controversy around this issue. One position is that MFN provisions only extend to substantive rights. In contrast, other tribunals have argued that MFN could apply to certain procedural obligations. In one claim pursued by a British investor against Russia the Tribunal allowed the investor to rely on an arbitration provision in the Danish-Russia BIT to bypass the more restrictive provisions of the UK-USSR BIT. According to the tribunal, this was "a normal result of the application of MFN clauses, the very character and intention of which is that protection not accepted in one treaty is widened by transferring the protection accorded in another." [37] If this reasoning is followed, British and Chinese investors could potentially rely on more comprehensive arbitration clauses in third-state BITs to also allow tribunals to determine questions of liability in expropriation disputes. This passage might even be read as allowing a tribunal under the UK-China BIT to apply substantive protections other than expropriation in an investor-state dispute. However, to date,

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[34] UK-China BIT, 1986, art. 3.
[35] Similarly, Gallagher and Shan 2009, 170.
[36] For an introduction to this debate, see Douglas 2011.
[37] *RosInvest Co v Russia*, SCC Case No. ARB V079/2005, Award on Jurisdiction, October 2007, par. 131. Article 8(1) of the UK-USSR BIT allowed investors recourse to arbitration in legal disputes concerning:
the amount or payment of compensation under Articles 4 or 5 or this agreement, or concerning any other matter consequential upon an act of expropriation in accordance with Article 5 of this Agreement, or concerning the consequences of the non-implementation, or of the incorrect implementation, of Article 6 of this Agreement.

no tribunal has used an MFN provision of a treaty akin to the UK-China BIT to extend an investor's right to investor-state arbitration beyond claims of expropriation.[38] While the point remains unsettled, it would be a highly uncertain option for British and Chinese investors to attempt using the MFN clause of the UK-China BIT to bring claims, aside from claims of expropriation, to investor-state arbitration.

***Possibilities to rely on other investment treaties via corporate structuring***

In principle, UK and Chinese investors could also take advantage of more favourable BITs through corporate structuring. Investors routinely route their foreign investments through holding companies in third states in order to optimise their investment's tax treatment. Similarly, it would be possible to structure investments so as to take advantage of another state's BIT. For example, a Mainland Chinese investor who routes its investment in the UK through a Hong Kong-based holding company would benefit from the 1998 Hong Kong-UK BIT, which contains comprehensive investor-state dispute settlement and post-establishment national treatment. Likewise, a UK investor could route its investment in Mainland China through a holding company incorporated in the Seychelles; that holding company, as a Seychelles company, would then be entitled to national treatment in China under the Seychelles-China BIT.

For investors that regard the protection of a 'strong' BIT as a necessary condition for making an investment, corporate structuring avoids the uncertainties of using an MFN clause to import more favourable dispute settlement provisions into the UK-China BIT. On this basis, one might expect UK investors in Mainland China and Mainland Chinese investors in the UK consistently to structure investments so as to bring them within the protection of other BITs. However, we have no evidence that the structuring of UK investment in Mainland China is influenced by the objective of accessing the protections of third state BITs. This is not surprising. In our view, corporate structuring decisions of UK outward investment are largely driven by tax and regulatory considerations. Nevertheless, we cannot rule out the possibility the some existing UK investment in Mainland China is structured with the purpose of

[38] The argument that an MFN provision should be used in this way was put by the claimant in *Tza Yap Shum*, but rejected by the Tibunal. *Tza Yap Shum v. The Republic of Peru*, ICSID Case No. ARB/07/6, Award on Jurisdiction, 19 June, 2009, par. 216.

obtaining the benefit of BITs between China and a third states. There are known cases of companies structuring investments in developing companies in order to obtain the protection of a BIT.[39] Structuring an investment for the sole purpose of accessing investment treaty protections would be inconvenient and potentially costly from the perspective of the investor. Depending on the third state and on the way the corporate group is organised, structuring outward investment via holding companies could also reduce the proportion of the corporate group's earnings that are taxable in the UK. This would constitute a cost to the UK.

In the case of Mainland Chinese investment in the UK, it is true that most investment seems to be structured in such a way to bring it within the protection of one of the UK's existing 'strong' BITs. The vast majority of Chinese investment in the UK is made from Hong Kong and it is reasonable to infer that much of this investment originates from Mainland China. Regardless of their origin, investments in the UK made by Hong Kong entities are protected by the UK-Hong Kong BIT. The same point applies to Chinese investments in the UK routed through other countries with which the UK has a BIT. For example, it appears that SAFE, one of China's SWFs, has routed its recent investments in UK equities through a Singapore-based holding company.[40] SAFE's investments presumably enjoy the protections of the 1975 Singapore-UK BIT, which, unlike the 1986 UK-China BIT, contains a comprehensive investor-state dispute-settlement clause. However, this phenomenon is driven by capital controls and other regulatory constraints that apply on the Mainland. As we note in Section 3, below, there is no evidence that Chinese investors in the UK are concerned about the sort of risks that a BIT might plausibly redress. While the desire to gain the protection of 'strong' BITs does not drive the corporate structuring of Chinese investment in the UK, the fact that most outward Mainland Chinese investment is routed via intermediaries incorporated in other jurisdictions has important implications for our assessment of the costs and benefits of an EU-China investment treaty.

## LIKELY CONTENT OF AN EU-CHINA INVESTMENT TREATY

The legal status quo of the UK-China investment relationship, as just outlined, is bound to be different than the legal protections enshrined in a future EU-China investment treaty.

[39] *Mobil v Venezuela* ICSID Case No ARB/07/27, Decision on Jurisdiction, 10 June 2010 [204]
[40] McMahon and Wei 2013.

Although the specific wording of individual provisions of such a treaty could have considerable bearing on its potential costs and benefits from the perspective of the UK, we are naturally unable to make any precise predictions about the exact drafting of the agreement. As such, for the analysis below we assume that an EU-China treaty would closely follow recent Chinese BIT practise.

A key argument for EU-wide investment treaties is that they can include comprehensive provisions for pre- and post-establishment provisions. In the case of China, this would be an important achievement as China's existing FDI regime is highly restrictive in a range of important sectors. And indeed, the European Commission has expressed their wish to include liberalization provisions in an EU-China investment treaty.[41] However, most investment treaties entered into by China only grant foreign investors treatment and protection rights post-establishment. This is in line with existing European BITs, including the UK-China treaty. Here, there is no legally binding liberalization requirement as the admission of investments is 'subject to its right to exercise powers conferred by its laws'.[42] In more recent investment treaties, China has taken small steps towards further liberalization obligations. In the 1992 BIT with Korea, the 2001 BIT with Finland, and the 2012 BIT with Canada, for instance, the MFN standard is extended to admission of investments.[43] These provisions oblige the contracting parties to treat investors of the other contracting party treatment no less favourably than investors from any third state. The same is the case in the preferential trade and investment agreements (PTIA) with Peru, the ASEAN bloc, and New Zealand.[44] The latter agreement also extends the protection of rights of transfers to the establishment of investments.[45]

While such provision put foreign investors of different nationalities in China on an equal footing, they do not limit the ability of China to restrict the entry of foreign investment in general. China has never agreed to extensive investment liberalization provisions in an investment treaty. Peru, ASEAN, New Zealand, and Canada tried to extend national treatment

[41] Gucht 2012.
[42] UK-China BIT, 1986, art. 2(1).
[43] Korea-China BIT, 1992, art. 2(2); Finland-China BIT, 2004, art. 3(3); Canada-China BIT, 2012, art. 5.
[44] Peru-China PTIA, art. 131; ASEAN-China PTIA, 2009, art. 5(1); New Zealand-China PTIA, 2008, art. 139.
[45] New Zealand-China PTIA, 2008, art. 142. Further, Art. 135, fn. 9 clarifies that:
For greater certainty, the elements of the definition of investor of a Party that relate to the establishment of investment are only applicable to Art 139 and Art 142.

to the pre-establishment phase, but all failed.[46] Similarly, in the on-going negotiations with the US, one of the main stumbling blocks is reportedly China's resistance to including binding market access provisions.[47] Accordingly, a key assumption of this report – as agreed with BIS - is that China will stick with this negotiation position, and that an EU-China investment treaty is unlikely to offer any comprehensive investment liberalization of the Chinese market *compared to what China would offer without the treaty.*

With respect to post-establishment provisions, we assume that the Chinese negotiating position will be based on modern Chinese BITs and that the EU negotiating position will be based on the model BITs of Western European states, such as the UK. These two initial negotiating positions share a great deal of common ground. Accordingly, we expect that an EU-China investment treaty would include broad definitions of 'investor' and 'investment'. We also expect that the EU-China BIT would contain substantive protections common to EU and Chinese model BITs, and to the UK-China BIT, including guarantees of: MFN treatment, full protection and security, fair and equitable treatment, compensation for expropriation and free repatriation of capital and profits.[48] Crucially, and unlike the 1986 UK-China BIT, an EU-China agreement is expected to include a comprehensive investor-state arbitration provision.

On the points on which the parties negotiating positions diverge, it becomes more difficult to predict the content of an EU-China BIT. We would expect China to concede a right to post-establishment national treatment, while insisting on a grandfathering clause akin to recent Chinese BITs, including its BIT with Canada.[49] China may also insist on additional text limiting and clarifying certain substantive protections contained in the treaty. For example, China may insist that the fair and equitable treatment standard be subject to the clarification that it does not grant protections over and beyond those in customary international law[50] and that the treaty should include general exceptions for non-discriminatory measures designed to protect legitimate public welfare objectives, such as public health, safety, and the

[46] Chen 2006, 147; Berger 2013; Peterson 2012a.
[47] Berger 2011.
[48] UK-Hong Kong BIT, 1998, arts 2(2), 3(1), 5, 6.
[49] Canada-China BIT, 2012, art. 8(2).
[50] *See* e.g. Canada-China BIT, 2012, art. 4(2); Mexico-China BIT, 2008, art. 5(2); Colombia-China BIT, 2008, art. 2(3-4). Note, however, that China's position on this is unclear as such clarifying language is not included in China's model BIT nor in its PTIAs with New Zealand (2008) and ASEAN (2009).

environment.[51] Finally, China may want to include a self-judging security exception, as seen in the 2012 China-Japan-Korea Trilateral investment agreement[52] and the China-ASEAN PTIA.[53] A self-judging security exception was also included in the Canada-China BIT, but the scope of this exception is limited to the regulation of transactions related to the military, times of war or 'other emergency in international relations, and nuclear non-proliferation.[54] These would be departures from standard UK and Western European treaty practice and, more specifically, points of contrast with both the UK-China and UK-Hong Kong BITs.

*In sum, an EU-China investment treaty is likely to contain important changes compared with the 1986 UK-China BIT. While certain substantive provisions may be modified, the most significant difference will be access to comprehensive investor-state dispute settlement. In practice, however, many UK investors in China and Chinese investors in the UK may already be able to access protections broadly equivalent to those likely to be contained in an EU-China investment treaty through corporate structuring. If so, then an EU-China treaty will only modestly increase the level of protection compared to the status quo by making it unnecessary for UK investors in China (or Chinese investors in the UK) to incur the transaction costs of corporate restructuring.*

## 3. Economic benefits of an EU-China investment treaty

As we described in our Analytic Framework report, an EU-China investment treaty may provide economic benefits to the UK in two main ways. First, the treaty might encourage Chinese investors to make investments in the UK. Second, the treaty might benefit the UK economically by protecting UK investments in China.

### Promotion of Chinese Investment in the UK

As suggested in Box 1 of Analytic Framework report, the principal question here is whether Chinese investors looking to invest in the UK are likely to factor in the existence of a modern

[51] *See e.g.* ASEAN-China Investment Treaty, art. 16. *See also* comments in, Gucht 2012. Note again, however, that such an exceptions clause is not included in China's current model BIT.
[52] Art. 18(1). See also Canada-China BIT, 2012, art. 8.

[53] Art. 17(b).
[54] Canada-China BIT, 2012, art. 33 (5) b).

EU-China BIT when deciding whether to invest in the UK. Embedded within that main inquiry are several sub-questions, such as whether Chinese investors view the UK as suffering from the kinds of political risks that BITs might be viewed as successfully mitigating.

Unsurprisingly, the Chinese government appears to view the UK as a very safe place to invest, and advertises it as such to potential Chinese investors. Our assessment is based upon the UK entry in a series of investment climate reports that MOFCOM has drafted for numerous countries, including the UK.[55] The reports are aimed at providing potential Chinese investors abroad with various practical kinds of information about the potential host state's laws, regulations, norms, customs, and the like. While we were unable to locate English-language versions of the UK report, we had a native Chinese-speaking law student prepare an informal translation of the most relevant sections. Those sections emphasize the UK's "highly mature" "rule of law" tradition and that the UK "provides a safe and orderly environment for foreign investors to establish ventures". Perhaps most relevantly, the report notes that the UK "government will not interfere in business activities of enterprises" and that "therefore, the most important point for Chinese enterprises which are willing to invest in the UK is how to deal with commercial risks".[56] We read "commercial risks" as distinct from the kinds of "political risks" against which investment treaties are meant to protect.

Other sources support MOFCOM's evaluation of the UK as characterized by low levels of political risk. For example, the PRS Group's ICRG index of political risk assigns the UK a high (or favorable) rating, both in an absolute and relative sense. Taking ICRG's 2011 data for "investment profile" (the component of political risk, as defined by ICRG, that is most relevant to the subject of this report), the UK scores a 10.875/12, a higher (better) score than the EU27 mean score of 9.96, and significantly better than the world mean score of 8.37. For reference, China's ICRG "investment profile" rating is 6.58, significantly worse than the UK score.

Looking at the EU more generally, a recent survey of Chinese investors in the EU by the European Union Chamber of Commerce in China reports that Chinese investors view the EU

[55] http://fec.mofcom.gov.cn/gbzn/gobiezhinan.shtml.

[56] None of the present authors reads Chinese, and we are unable to certify the accuracy of our student's informal translation. However, we believe the translation to be fair and accurate.

as a “safe and stable place to invest, with a transparent and predictable legal environment…. Chinese companies are confident about the long-term prospects of their investments there, which were contrasted with regions such as Africa and Southeast Asia.”[57] While the report includes some complaints by Chinese investors about certain difficulties encountered in operating in the EU, those complaints seemed to concern issues that are not typically dealt with in investment treaties, such as inflexibility of labour laws, difficulties in obtaining visas and work permits, and high costs and taxes.[58]

Patterns and trends in Chinese foreign investment support the inference that Chinese investors view the UK as an attractive investment destination even absent a modern UK-China (or EU-China) investment treaty. We’ve already noted above that the UK is among the most attractive destinations for Chinese investors.[59] As also noted above, SAFE has recently begun to make substantial portfolio investments in UK companies and it appears that the UK has been the sovereign wealth fund’s primary target for equity investments.[60] The Sovereign Wealth Fund Institute estimates that SAFE has made around 6 billion USD in investments in FTSE 100 companies.[61] The UK also seems able to attract Chinese investment in sectors that might be viewed as especially prone to the kinds of political risk that investment treaties are intended to protect against, such as infrastructure. For example, the UK has recently attracted high-profile Chinese investments in public infrastructure, including an investment in UK utility Thames Water and in Heathrow Airport Holdings.

Hypothetically, of course, Chinese investors could attach considerable importance to a modern investment treaty despite apparent existing perceptions of the UK as a desirable (low-risk) place to invest and the UK’s relative success in the recent past of attracting Chinese investments. If so, then Chinese investors would be likely to invest even more in the UK should such a treaty be in place at the EU level. This might be the case if, for example, Chinese investors are unusually sensitive to political risk, or if they place unusual value on investment treaties. This is a difficult hypothesis to test definitively. However, a recent statistical study of the determinants of Chinese outward investment reported that Chinese

[57] European Union Chamber of Commerce in China 2013.
[58] Ibid., 33.
[59] See again; Hanemann and Rosen 2012; IBM Belgium 2010.
[60] McMahon and Wei 2013.
[61] www.swfinstitute.org/swfs/safe-investment-company/.

investors appear to be unusually *insensitive* to political risk.[62] Also, the literature on the role of investment treaties for foreign investors' investment decisions mean we are more than doubtful that the presence or absence of modern investment treaties would play a tangible role, if any, in Chinese decisions to invest in the EU. In fact, the recent study of Chinese investments in the EU by the Rhodium Group concludes that there is no evidence that "the existence or strength of [investment treaties] is a factor in shaping location decisions of Chinese firms in Europe."[63] That conclusion is based upon the Rhodium Group report's authors' "numerous interviews with executives of private and state-owned Chinese firms in the period of 2009-2011."[64]

Another issue is whether an EU-China investment treaty may have a greater promotional impact on inward investment than previous investment treaties, due to its high profile as compared with previous BITs. In our US report, we note that awareness of investment treaties is much higher among US outward investors than it is among European and, presumably, Chinese outward investors. Notwithstanding this greater awareness, evidence suggests that US investment treaties have not significantly increased outward US investment. It seems, in other words, that awareness of an investment treaty is unlikely, in itself, to lead to greater investment flows. Rather, awareness of an investment treaty is a necessary but not a sufficient condition for the treaty to affect investment flows. Widespread awareness of an EU-China investment treaty would therefore only translate to increased Chinese investment in the UK if other conditions were also present – notably, if the investment treaty redressed risks that Chinese investors perceive themselves as facing in the UK.

A final reason why we would not expect an EU-China investment treaty to meaningfully impact Chinese investment flows to the UK is that Chinese investors already have access to some of the international law protections that an EU-China treaty would be likely to contain. Those protections are embedded in the UK-China investment treaty, which, despite a limited investor-state dispute settlement clause, may be viewed by Chinese investors as offering a

[62] Buckley et al. 2007.
[63] Hanemann and Rosen 2012, 74.
[64] One of the authors the present report for BIS was involved in a recent European Commission study that included a large survey of European investors operating in China asking about the relevance of investment treaties in their investment decisions. At the time of writing, the EC study had not been de-classified by the Commission, and nothing in this report contains any information from the EC study.

certain level of international legal protection against some kinds of potential UK-government mistreatment. We also note that the MFN clause of the UK-China BIT may have the effect of expanding the investor-state arbitral tribunals' jurisdiction to the merits of expropriation claims (although we think it unlikely that the MFN clause could be relied upon to allow claims other than expropriation to be brought to arbitration). Furthermore, insofar as Chinese investment in the UK is made by entities incorporated in Hong Kong, it would be entitled to the full set of protection provided by the UK-Hong Kong BIT. This is an important consideration because Hong Kong accounts for the majority of outward Chinese investment. Finally, as also discussed above, Chinese investors may be able to gain access to modern UK investment treaties by routing their investments through third states with which the UK has a more favourable investment treaty. As mentioned, there is some evidence that the Chinese government is routing at least some of its sovereign wealth fund investments in the UK through Singapore-registered companies, though we have no evidence that this decision was driven by investment-treaty considerations.[65]

*In sum, we do not expect an EU-China investment treaty to economically benefit the UK by promoting significant new investments to the UK. This conclusion reflects our assessment that Chinese investors already view the UK as a very desirable, safe place to invest. Furthermore, in rare cases where Chinese investors have atypical concerns about investing in the UK, they may be able to address those concerns through appropriate structuring of their investment.*

## PROTECTING UK INVESTMENTS IN CHINA

An EU-China investment treaty might provide economic benefits to the UK if it more adequately protects UK investors in China from treaty-relevant mistreatment compared to the level of protection that UK investors currently enjoy (Box 2 in our Analytic Framework report). The question for the UK analyst, then, is whether an EU-China investment treaty could mitigate against problems experienced by investors in China.

UK investors in China may be especially unlikely to view Chinese courts or the Chinese legal system as effective at resolving treaty-relevant disputes. For example, China ranks 80th on

[65] McMahon and Wei 2013.

Transparency International's 2012 Corruption Perceptions Index (the UK ranks $17^{th}$),[66] and China performs relatively poorly on the World Bank's indicators of "rule of law", ranking below the $50^{th}$ percentile.[67] (In contrast, the World Bank places the UK in the $90^{th}$ percentile in terms of "rule of law"). As such, UK investors may value a modern BIT's greater access to international law standards and international arbitration.

That said, some of the most important difficulties that foreign investors face in China are largely commercial in nature and not governed by investment treaties (e.g. rising labour costs; unreliable private partners). In fact, UK government sources do not appear to view expropriation and similar kinds of obvious violations of international law as a major concern for UK investors in China. UK Trade & Investment's (UKTI) "Overseas Business Risk" analysis of China lists a number of potential problems that UK businesspeople may face in China, but few of these problems seem particularly relevant to investment treaties.[68] Other difficulties experienced by British investors according to UKTI are more "political" in nature but are not easily addressed through the standard provisions of BITs. This includes concerns about "bribery and corruption" as well as lacking enforcement of intellectual property rights.

Other difficulties may be theoretically addressable through a modern BIT, though perhaps not practically so. An example is what the UKTI report describes as a "small but growing incidence of 'non-official detentions' of foreigners", in which the foreign investor's Chinese partners will send people to "surround a facility and refuse to allow the foreign partner to leave until payment has been made." Chinese security forces are reportedly hesitant to intervene in these kinds of disputes. Hypothetically, a UK investor subject to such extortion could invoke a modern investment treaty's "full protection and security" clause to hold the Chinese government liable for damages resulting from the failure of security forces to intervene. It is unlikely, however, that a UK investor would find it worth the time and money to bring such a claim, given the uncertainty of its success and the possibility that bringing the claim would harm valuable business and political relationships.

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[66] http://cpi.transparency.org.
[67] http://info.worldbank.org/governance/wgi/index.asp.
[68] www.ukti.gov.uk/export/countries/asiapacific/fareast/china/overseasbusinessrisk.html.

While the overall legal climate for investment protection in China is not considered particularly problematic by British – or indeed American[69] – investors, a recent survey of EU investors in China by the European Union Chamber of Commerce did identify a somewhat different set of concerns that may be more treaty-relevant. In particular, EU investors in China seem to view Chinese government policies as discriminatory (favouring Chinese domestic investors over established foreign investors) and the application or enforcement of regulations as arbitrary.[70] This may be prohibited under a modern investment treaty's standard substantive provisions prohibiting unfair, inequitable, or arbitrary treatment, or mandating national or MFN treatment. Under the 1986 UK-China BIT, with its restrictive investor-state arbitration provision, it would be difficult or impossible to challenge this kind of treatment. But under a modern BIT, such a challenge might well be possible, and even plausibly successful. On the other hand, UK investors may hesitate to invoke a BIT's protections against this kind of treatment if they fear damage to their relationship with the government or their continued access to investment opportunities, most of which depend upon formal or informal Chinese government approval.

Apart from occasional discriminatory and arbitrary treatment another treaty-relevant challenge that foreign investors in China face is navigating China's foreign-exchange regime, which restricts the ability to transfer foreign exchange out of the country. The 1986 UK-China BIT contains a free-transfer provision that provides UK investors in China with a limited guarantee of the right to repatriate investments and returns in a freely convertible currency. As the main scholarly commentary on China's BITs recognizes, such free-transfer provisions "are central to the promotion and protection of foreign investment,"[71] and virtually all BITs contain some version of free-transfer provision. The free-transfer provision in the 1986 UK-China is, however, somewhat out-dated. Article 6 of the 1986 treaty subjects the UK investor's right to transfer funds out of China to the amount of funds in the investor's official

[69] The U.S. Department of State's "2013 Investment Climate Statement" for China recounts a number of "challenges" faced by foreign investors in China. Those challenges "include industrial policies that protect and promote state-owned and other domestic firms, equity caps and other restrictions on foreign ownership in many industries, weak intellectual property rights (IPR) protection, a lack of transparency, corruption, and an unreliable legal system." On the other hand, the U.S. Department of State is not aware of any instances in which China has "expropriated" a U.S. investment in China in the modern era. The Investment Climate Statement is available at www.state.gov/e/eb/rls/othr/ics/2013/204621.htm.
[70] European Union Chamber of Commerce in China 2012.
[71] Gallagher and Shan 2009, 201.

foreign exchange account. This requirement reflected China's quite restrictive foreign exchange regime in force at the time, while in recent years China has significantly (if imperfectly) liberalized its foreign exchange rules.[72] Free-transfer provisions in more recent Chinese BITs seem to reflect this domestic liberalization. For example, Article 6 of the 2003 Germany-China BIT provides German investors with the right to transfer investments and returns subject only to compliance with "the relevant formalities stipulated by" Chinese law.[73] UK investors may appreciate the equivalently modern free-transfer provisions that an EU-China investment treaty is likely to contain. However, it is likely that UK investors in China already enjoy access to the free-transfer provisions in other BITs by operation of the MFN clause in the 1986 UK-China treaty. An EU-China investment treaty is also likely to contain a balance-of-payments or similar exception to the right to free transfer that might limit the utility of the free-transfer guarantee in times of emergency.[74]

To conclude this section: in our view, an EU-China investment treaty would offer UK investors in China some useful additional protections beyond those currently provided by the 1986 UK-China BIT, even if the EU-China treaty would be unlikely to cover the panoply of business concerns and difficulties that investors in Mainland China face. The extent that these protections constitute benefits must be tempered in light of our prior discussion of the effects of MFN clauses and the ability to "treaty shop" by routing investments through third states. The MFN clause of the UK-China BIT has the effect of expanding the substantive rights of UK investors in China beyond those enumerated in the UK-China BIT and may have the effect of expanding the investor-state arbitral tribunals' jurisdiction to the merits of expropriation claims (although it is unlikely that the MFN clause could be relied upon to allow claims other than expropriation to be brought to arbitration). Investment structuring could allow UK investors in Mainland China to enjoy the full range of protections that would be contained in an EU treaty, although we have no evidence that UK investors currently rely on these techniques.

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[72] Gallagher and Shan 2009, 189-192.

[73] The quoted text is from the Prototol attached to the 2003 Germany-China treaty.

[74] Article 6 of the 1986 UK-China BIT contains a balance-of-payments exception. However, other Chinese BITs, such as the 2003 Germany-China BIT, do not. As BIS is likely aware, the ECJ has recently ruled that certain Austrian, Swedish, and Finnish BITs violated EU law by failing to include necessary exceptions to the right to free transfer.

*In sum, an EU-China investment treaty has the potential to offer modest benefits to the UK by somewhat enhancing the level of protection that UK investors in Mainland China currently enjoy and, for UK investors that currently structure their investments so as to access protections of BITs that provide equivalent protection to a prospective EU-China investment treaty, eliminating the costs associated with more complex corporate structures. However, absent significant pre-establishment liberalization that removes barriers to entry, an EU-China investment treaty is probably not very likely to spur significant new UK investment to China. This is because, to the (limited) extent that UK investors in China regard the protections of a modern investment treaty as a necessary condition for the viability of their investment, they could relatively easily enjoy the protection of modern investment treaties under the status quo.*[75]

## 4. Economic costs of an EU-China investment treaty

### The Risk of Claims Against the UK by Chinese Investors

In our Analytical Framework report, we identify the risk of successful investment treaty claims against the UK as the primary economic cost associated with an investment treaty. In estimating the scale of this cost, the first step is to assess the size of investment stocks in the UK, as the likelihood of claims against the UK can be expected to increase roughly in proportion with the size of the investment stock in the UK covered by the treaty. As noted above, the stock of Chinese investment in the UK is significant and growing. However, most of this investment is either from, or routed via, Hong Kong. More than 95% of the existing stock of Chinese FDI in the UK (Table 1) is already covered by the Hong Kong-UK BIT. Accordingly, an EU-China BIT is unlikely to significantly expand the coverage of the existing stock of foreign investment in the UK. On this basis alone, an EU-China BIT should have relatively little impact on the likelihood of claims by Chinese investors against the UK government, at least at the time it is introduced. This could change in future, if an increasing

[75] This conclusion is consistent with a statistical study conducted by IBM Belgium on behalf of the European Commission that modelled the potential impact of an EU-China investment treaty on EU investment flows to China. The study concludes that the "marginal effect of any new [investment treaty with China] is likely to be low"; IBM Belgium 2010, 72.

proportion of Chinese investment in the UK is made directly by entities based in Mainland China, rather than via Hong Kong.

Two further issues relate to the type of Chinese investments in the UK: their size and sectoral composition. These issues are relevant because, as discussed in our Analytical Framework report, investment treaty claims involving investors in certain sectors and of certain sizes have been more common. We do not have data on the distribution of size of Chinese investments in the UK. However, it is likely that a significant quantity of Chinese investment in the UK is in projects of sufficient size to make the economics of an investment treaty claim (i.e. ratio of legal costs to potential award) viable in theory. With respect to sector, we do not have comprehensive data disaggregating inward Chinese investment in the UK either. Anecdotally, it seems that Chinese investment in the UK crosses several sectors, including sectors that have been prone to investment treaty claims in the past, such as extractive industries. For example, in 2012 the Chinese state owned oil company CNOOC acquired all the shares in the Canadian oil company Nexen. Nexen has interests in several of the UK's North Sea oil fields, including as operator of the Buzzard oil field.[76] Investments in public utilities operating under contracts with the host state have also been a disproportionate source of investment treaty claims. There is also a Chinese presence in these sectors in the UK. For example, as noted in our Introduction, a Chinese investor owns a minority stake in Thames Water.

A different consideration concerns the culture and practice of dispute resolution among Chinese investors in the UK. Some academics have suggested that Japanese investors operating abroad, and perhaps Asian foreign investors more generally, are more reluctant to bring investment treaty claims than their Western counterparts.[77] It is not clear to us that this cultural observation holds for Chinese investors. The first investment treaty claim by a Chinese investor was not brought until 2006. However, at that time, the stocks of Chinese outward foreign investment were relatively small. Moreover, China did not begin signing investment treaties with full consent to the settlement of claims through investor-state arbitration until 1998.[78] As shown by the table below, Chinese investors have been increasingly pursuing BIT claims over the past eight years. While this increase could reflect a

[76] www.nexeninc.com/en/Operations/Conventional/UKNorthSea.aspx.
[77] Nottage and Weeramantry 2011.
[78] Gallagher and Shan 2009, 40.

growing proclivity for litigation among Chinese investors abroad, it is perhaps more likely that the trend is the simple result of an expansion in the Chinese BIT network coupled with the rapid increase in the stock of outward Chinese investment.

| **Claimant(s)** | **Respondent** | **Treaty** | **Forum** | **Year** | **Dispute** | **Outcome** |
|---|---|---|---|---|---|---|
| *Andes Petroleum* | Ecuador | Probably China-Ecuador BIT | Ad hoc | 2006 or after | Windfall levy on energy companies | NA |
| *Señor Tza Yap Shum* | Peru | China-Peru BIT | ICSID | 2007 | Actions by tax administration against food products company | Awarded in favour of investor |
| *China Heilongjiang International and Technical Cooperative Corp, Qinhuangdaoshi Qinlong International Industrial, Beijing Shougang Mining Investment.* | Mongolia | China-Mongolia BIT | Ad hoc | 2010 | Cancellation of mining license | Pending |
| *Philip Morris Asia Limited* | Australia | Hong Kong-Australia BIT | Ad hoc | 2011 | Australian tobacco regulation | Pending |
| *Ekran Berhad* | China | Probably China-Malaysia BIT | ICSID | 2011 | Revoked leasehold over land | Suspended |
| *Ping An Life Insurance Company of China, Limited and Ping An Insurance (Group) Company of China, Limited* | Belgium | China-Belgium BIT | ICSID | 2012 | Nationalization of financial services group, Fortis | Pending |
| *Sanum Investments* | Lao | China-Lao BIT | Ad hoc | 2012 | Termination of hotel and casino project as well as gambling licenses | Pending |

**Sources:** ICSID, IAReporter.com, investmentclaims.com

TABLE 4. CLAIMS PURSUANT TO CHINESE AND HONG KONG INVESTMENT TREATIES

A distinct issue is the extent to which an EU-China investment treaty would grant Chinese investors greater rights than they would otherwise have under UK law. The UK is a state with an advanced judicial system, efficient bureaucracy and strong tradition of respect for the rule of law. For these reasons, the UK government can be assumed to treat Chinese investors at least as well as is required by UK law. Moreover, if the UK government fails to meet the standards of its own laws with respect to Chinese investors, UK courts would be available to provide a remedy to the wronged investor. Insofar as an EU-China investment treaty guarantees Chinese investors standards of protection that are equivalent to or lower than the investors entitlements under UK law, the treaty is unlikely to entail a significant risk to the UK adverse arbitral awards (subject to the caveat, noted below, about the differences in remedies available in investment treaty claim and claims under UK law).

On the other hand, if an EU-China investment treaty provided Chinese investors with more generous rights than they would otherwise have under UK law, the risk of adverse arbitral awards would rise considerably. This is especially so because, as we understand it, the UK government does not currently have a whole-of-government system in place to ensure compliance with its existing investment treaty obligations and there are no plans to implement such a system. Instead, we understand that the UK government intends to rely on the assumption that treating foreign investors in accordance with UK law will be sufficient to meet its obligations under an EU-China BIT. (Of course, in the event of a dispute with a Chinese investor, there would be processes within the UK government to respond and manage the dispute. Our point is simply that there are no general systems in place that provide for the screening and review of government policy in advance of specific concerns being raised about the policy by foreign investors.)

The question of whether an EU-China investment would provide Chinese investors with greater rights than those to which they would otherwise be entitled under UK law is a question of comparative legal analysis. We are not in a position to conduct a full legal comparison of this sort, not least because we do not know the precise terms of a prospective EU-China investment treaty. Rather, we hope to offer some more general reflections on this question.

In most respects, an EU-China investment treaty is unlikely to grant Chinese investors in the UK greater rights than they would otherwise have under UK law. Most successful investment treaty claims concern circumstances that would clearly be inconsistent with UK law, such as the unilateral abrogation of contracts by government authorities, or serious procedural failures in administrative or judicial processes. Arguably, the UK does not face a significant risk of claims arising from fact scenarios of this sort.

That said, we note that existing investment treaties of EU Member States, which are likely to be used as the model for a future EU-China investment treaty, have sometimes been interpreted as conferring more generous rights on foreign investors that would ordinarily be available under UK law. The protection of an investor's 'legitimate expectations' under fair and equitable treatment provisions of a prospective EU-China investment treaty is an important case in point. English law protects an individual's legitimate expectations only in very particular circumstances, such as when a government decision-maker has made a clear and specific promise to an individual.[79] In contrast, some arbitral tribunals have interpreted investment treaties as granting foreign investors a right to the 'stability' of the legal system, even when no representations have been made to the investor that the regulatory environment would remain unchanged.[80] Other tribunals have found that the grant of regulatory permission necessary to proceed with one step of investment project meant that the investor was entitled to expect that other regulatory agencies would grant approvals necessary for the project to proceed.[81]

There is a further issue relating to remedies in claims involving challenge to administrative action or legislative change under UK law. In investment treaty arbitration, the normal remedy is an award of damages for the investor's loss suffered as a result of the host state's breach of the treaty. In contrast, under English law damages are not normally available in cases challenging legislative or administrative action.[82] This difference is potentially significant in considering the likely economic cost of cases where an agency of the UK

[79] *R v North and East Devon Health Authority ex parte Coughlan* [2001] QB 213; *R (Bibi) v Newham Borough Council* [2001] EWCA Civ 607; [2002] 1 WLR 237
[80] *Occidental Exploration and Production Company v the Republic of Ecuador* LCIA Case No UN3467, Final Award, 1 July 2004 [202];
[81] *MTD v Chile* ICSID Case No ARB/01/7, Award, 21 May 2004 [163].
[82] Gaukrodger and Gordon 2012, 80.

government has failed to comply with the requirements of UK law – for example, in determining whether to issue a licence. If the investor successfully challenged the agency's actions under English law, the most likely result would be a non-pecuniary remedy. In contrast, a successful claim brought under the investment treaty on the same facts would see the award of damages. To the extent that an EU-China investment treaty encourages Chinese investors to litigate investment disputes through investment treaty arbitration rather than in UK courts, this difference in available remedies could constitute an economic cost to the UK government.

*Overall, our view is that the UK does face meaningful risk of adverse arbitral awards in claims brought by Chinese investors. This risk is attributable to the fact that some tribunals have interpreted investment treaties as conferring more generous rights on foreign investors than Chinese investors would otherwise be entitled to under UK and, to a lesser extent, to the fact that remedies in claims brought under the EU-China BIT may be more generous than those available under UK law. However, the UK has already assumed most of the risk of these future economic costs through its investment treaty with Hong Kong. As we have noted, the vast majority of Chinese investment in the UK is currently routed via Hong Kong. Thus, notwithstanding the risk of future claims against the UK by Chinese investors, we conclude that an EU-China investment treaty is unlikely to entail significant additional risk of adverse arbitral awards against the UK government.*

## THE RISK OF INVESTMENT DIVERSION

Another potential economic impact of an EU investment treaty with China is impact on Chinese foreign investors' location decisions with the EU. Such investment diversion effects may constitute either a cost or a benefit for the UK. If an EU-wide investment treaty with China increases the relative attractiveness of the UK as a destination for outward Chinese investment as compared to other EU states, diversion effects would likely benefit the UK. The converse is also true. Any investment diversion effects would operate at the margin, in the sense that they would be confined to cases where Chinese investors were choosing between (approximately) equally attractive investment options in different EU Member States.

In assessing the likelihood of investment diversion effects it is important to note our analysis in Section 3, above, which suggests that the presence or absence of an investment treaty is unlikely to play a significant role in the location decisions of Chinese investors. This observation implies that, even if an EU-China investment treaty alters the relative strength of investment protections available to Chinese investors in various states within the EU, this legal change is unlikely to induce significant diversion effects. This is a crucial point. The observations below about the extent to which an EU-China investment treaty might divert foreign investment from the UK are primarily of theoretical interest.

The UK currently has a 'weak' BIT with China, which does not provide for the submission of all investment disputes to arbitration. In contrast, Belgium (including Luxembourg), Cyprus, Czech Republic, Finland, France, Germany, Latvia, Malta the Netherlands, Portugal, Romania, Slovakia, Spain and Sweden all have 'strong' investment treaties with China that provide the full suite of investment treaty protections to investors and allow an investor to submit any dispute under the treaty to binding arbitration. On the assumption that investment treaties do play some role in the location decisions of Chinese investors, and recall again that there is no comprehensive evidence to sustain this assumption, an EU-China investment treaty could hypothetically be expected to make the UK relatively more attractive than these fifteen states. In such a scenario, any investment diversion effects between the UK and these fifteen states could be expected to benefit the UK.

While the UK does not currently have a 'strong' investment treaty with China, it does, however, have a 'strong' BIT with Hong Kong. Most existing Chinese investment in the UK is routed via Hong Kong, so an EU-China investment treaty would not significantly expand the coverage of Chinese investment in the UK. Several other Western European states have near identical 'strong' investment treaties with Hong Kong – specifically, Austria, Belgium (including Luxembourg), Denmark, France, Germany, Italy, the Netherlands and Sweden. As Belgium (including Luxembourg), France, Germany, the Netherlands and Sweden also have 'strong' BITs with China, their BITs with Hong Kong are of less relevance. In contrast, Austria, Denmark, and Italy find themselves in the same situation as the UK, in that they currently have 'strong' BITs with Hong Kong and 'weak' BITs with China. Accordingly, an EU-China BIT would not change the relative attractiveness of these three states – Austria,

Denmark and Italy – as compared to the UK. Thus, even if an EU-China investment treaty was relevant to Chinese investors' investment decisions, it is highly unlikely that there would be any investment diversion effects as between the UK and these states.

The remaining eight EU Member States lack 'strong' BITs with either China or Hong Kong. (All these states except Ireland have 'weak' BITs with China).[83] On the same assumption that investment treaties do play some role in the location decisions of Chinese investors, an EU-China investment treaty could hypothetically be expected to make the UK relatively less attractive than these eight states. As such, any investment diversion effects as between the UK and these eight states could in that scenario be expected to disadvantage the UK.

Overall, an EU-China BIT could in theory make the UK relatively less attractive than only a minority of EU Member States. An EU-China BIT would theoretically make the UK a relatively more attractive investment destination than most Member States. There is a further qualification that should be added to our discussion of diversion effects – not all EU Member States will be equally substitutable for the UK as investment destinations. In our view, Northern and Western European states that are geographically proximate and economically similar to the UK are more likely to be seen as alternatives to the UK for Chinese investors looking to invest in the EU. Most Western and Northern EU Member States already have 'strong' BITs with either China or Hong Kong. The one important exception to this is Ireland, which does not currently have any investment treaties. To the extent that Chinese investors value the protection of an investment treaty, an EU-China BIT could theoretically make Ireland a more attractive destination as compared to the UK.

Overall, however, it is our more general observations about the likely impact of investment treaties on investment decisions that is controlling. In our view, the availability of investment treaty protection is unlikely to be a significant consideration for Chinese investors considering investing the EU. Accordingly, investment diversion effects are likely to be small, or perhaps even non-existent. Moreover, our analysis of the existing pattern of investment treaty protection for Chinese investors in the EU shows that an EU-China investment treaty would not make the UK a less attractive destination than most comparable economies of Western

[83] Namely, Bulgaria, Estonia, Greece, Hungary, Lithuania, Poland, and Slovenia.

and Northern Europe. *On this basis, we conclude that investment diversion effects of an EU-China investment treaty are highly unlikely to result in a net economic cost to the UK. If anything, diversion investment effects could in theory amount to a small net benefit to the UK.*

# 5. POLITICAL BENEFITS OF AN EU-CHINA INVESTMENT TREATY

## DE-POLITICISING INVESTMENT DISPUTES

In our Analytical Framework report, we identify de-politicisation of investment disputes as a potential political benefit from 'strong' investor state arbitration provisions in investment treaties. Given that a carefully managed relationship with China is likely to be important foreign policy objective of the UK in the coming decades, this could be a crucial benefit from an EU-China investment treaty: investment disputes with potential to derail delicate political and economic engagement between Whitehall and Beijing could simply be referred to international arbitration.

***UK as a home state***

In principle, an EU-China investment treaty could allow the UK government to avoid being drawn into investment disputes on behalf of British investors in China in ways that could compromise broader foreign policy goals. If the British government has had problems saying 'no' to UK investors in China seeking government assistance to resolve sensitive disputes, a strong investment treaty could provide an opportunity to refer British investors to international arbitration. It is only possible to assess the extent to which this would constitute a benefit with comprehensive information about the susceptibility of the UK government to pressure by British industry to exercise diplomatic protection in situations that could lead to foreign policy complications. This is information we do not have, but which BIS could obtain from consultations with the Foreign and Commonwealth Office. In the case of the United States, for instance, foreign investors have often used Congress to apply pressure on the American executive branch to become involved in investment disputes that the executive, in circumstances where the executive branch would have preferred to avoid diplomatic

complications.[84] If the same is true in the case of the UK, this could be an important advantage from the treaty given the sensitive relationship with China in international economic affairs.

***UK as a host state***

As a host state, the UK could also – potentially – benefit from treaty-based investor state arbitration by adjudicating investment disputes with Chinese investors without the involvement of the Chinese state. Diplomatic pressure on the British government to resolve the dispute in favour of Chinese investors could be avoided if it is delegated to a neutral international arbitration forum. In practice, however, we find this unlikely.

There is no evidence the Chinese government will refrain from assisting its investors, even when disputes are referred to investor-state arbitration. For instance, it has been reported that Chinese Premier Wen Jiabao and his relatives own a significant interest in Ping An – the company filing a large investment treaty claim against Belgium.[85] Perhaps as a result, the Chinese government was reported to have lobbied the Belgian government about the Ping An dispute before it was brought to arbitration.[86] While relatively little information on the case is available, it does not seem that arbitration under the treaty has been successful in depoliticising the dispute.

Also, as we point out in the Analytical Framework report, the extent to which governments are vulnerable to company pressure to involve themselves in investment disputes partly depends on the nature of their political system. In the case of China, the government would presumably not be subject to the same sorts of pressures that apply in the United States. So if involvement in a dispute between a Chinese investor and the British government risks Chinese foreign policy objectives, it is unlikely that the Chinese government would respond to investor requests for diplomatic aid. At a general level, this means the need for de-politicisation may be less in the case of investment disputes with Chinese investors compared to, say, investment disputes with American firms.

[84] Maurer 2013.
[85] Barboza 2012.
[86] Peterson 2012.

That said, it is rarely possible to consider Chinese overseas investors as entirely 'private',[87] and the most politicized and sensitive disputes over Chinese investment in recent years have involved state-owned or controlled entities operating, or seeking to operate, in Europe.[88] Disputes involving these investors therefore have the most potential to benefit from the promises of de-politicisation. And while investor-state arbitration is primarily an instrument to resolve disputes between governments and private investors, the ICSID Convention does allow sovereign or quasi-sovereign entities to file a claim if their activities are essentially commercial in nature. [89] This is important as many of the measures taken against SOEs and SWFs in recent years are covered by investment treaty protections.[90] So if China's fears about investment protectionism in Europe (including in the UK) could be alleviated by referring disputes involving Chinese sovereign investment to international tribunals, this has potential to significantly reduce economic tensions in Sino-Europe relations.

We find it unlikely, however, that allowing Chinese SOEs and SWFs to file international arbitration claims against the United Kingdom will de-politicise their investment disputes. Given that Chinese SOEs or SWFs cannot be expected to aggressively pursue a disagreement with the UK without the explicit approval of the leadership in Beijing, an investment treaty claim would essentially be diplomatic espousal in disguise. As recently noted by Alvarez:

> … to the extent sovereign investors make use of investor-state dispute settlement, that arbitral mechanism is transformed from an *alternative* to politicized diplomatic espousal to itself a form of interstate dispute settlement not unlike diplomatic espousal itself.[91]

In the particular case of China, one of us has equally argued elsewhere that it may be difficult:

> … to see a dispute between a European government and the China Investment Corporation … as anything but a state-to-state affair. And if disputes are ultimately perceived to be between governments themselves, then surely the 'de-politicisation' (allegedly) offered by investor–state arbitration would

[87] See above. See also generally; Morck, Yeung, and Zhao 2008. For an insightful account of the relationship between the Communist party and Chinese business, see ch. 2; McGregor 2010.
[88] See e.g. comments by EU trade commissioner, Peter Mandelson at OECD Conference on Sovereign Wealth Funds, Paris, 28 March 2008.
[89] Feldman 2011. See also; Broches 1972, 334–335; Schreuer 2009, 160–161.
[90] Poulsen 2013.
[91] Alvarez 2013, 261.

largely be a myth.[92]

As such, and as we will also mention below, the political nature of disputes involving sovereign investment will typically make them unsuitable for investor state arbitration. For instance, the UK government may be uncomfortable allowing an international tribunal to override its decision to block acquisitions of Chinese SOEs based on national security concerns (as per Section 58 of the UK Enterprise Act).

*Overall, while we must stress that there is no comprehensive evidence on the extent to which investment treaties depoliticize investment disputes in practice, we find it unlikely that the treaty is going to make a tangible difference for the politicization of disputes between Chinese investors and the UK government. This is not least because of the considerable state ownership and control in the internationalisation activities of Chinese firms.*

## 6. Political costs of an EU-China investment treaty

### The Political Cost of Reduced Policy Space

In our Analytical Framework report, we suggest that an EU-China investment treaty would impose costs on the UK to the extent that it prevents the UK government from regulating in the public interest. We use the term 'policy space' to refer to this potential cost. In assessing the impact of an EU-China investment treaty on the UK government's policy space, we do not propose a theory of what sorts of policies would be in the UK 'public interest'. Rather, we suggest that it is for the government of the day to make its own assessment of the public interest. Thus, the impact of an EU-China investment treaty on UK policy space can be understood as the extent to which the treaty prevents the government of the day adopting policies that the government would have preferred to adopt in the absence of the treaty.

Assessing the likely size of this cost raises many of the same issues that were considered in our assessment of the likely economic cost to the UK of adverse arbitral awards under the EU-China investment treaty. The size and composition of Chinese investment stocks in the UK is relevant to the impact of an EU-China investment treaty on UK policy space. The

[92] Poulsen 2013.

likelihood of disputes between Chinese investors and the UK government can be expected to increase roughly in proportion with the size of the Chinese investment stock in the UK covered by the treaty. The composition of Chinese investment in the UK is also relevant because investments in particular sectors have proven more likely to result in investment treaty disputes in the past. Another important issue is the extent to which an EU-China investment treaty grants Chinese investors in the UK more generous legal rights than they would otherwise have under UK law. In determining, the extent to which a EU-China investment treaty would restrict UK policy space a useful first approximation is the principle that the treaty only restricts UK policy space to the extent it prohibits the UK from acting in a way that would otherwise be permissible under national law. However, this in principle is only an approximation as, constitutional principles aside, the law of the UK can be changed by the Parliament. A final consideration is the UK's existing BIT with Hong Kong. As illustrated in the first section of this Report, the vast majority of Chinese investment in the UK is made from or via Hong Kong. Whatever the scale of future political costs associated with the grant of investment treaty rights to Chinese investors in the UK, those future costs have already been incurred, to a large extent, through the Hong Kong BIT. All these issues have been examined in the section on Economic Costs, above, and we do not restate this analysis here.

In reconciling our assessment of the political costs associated with lost UK policy space under an EU-China investment treaty and our assessment of the economic costs associated with adverse arbitral awards, it is important to acknowledge the risk of double-counting the same costs. If the UK fully complies with its obligations under an EU-China investment treaty it will not incur any economic costs as a result of adverse arbitral awards, however, it may refrain from regulating in ways that it would otherwise regard as desirable. In contrast, if the UK ignores the risk of claims under an EU-China investment treaty it will not suffer from any reduction in policy space *in practice*. It would, instead, expose itself to the risk of economic costs associated with adverse arbitral awards.

As we understand it, the UK government does not currently have a whole-of-government system in place to ensure compliance with its existing investment treaty obligations, nor are there plans to implement such a system. Of course, in the event of a dispute with a Chinese

investor, there would be processes within the UK government to respond and manage the dispute. Our point is simply that there are no general systems in place that provide for the screening and review of government policy in advance of specific concerns about particular policies being raised by investors. The absence of a system to ensure compliance with an EU-China investment treaty means that the provisions of the treaty are unlikely be internalised within the UK government in a way that discourages or prevents government decision-makers from pursuing preferred policies prior to specific disputes arising. This significantly decreases the likelihood of an EU-China investment treaty interfering with UK policy space *in practice*.

While it is unlikely that an EU-China investment treaty would, through the operation of processes internal to the UK government, prevent UK government decision-makers from adopting preferred policies, there are other ways in which a treaty could affect UK policy space. The treaty could also affect UK policy space to the extent that the UK government responds to objections of Chinese investors to particular UK policies. Chinese investors could oppose UK policies on the basis of an EU-China investment treaty either through lobbying, through submissions to government inquiries or by initiating arbitration proceedings under the treaty. In each of these situations, the investor's recourse to its rights under the EU-China investment treaty could encourage a UK government decision-maker to modify or abandon a preferred measure, so as to avoid a specific investment treaty claim. These effects on UK policy space are more difficult to assess than costs that flow from the internalisation of the treaty within government; they relate to specific disputes concerning particular investors and particular government decisions.

In our view, in assessing the likely impact of Chinese investors' objections UK government decision-making, one of the most important considerations is the availability of high quality legal advice. It is reasonable to assume that high quality legal advice is available throughout the UK government. On this assumption, it is highly unlikely that the UK government would be persuaded by the objections of Chinese investors in UK to abandon or modify preferred policies that would be consistent with the EU-China investment treaty. On the other hand, where Chinese investors object to UK government policies that are inconsistent, or probably inconsistent, with the EU-China investment treaty, it is more likely that, having taken legal advice within government, those policies would be modified or withdrawn. An example, of

this phenomenon is the recent announcement by the New Zealand relating to its policy on tobacco plain packaging. While the New Zealand government has made clear that its preferred policy would be to introduce tobacco plain packaging, in light of legal objections raised by tobacco companies, it has decided to delay the enactment of legislation until after the investment treaty claim concerning Australian tobacco plain packaging – *Philip Morris v Australia* – has been resolved.[93]

In light of this analysis, the extent to which an EU-China would interfere with UK policy space is closely linked to legal questions about the extent of protection granted to Chinese investors in the UK by such a treaty. We are not in a position to conduct a full legal assessment of an EU-China investment treaty, not least because we do not know the precise terms of a prospective treaty. Nevertheless, we note that, in the past, investment treaties have sometimes been interpreted as conferring rights on investors that would go beyond the rights that Chinese investors would normally have under UK law. On these grounds alone, there is a significant risk of political costs to the UK arising from future preferred policies being abandoned or modified on account of objections from Chinese investors in the UK.

*Overall, our view is that the UK does face meaningful risks of political costs associated with the grant of investment treaty rights to Chinese investors. These risks arise from the likelihood that UK government decision-makers will be persuaded to modify of abandon preferred policies that are consistent with UK law on the grounds that those policies are inconsistent with Chinese investors' rights under investment treaties. However, the UK has already assumed most of the risk of these future political costs through its investment treaty with Hong Kong. As we have noted, the vast majority of Chinese investment in the UK is currently made from or via Hong Kong. Thus, notwithstanding the political costs associated with conferral of investment treaty rights on Chinese investors in the UK, we conclude that an EU-China investment treaty is unlikely to entail significant additional impact on UK government policy space.*

[93] Turia 2013.

## THE POLITICAL COST OF CONTROVERSIAL CLAIMS

Another potential political cost of an EU-China investment treaty is the controversy engendered by high profile claims against the UK government. The political cost of the controversy itself is distinct from, and additional too, any economic costs to the UK of adverse arbitral awards and any political costs associated with loss of UK policy space. In our Analytical Framework report we suggested that the assessment of political costs attributable to public controversy associated with high profile investment treaty claims should be handled with great caution. Disagreement and controversy about public affairs is a normal feature of democratic society. The possibility of controversy surrounding high profile claims against the UK government under an EU-China investment treaty should not, in itself, be understood as a political cost to the UK government. Rather, it is only if controversy around a *specific* claim triggers such widespread opposition to treaties and international cooperation *in general* that it limits the ability of the government of the day to pursue preferred policies on the international plane that this public backlash could be considered a cost.

In our view, the characteristics of Chinese investment in the UK make the possibility of controversial claims more likely than would be the case with inward investment from other states. As noted above, a great deal of inward Chinese investment in the UK is made by Chinese state-owned enterprises. Moreover, even privately owned Chinese companies investing in the UK may be perceived to have close links to the Chinese state. (For example, there has recently been some discussion in the UK press about the relationship of Huawei, an ostensibly private investor, to the Chinese state.) In the event of a high profile investment treaty claim against the UK government, the sovereign - or quasi-sovereign - nature of much Chinese investment could result in perceptions that the claim amounts to political interference in the UK by the Chinese state. *So while we are not aware of any investment treaty claims where the state ownership or control of Chinese investment abroad has played a significant role in aggravating controversy around the dispute, this could become an issue in a particularly sensitive case.*

## THE OPPORTUNITY COSTS OF AN EU-CHINA INVESTMENT TREATY

A final set of potential political costs are the opportunity costs of diplomatic and bureaucratic resources expended in the negotiation and implementation of an EU-China investment treaty. Our primary focus is on the commitment of the UK's diplomatic and political resources necessary to negotiate and implement the EU treaty. However, the scale of commitment of EU resources is also relevant, to the extent the EU resources might otherwise be devoted to other initiatives that would be of greater benefit to the UK.

One factor that is likely to affect the commitment of diplomatic and bureaucratic resources required to negotiate an EU-China investment treaty is the degree to which the original negotiating positions of the EU and China differ from one another. The model investment treaties of most Western European states are short documents that set out standards of investor protection in simple, terse language. In contrast, China's current model investment treaty and recent Chinese investment treaties with developed states are longer documents that set out applicable standards of protection.[94] For this reason, reaching agreement on an EU-China investment treaty is likely to raise issues of some complexity and require a commensurate commitment of resources.

A countervailing consideration is the possibility that an EU-China investment treaty could economise on bureaucratic or diplomatic resources by serving as a stepping-stone to an EU-China Free Trade Agreement (FTA), or some other desirable economic agreement. In our Analytical Framework report we noted that there is little reliable empirical evidence to support the *general* proposition that investment treaties tend to facilitate the conclusion of other valuable international agreements. While it has been suggested by the European Commission that an EU-China investment treaty may facilitate negotiations for an EU-China FTA,[95] we are not aware of any evidence of a general practice in China of using BITs as a platform for launching negotiations for FTAs. On the contrary, while China now has over one hundred and thirty BITs it has FTAs with only six states – Chile, Costa Rica, New Zealand,

[94] Gallagher and Shan 2009, Appendix IV; Free Trade Agreement Between The Government of the People's Republic of China And The Government of New Zealand, Chapter 11; Agreement Between the Government of Canada and the Government of the People's Republic of China for the Promotion and Reciprocal Protection of Investments.
[95] Falletti 2012.

Pakistan, Peru and Singapore – with a further five under negotiation.[96] In the case of five of China's six existing FTAs, the partner state signed its BIT with China over a decade before the opening of negotiations leading to the FTA. This strongly suggests that, for most of China's existing FTAs, negotiation of a BIT did not play a role in launching negotiations for an FTA. China also has an FTA with the regional grouping ASEAN. While this FTA includes an Agreement on Investment, it was the last component of the FTA negotiated, and was only signed after Agreements dealing with trade in goods and trade in services had been signed and ratified.[97]

It is possible, however, that different negotiating dynamics would be at play in negotiations between the EU and China than those that were at play when China negotiated BITs and FTAs with much smaller economies in the past. While there is little public available information to support the inference that an EU-China investment treaty is likely to lead to facilitate the conclusion of an EU-China FTA, the European Commission may be in possession of confidential information that supports such an inference. The UK government may wish to make inquiries with the Commission to obtain such information, if it exists and has not already been shared with the UK government. Another factor that could distinguish the dynamics of EU-China investment treaty negotiations from the negotiation of Chinese BITs is the possible inclusion of market access provisions. In this report, we have not attempted to assess the costs and benefits of market access provisions in an EU-China investment treaty. However, if the EU and China were to agree on the inclusion market access provisions in an investment treaty, this would narrow the range of issues on which agreement was required in subsequent negotiations for a full FTA.

The question of bureaucratic resources required to implement an EU-China investment treaty in the UK can be addressed more succinctly. We understand that there are no plans to create any new processes or agencies within the UK government to ensure compliance with a prospective EU-China investment treaty. Instead, we understand that the UK government intends to rely on the assumption that treating foreign investors in accordance with UK law will be sufficient to meet its obligations under an EU-China BIT. If our understanding is

[96] China also has 'Closer Economic Partnership Arrangements' with Hong Kong and Macau, both of which constitute 'special administrative regions' within Chinese territory.
[97] MOFCOM 2013.

correct, there are unlikely to be any meaningful political costs associated with the implementation of an EU-China investment treaty.

*Overall, we conclude that there are likely to be some net political costs associated with the diplomatic and bureaucratic resources required to negotiate and EU-China investment treaty. We are conscious of the argument that the commitment of these resources to the negotiation of an EU-China investment treaty could economise on bureaucratic and diplomatic resources required to negotiate subsequent desirable economic agreements, but are unaware of any publicly available evidence to support it. If the Commission is able to provide evidence to support this contention, for instance based on discussions with the Chinese leadership, our conclusion would need to be revised.*

# 7. CONCLUSION

In this report, we have offered an informed qualitative assessment of the likely costs and benefits of an EU-China investment treaty as compared to a continuation of the legal status quo. We have not attempted to value these costs and benefits in monetary terms. Given the information currently available on the impacts of investment treaties, we doubt whether a quantitative analysis of that sort would be feasible or informative, even with a significantly larger commitment of time and resources than were available to us. Because our analysis is qualitative, the final step of this report is to offer an informed judgement about the relative scale of the various costs and benefits identified in the report.

In our analysis, we concluded that an EU-China investment treaty is highly unlikely to increase Chinese FDI in the UK and that it is unlikely to be effective as a tool to depoliticise investment disputes between the UK and China. We encourage the Department of Business Innovation and Skills to inquire with the UK Foreign Commonwealth Office about the potential for the treaty to de-politicize investment disputes that the UK government would prefer to stay clear of. This would provide further insight into possible benefits associated with the de-politicisation of disputes. However, based on the information available, these potential benefits play little role in our overall assessment. We also concluded that it is unlikely that an EU-China investment treaty would result in significant investment diversion

effects. Accordingly, this effect plays little role in our overall assessment, either as a cost or benefit.

The political costs associated with controversial claims and the opportunity costs associated with negotiating figure differently in our overall analysis. The opportunity costs associated with an EU-China investment treaty are relatively certain to be incurred, but relatively minor in their likely scale compared to other potential costs. In contrast, political costs associated with the controversy engendered high profile claims are less likely to arise but could, in plausible but unlikely scenarios, create serious difficulties for the government of the day. We note these costs, but do not consider them to be decisive in our overall evaluation.

Our overall assessment is driven by three factors that we consider both likely and significant in scale. These factors are the economic benefit of an EU-China treaty in protecting UK investment in China, and the political and economic costs associated with the risk to the UK of liability under an EU-China investment treaty.

It is clear that an EU-China investment treaty would be of some value to UK investors investing in Mainland China. While investment treaties are inapt to address many of the difficulties faced by UK investors operating in China, there are some challenges facing British investor in Mainland China – notably, the arbitrary or discriminatory application of regulation for the purpose of shutting down an investment or applying pressure in order to solicit a bribe – which an investment treaty could ameliorate. An EU-China investment treaty could also provide stronger guarantees relating to the repatriation of capital. In both respects, we consider that an EU-China investment treaty would be of real benefit to the UK. To further sustain this conclusion we suggest that the Department of Business Innovation and Skills consider inquiring with the UK Export Credits Guarantee Department whether it has more detailed information about the political risks British investors face in China. We also suggest that the Department of Business Innovation and Skills consider conducting a survey of political risk insurers in London and of British investors operating in China about the relevance of investment treaty protections.

It is also clear that an EU-China investment treaty creates real risks of liability for the UK. The stock of Chinese investment in the UK is significant and growing; disputes between

Chinese investors and the UK government will inevitably arise. A key question is whether the EU-China investment treaty would grant more generous rights to Chinese investors than those to which they are entitled under UK law. We note that some arbitral tribunals have interpreted provisions that are likely to be included in an EU-China investment treaty, in ways that confer significantly more generous rights than are available under UK law. We also note that other arbitral tribunals have taken a more restrained view.

These costs and benefits are difficult to weigh against one another. We find the economic and political costs associated with the risk of liability under an EU-China investment treaty particularly difficult to assess, and suggest that the Department of Business Innovation and Skills consider commissioning legal research to determine the extent to which the terms of an EU-China investment treaty would confer substantive rights on Chinese investors that are more generous than those that would otherwise be available under UK law.

Overall, however, there is another issue that figures prominently in our analysis. The vast majority of Chinese investment in the UK is made from or via Hong Kong. To the extent there is a political and economic cost associated with the grant of investment treaty rights to such investors, the UK has already incurred that cost under the UK-Hong Kong BIT. This means that the *additional* costs associated with an EU-China investment treaty are relatively low. In contrast, there is a significant stock of British investment in Mainland China that stands to benefit from the *additional* protection of an EU-China investment. To put these two stocks of investment in proportion, the stock of UK investment in Mainland China is over eight times the stock of investment that arrives in the UK from Mainland China (Table 1).

On this basis, we conclude that, as compared to the status quo, the benefits of an EU-China investment treaty to the UK are likely to exceed the costs, at least while the stock of UK investment in Mainland China remains much larger than the stock of investment in the UK made directly by entities incorporated in Mainland China. In short, an EU-China investment treaty is likely to be weakly beneficial from the perspective of the UK, but the balance of costs and benefits may become more neutral over time as the stock of Mainland Chinese investment in the UK increases.

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