

# International Trade and Investment Rules and State Regulation of Desalination Facilities

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This report reflects the views of its  
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## EXECUTIVE SUMMARY

The National Association of Attorneys General (NAAG) wrote to the chief U.S. trade negotiator in July 2003 stating that trade negotiations on water, wastewater, construction and other services “clearly implicate the entire scope of state police and regulatory power.” The lead author of that letter was Bill Lockyer, the Attorney General of California and then President of NAAG. In order to safeguard state regulatory power, he called for “a broader and deeper range of contacts [between trade negotiators and] a variety of state entities, and particularly those bearing regulatory and legislative authority ... over the next several years.”<sup>1</sup>

The California Coastal Commission has raised similar concerns about potential conflicts between trade rules and state regulatory authority, particularly with regard to desalination (or “desal”) facilities in the coastal zone. This paper examines the potential that international trade and investment rules could be used to challenge state regulatory permitting decisions concerning desalination projects, specifically those permitting decisions made by the state agencies designated as the primary agencies for implementation of coastal zone management programs pursuant to the Coastal Zone Management Act (“State Coastal Agencies”).<sup>2</sup> Many of the relevant trade and investment rules are phrased in extremely broad and vague terms and provide the international tribunals that interpret them with significant discretion in how they are applied. Accordingly, this paper does not attempt to reach definitive conclusions about the outcomes of any future challenges, but rather attempts only to identify the most likely areas of potential conflict and to explain what the legal implications of such conflicts would be. Some of the more important questions regarding the relationship between trade rules and State Coastal management regulatory authority are set out in text boxes throughout the paper. These questions could be posed to U.S. trade negotiators in order to clarify potential adverse impacts on the ability of a state to adequately protect its coastal zone.

There are two trends that suggest that the potential for conflicts between State Coastal Agencies’ regulatory authority and trade rules is increasing. First, desal facilities are part of a water service industry that is dominated by multinational corporations. For example, California-American Water Company is a subsidiary of Thames Water (UK) and RWE (Germany). European ownership brings local water service within the reach of international trade rules.

Second, the United States continues to aggressively pursue new trade agreements without clarifying the meaning of the rules that have the greatest potential for conflicting with State Coastal Agencies’ authority.

As discussed below, the two types of rules that present the greatest potential for conflict with regulation of desalination facilities are rules governing trade in services, such as those contained in the World Trade Organization (WTO)’s General Agreement on Trade in Services (GATS), and investment rules, such as those contained in Chapter 11 of the North American Free Trade Agreement (NAFTA).

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<sup>1</sup> Letter from Bill Lockyer and others, Natl. Assn. of Attorneys General, to Amb. Robert Zoellick, July 2, 2003.

<sup>2</sup> See 16 U.S.C. § 1455(d)(6).

## I. Regulation of Desalination Facilities and Rules on Trade in Services

Three agreements on trade in services currently apply to State Coastal Agencies' regulation of desalination facilities – GATS and bilateral free trade agreements (FTAs) with Chile and Singapore. GATS and the FTAs share a framework on how they limit governing authority.

- A. **General coverage of government measures.** First, the framework defines the general scope of the agreement as covering “commercial” rather than “government” services. However, “commercial” is defined so broadly as to cover both regulated private services and government service providers unless government provides the service exclusively and without charge.
- B. **Two levels of coverage.** Second, the framework applies two levels of rules to government measures –
  - 1. **A set of general trade rules** could apply to all measures that are covered by the agreement's general scope of coverage. The rules are still being negotiated at the WTO. In the context of regulating desal permits, these rules include:
    - a. **A transparency rule** that requires governments to publish their measures and notify the WTO of significant changes. This rule could affect unwritten procedures such as staff consultations for desal permits.
    - b. **Domestic regulation rules** that require governments to use objective criteria and limit measures to those that are no more burdensome (on the service provider) than necessary to ensure the quality of a service. This rule has the greatest potential impact of any of the services rules because some State Coastal Agencies function under a mandate that does not ensure the quality of water services; they ensure protection of the quality of coastal resources such as coastal access, recreation, scenic beauty, and biological productivity of ocean waters and the environment.
  - 2. **A set of additional trade rules** apply to negotiated commitments. GATS uses a positive (or “bottom-up”) list of commitments in specific service sectors. FTAs presume that all measures are covered except for those on a negative (or “top-down”) list of service sectors or levels of government that are excluded from coverage. The negotiated commitments are contained in attachments to the trade agreement – a “schedule of commitments” for GATS and “annexes” for the FTAs. The additional trade rules that could affect regulation of desal permits or water services include:
    - a. **Market access rules** that prohibit limits on the number of service providers or the total output, assets, number of employees or legal organization of a service provider. This rule could affect desal permit criteria that limit the number of facilities or the type of applicant for a permit.
    - b. **A national treatment rule** that prohibits discrimination against foreign service providers. It also prohibits nondiscriminatory measures that have the effect of changing conditions of competition to the disadvantage of a foreign service provider. Consequently, either a prohibition on foreign ownership of desalination facilities, or a prohibition on private ownership of desalination facilities which effectively precluded foreign ownership, could be challenged as a violation of the national treatment principle. This rule could also affect desal permit criteria that change conditions of competition by limiting or favoring certain technologies.

## II. Regulation of Desalination Facilities and Investment Rules

In addition to being challenged by another country under services rules, a State Coastal Agency's refusal to issue a permit for a desalination facility could also potentially be challenged by a multinational corporation under international investment rules, such as those contained in Chapter 11 of NAFTA.

- A. *Standing to invoke investment rules.*** In order to bring such a claim, the corporation would either have to (a) be a national of a country that is a party to an investment agreement with the United States, or (b) bring the claim through a subsidiary in a country that is a party to an investment agreement with the United States, and in which the corporation has “substantial business activities.”
- B. *Potential Conflicts.*** The provisions in investment agreements that could be found to conflict with State Coastal Agencies' authority regarding desalination facilities include the rules regarding *indirect expropriation*, *minimum treatment*, and *national treatment*.
- 1. *Indirect expropriation.*** A refusal to issue a foreign investor a permit for a desalination facility could be found to constitute an act of indirect expropriation if it were found to cause a “significant” or “substantial” adverse effect on the foreign corporation's “reasonably-to-be-expected economic benefit” from its investment. The relevant “investment” for the purposes of this analysis could be either the desalination project or a U.S. subsidiary of the investor that was managing the project.
  - 2. *Minimum treatment.*** Actions regarding a foreign-owned desalination project could also be challenged as a violation of the “minimum treatment” rule. Minimum treatment requires that foreign investors be provided with “fair and equitable” treatment. A leading commentator has described fair and equitable treatment as “an intentionally vague term, designed to give adjudicators a quasi-legislative authority . . . .” Accordingly, it is difficult to predict under what circumstances an international investment tribunal might determine that a State Coastal Agency's treatment of a foreign investor violated minimum treatment.
  - 3. *National treatment.*** As under services rules, national treatment as an investment rule prohibits both explicit and de facto discrimination against foreign investors, and could be used to challenge a preference for public ownership of desalination facilities or other measures that effectively made it more difficult for a foreign investor to receive a permit.
- C. *Exceptions and waivers.*** It has been suggested that State Coastal Agencies' actions regarding desalination facilities are not vulnerable to challenges under investment rules for two reasons. First, it has been argued that these actions fall under the “environmental exceptions” in trade agreements. Second, it has been suggested that State Coastal Agencies could require foreign investors to waive their rights under international investment rules as a condition of receiving permits for desalination facilities. Neither of these assertions is accurate.
- 1. *Environmental exceptions.*** Trade agreements typically contain exceptions for certain types of government action, including measures related to environmental protection. These exceptions, however, do not apply to investment rules.
  - 2. *Waivers.*** A government that enters into a contractual relationship with a foreign investor may require the investor to waive the right to have an international tribunal adjudicate any disputes concerning the contract. The government may

not, however, require a foreign investor to waive substantive rights under an international investment agreement in order to obtain a regulatory approval. Accordingly, a State Coastal Agency could not require a foreign investor to waive its rights under any applicable international investment rules in order to obtain a permit for a desalination facility.

### III. The Legal Effect of International Services and Investment Rules

- A. *International legal effect.*** If a State Coastal Agency were found to have violated provisions of an international services agreement, retaliatory tariffs could be imposed on the United States. If a State Coastal Agency were found to have violated an investment agreement, the United States could be required to pay damages. Under international law, the United States rather than the offending state is responsible for any violations of services or investment rules by the State's Coastal Agency. A complaint under services rules could be brought by a government that was a party to the relevant agreement through a process known as "state-to-state" dispute settlement. If an international dispute settlement panel concluded that a State Coastal Agency had violated a services rule, it could authorize the complaining country to impose retaliatory tariffs on the United States or take other actions to discriminate against United States companies.

Under investment rules, in contrast, an individual corporation could bring a challenge through a process known as "investor-to-state" dispute settlement. If the investor were to prevail in its claim, the United States would be required to pay the investor monetary damages.

- B. *Domestic legal effect.*** As a matter of United States law, restrictions and obligations that are adopted through international trade treaties do not preempt state law. Moreover, even a decision by an international tribunal holding that a State Coastal Agency had violated services or investment rules would not directly preempt the agency's rights or obligations under its enabling act or otherwise directly invalidate its action as a matter of United States law. The laws implementing trade and investment agreements, however, generally permit the federal government to sue to preempt state and local laws based on their inconsistency with trade rules. Accordingly, if a State Coastal Agency were found to have violated international services or investment rules, the federal government could sue to overturn the agency's action or to preempt the relevant portions of its governing statute. It is not clear whether the implementing legislation would also permit the federal government to sue the state for monetary damages to indemnify the federal government for any payments it is required to make to a foreign investor.

In addition, an adverse decision by an international tribunal could undermine a State Coastal Agency's authority in a variety of other ways. Congress could either preempt the relevant provisions of the agency's enabling act or condition federal grants to the state on the state's agreement to modify the way in which it interprets or enforces its laws. Even in the absence of any action by Congress, the prospect of federal preemption or the loss of federal funds could have a chilling effect that would cause state legislators to amend the state law in response to an adverse decision by an international tribunal.

### IV. Options for Dealing with Potential Conflicts

State Coastal Agencies have several options for responding to the potential conflicts between their regulation of desalination facilities and trade and investment rules, including –

- A. ***Do Nothing at this Time.*** There is no imminent threat of a trade dispute based on any of the potential conflicts noted above. However, if State Coastal Agencies wait until there is an imminent threat of a trade dispute regarding the relationship between international trade treaties and state laws implementing the Coastal Zone Management Act (“CZMA”) or state coastal law, it will likely be too late to influence the trade negotiations. The only option at that point would be to choose between enduring economic sanctions or repealing the allegedly noncompliant state measure.
- B. ***Oversee Trade Negotiations.*** State Coastal Agencies provide oversight by:
  - 1. ***posing questions to U.S. trade negotiators*** that will help to clarify the potential impact of trade rules on State Coastal Agencies’ regulatory authority, and
  - 2. ***identifying safeguards*** that would avoid the potential conflicts.

## I. SERVICES RULES

### A. Coverage of Agreements on Trade in Services

Desalination is a service. It requires a local facility to deliver the service of providing potable water. In the trade parlance, this is called a *commercial presence*, one of four types of service delivery.<sup>3</sup> Desalination (or desal) projects may also involve construction, engineering and environmental mitigation or monitoring services.

#### 1. The Relevant Agreements

Three agreements on trade in services currently apply to regulation of desalination facilities. They include the General Agreement on Trade in Services (GATS) and bilateral Free Trade Agreements (FTAs) with two countries – Chile and Singapore.

GATS is one of the 18 agreements under the World Trade Organization. It involves all 146 members of the WTO. While the GATS took effect in 1995, it has a built-in process of never-ending negotiations of two kinds. One is a set of negotiations to expand the trade rules on domestic regulation (explained below), government procurement and subsidies. The other is a process to expand the service sectors to which the trade rules apply.

The Chile and Singapore FTAs are being used as models for negotiating a growing number of bilateral and regional FTAs. In the absence of public text for the pending FTAs, our analysis below is based on the Chile model.

Two bilateral FTAs have been negotiated and await Congressional action – the Central American FTA and the Australia FTA. In addition, the United States is negotiating new FTAs that are based on the Chile FTA text. The next FTAs will be bilateral or cover small regions – including Panama, Morocco, Thailand, Bahrain, the Dominican Republic, the Andean nations, and the Southern African Customs Union. The largest and slowest-developing agreement is the Free Trade Area of the Americas (FTAA), which includes 34 countries.

The strategy of pursuing many negotiations, one after another, promotes incremental expansion of the scope of trade rules and incremental changes to strengthen trade rules. At first blush, the GATS negotiations would appear to pose a greater risk of trade conflict because they cover trade among 146 nations. On the other hand, the FTAs provide a vehicle to strengthen trade rules in ways that the WTO would not accept.

The FTAs also provide a vehicle to cover trade by multinational companies that are based in Europe or in other nations that are not part of the FTA. Specifically, the FTAs apply to “measures ... affecting the supply of a service ... *by an investor of the other party or a covered investment.*”<sup>4</sup> A clause in the FTAs titled “Denial of Benefits” provides that investors of the “other party” include corporations

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<sup>3</sup> The other delivery methods for “trade in services” are *cross border trade* (e.g., a U.K. accounting firm servicing a U.S. company), *consumption abroad* (e.g., U.S. tourists in Europe), and the temporary *movement of natural persons* (e.g., French acrobats performing in L.A.).

<sup>4</sup> U.S.-Chile Free Trade Agreement, June 6, 2003 (U.S.-Chile FTA), available at <http://www.ustr.gov/new/fta/chile.htm>, art. 11.3; U.S.-Singapore Free Trade Agreement, May 6, 2003 (U.S.-Singapore FTA), available at <http://www.ustr.gov/new/fta/singapore.htm>, art. 8.2 (emphasis added). See also U.S.-Chile FTA, art. 2.1 and Singapore FTA, art. 15.1(4) (covered investment); U.S.-Singapore FTA, art. 15.1(17) and U.S.-Chile FTA, art. 10.27 (investor of a party); and U.S.-Chile FTA, art. 2.1, U.S.-Singapore FTA, art. 15.1(8) (enterprise).

that are actually based in non-FTA countries (*e.g.*, European countries) or the United States, so long as they have “substantial business activities” in the FTA-party country.<sup>5</sup>

For example, the FTAs enable a multinational company like RWE (Germany) to set up a subsidiary in Chile, which owns or operates a desal facility in California. RWE’s Chilean subsidiary could ask Chile to challenge California measures under the Chile FTA. Chile can press the claim under the FTA so long as the RWE subsidiary engages in *substantial business activities* in Chile. The text of the FTA does not define substantial business activities, and it is premature to gauge the ability of multinationals to influence Chile or another FTA-member.

#### Oversight Question

- **Multinational subsidiaries.** What is the threshold for a company foreign to Chile or Singapore to establish “substantial business activities” thereby earning the same trade rights as a corporation domestic to Chile or Singapore?

To summarize, the GATS and FTA negotiations on trade in services seek to strengthen trade rules and expand the participating countries and investors who are covered by the trade rules. While the negotiations threaten to adversely affect state regulation of services, they also present a series of opportunities for state and local governments to assess the threat and seek safeguards for their governing authority.

## 2. General Framework of Trade Rules and What They Cover

GATS and the FTAs share a framework for how they limit the authority of governments to regulate services.

**General coverage of government measures.** First, the framework defines the general scope of the agreement as covering “commercial” rather than “government” services. However, “commercial” is defined so broadly as to cover both regulated private services and government service providers unless government provides the service exclusively and without charge.

**Two levels of coverage.** Second, the framework applies two levels of trade rules to government measures –

- **A set of general trade rules** apply to all measures that are covered by the agreement’s general scope of coverage. In the context of regulating desal permits, these rules include:
  - **A transparency rule** that requires governments to publish their measures and notify the WTO of significant changes. This rule could affect unwritten procedures such as staff consultations for desal permits.
  - **Domestic regulation rules** that require governments to use objective criteria and limit measures to those that are no more burdensome (on the service provider) than necessary to ensure the quality of a service. This rule has the greatest potential impact because some State Coastal Agencies function under a mandate that is not involved in regulating the quality of water services; instead, they ensure the quality of coastal resources such as public coastal access, recreation, scenic beauty, biological productivity of coastal waters, and the environment.
- **A set of additional trade rules** apply to service sectors with respect to which a member state has negotiated commitments. GATS uses a positive (or “bottom-up”) list of commitments in specific service sectors. FTAs presume that all measures are covered except for those on a negative (or “top-down”) list of service sectors or levels of

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<sup>5</sup> U.S.-Chile FTA, art. 11.11(2); *see also* U.S.-Singapore FTA, art. 8.11(b).

government that are excluded from coverage. The negotiated commitments are contained in attachments to the trade agreement – a “schedule of commitments” for GATS and “annexes” for the FTAs. The additional trade rules that could affect regulation of desal permits or water services generally include:

- **Market access rules** that prohibit limits on the number of service providers or the total output, assets, number of employees or legal organization of a service provider. This rule could affect desal permit criteria that limit the number of facilities or the type of applicant for a permit.
- **A national treatment rule** that prohibits discrimination against foreign service providers. It also prohibits nondiscriminatory measures that have the effect of changing conditions of competition to the disadvantage of a foreign service provider. This rule could affect desal permit criteria that change conditions of competition by limiting or favoring certain technologies.

The remainder of this section provides more detail on this framework of coverage – the general scope of measures covered and the additional negotiated commitments. Before diving in, we want to note why it is worth learning about such a complex international system that may seem far-removed from regulation of local desal permits. The GATS and FTA rules on trade in services are designed to limit governing authority in areas that states traditionally regulate (*e.g.*, coastal development) or in services that local governments traditionally provide (*e.g.*, water and wastewater services). This may seem odd to an American public official. But many other countries handle these functions at the national level. To them, our complex federal system with 50 states and hundreds of home-rule cities and counties is a chaotic system that throws up countless “government measures” that pose “technical barriers to trade.”

The GATS and FTA framework for coverage of government measures is complex, to be sure. But each part of the system is still being interpreted or negotiated, which means that there will be a series of opportunities over the next decade for state and local officials to limit the meaning of the trade rules or the scope of measures that the trade rules cover.

#### **a. General Coverage of Government Measures**

The preamble of the GATS recognizes “the right of Members to regulate, and to introduce new regulations, on the supply of services within their territories.”<sup>6</sup> However, preamble statements merely provide context for interpreting the text;<sup>7</sup> they do not safeguard measures that are otherwise covered by trade rules in the text of the agreement.

A conflict between state law and a trade rule is possible only if the trade agreement covers the state measure. Once it does, the general trade rules – such as transparency and domestic regulation – automatically apply.

Both GATS and the FTAs cover government measures that affect trade in services. As noted above, measures that regulate development of desal facilities affect several sectors of services – for example, construction, mitigation of environmental harms, and provision of water services. GATS and the FTAs define these as services provided through the commercial presence of a multinational service provider or investor. The foreign ownership of the service provider is what makes the service international.

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<sup>6</sup> GATS preamble, paragraph 4.

<sup>7</sup> See Sinclair and Grieshaber-Otto, “Facing the Facts: A Guide to the GATS Debate,” Canadian Centre for Policy Alternatives (2002) at 41-44 (Facing the Facts). In international law, treaty provisions are interpreted based on their plain text, with preamble statements going to show the context for interpreting that plain language. See Vienna Convention on the Law of Treaties at Article 31(1), *available at* <http://www.un.org/law/ilc/texts/treaties.htm>.

A “measure” is any exercise of governing authority – *e.g.*, a law, an agency regulation, a permit decision, a procedure – at any level of government, national, state or local. The following subsections explain what measures are not covered, the levels of government that are covered, and the two-tiered framework for how “general” and “specific” trade rules apply to different service sectors.

GATS and the FTAs cover all measures except those affecting “services supplied in the exercise of governmental authority.”<sup>8</sup> This exclusion only applies when both (1) the government is not supplying the service “on a commercial basis” and (2) when the service supply is not “in competition with one or more service suppliers.”<sup>9</sup>

The WTO Secretariat has asserted that this government authority exclusion means that none of the trade rules apply to a service if a government provides it.<sup>10</sup> It has also, however, interpreted commercial basis to cover all services except those supplied “directly through the government, free of charge.”<sup>11</sup> Thus, according to the WTO Secretariat, charging a fee—even a subsidized fee—means that the service is covered.<sup>12</sup> For example, a government-metered water service operates on a commercial basis. And,

“if services [are] deemed to be supplied on a commercial basis, then, regardless of whether ownership was in public or private hands, the sector would be subject to the main GATS rules and to the negotiation of commitments [for application of specific rules].”<sup>13</sup>

This is not a legally binding interpretation; it is just the opinion of WTO staff. Nonetheless, it suggests that the government authority exclusion will not protect desalination because even government agencies charge end-users for the desalinated water they consume.<sup>14</sup> Canada appears to share this view because it included safeguards for all public services in its GATS commitments.<sup>15</sup>

While desal permits are likely to be covered by trade rules, state and local officials could seek to clarify and limit the vague standard for the level of competition that triggers the government authority exclusion. Alternatively, they could use the vagueness of that standard to press for exclusion of government levels or agencies altogether.

## **b. Additional Coverage under Negotiated Commitments**

While the general trade rules (transparency and domestic regulation) could apply to measures within the general scope of the agreements, there are additional rules that apply within a service sector in which there is a negotiated commitment. For services that multinational corporations provide through a

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<sup>8</sup> GATS, art. I:3 (b and c).

<sup>9</sup> *See id.*

<sup>10</sup> WTO Secretariat, “GATS–Fact and Fiction,” (2001) *available at* [http://www.wto.org/english/tratop\\_e/serv\\_e/gats\\_factfiction\\_e.htm](http://www.wto.org/english/tratop_e/serv_e/gats_factfiction_e.htm), at 10.

<sup>11</sup> Background Note by the WTO Secretariat, “Health and Social Services,” WTO Doc. S/C/W/50 (98-3558), September 18, 1998, at 10, No. 37-39.

<sup>12</sup> Background Note by the WTO Secretariat, “Postal and Courier Services,” WTO Doc. S/C/W/39 (98-2436), June 12, 1998, at 2.

<sup>13</sup> Background Note by the Commission, “Environmental Services,” WTO Doc. S/C/W/46 (98-2690), July 6, 1998, at 14.

<sup>14</sup> Facing the Facts at 17-25.

<sup>15</sup> Canada, “Schedule of Specific Commitments,” WTO Doc. GATS/SC/16 (94-1015), April 15, 1994, at 3 (Horizontal Commitments).”

commercial presence, the additional rules are market access (GATS and FTAs) and national treatment (GATS only).<sup>16</sup>

First negotiated in 1994, GATS uses a “positive list” approach to making commitments. Each country specifically lists the categories of regulations that will be covered by selecting service sectors. The resulting list is called the *schedule of commitments*. For example, the United States made no commitment for water services in 1994, but the European Union is now asking it to do so.<sup>17</sup> In exchange, the E.U. might offer a reciprocal commitment that the United States is seeking – for example, a commitment in electricity or entertainment services. The current round of negotiations is scheduled to finish at the end of 2004, although the WTO may extend that deadline.

When countries make their GATS commitments, they can also limit those commitments so that they do not apply to state or local laws. These limits can apply to individual listed laws, the effect of which is to grandfather that law but freeze its further development. Limits on commitments can also apply to a broad category of laws, which preserves future lawmaking in that category. As noted above, Canada limits its GATS commitments on regulation of commercial presence by stating, “the supply of a service, or its subsidization within the public sector is not a breach of this commitment.”<sup>18</sup> Because this limit applies across all service sectors, it is called a “horizontal” limit.<sup>19</sup>

The FTAs negotiations use a “negative list” approach. The FTAs presume that the additional commitments apply in a “top down” fashion unless a country states that it does not. These negative lists of measures of FTA countries are contained in the following annexes to the agreements:

- ***The grandfather annex.*** The FTAs provide “Annex I” to enable countries to list existing nonconforming measures that the countries want to safeguard. Annex I is a way to “grandfather” nonconforming measures, but it also freezes future lawmaking for the measures listed, and the annex creates an agenda for future negotiations to roll back the nonconforming measures. Annex I does not grandfather measures from the general trade rules – transparency and domestic regulation; countries can only use Annex I to limit commitments on market access and national treatment.
- ***Future law-making annex.*** The FTAs also provide “Annex II” to enable countries to list types of measures for which they want to safeguard future lawmaking as well as existing laws. Annex II is a true safeguard, but it also creates an agenda for future negotiations to roll back the nonconforming measures. Like Annex I, Annex II does not exclude measures from the general trade rules – transparency and domestic regulation. Countries can only use Annex II to limit commitments on market access and national treatment.

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<sup>16</sup> The FTAs apply national treatment to measures affecting cross-border trade in services, but not commercial presence, which is the type of service involved with constructing or operating a desal facility. See U.S.-Chile FTA, art. 11.1.

<sup>17</sup> See European Union, “GATS 2000: Environmental Services,” WTO Doc. S/CSS/W/38 (00-5633), December 22, 2000, at 2 (request for reclassification to include “water for human use & wastewater management”); see also “Request from the EC and its Member States to the United States of America: Water for Human Use and Wastewater Management,” available at <http://216/18/14/226/Usa.htm/> (request to commit water services), Gould, Ellen “Water in the Current Round of WTO Negotiations on Services,” Canadian Centre for Policy Alternatives (January 2003) at 2 (Gould).

<sup>18</sup> Canada, “Schedule of Specific Commitments,” WTO Doc. GATS/SC/16 (94-1015), April 15, 1994, at 3 (Horizontal Commitments).”

<sup>19</sup> A vertical limit on a commitment would apply to only one service sector, a vertical column on the schedule of commitments.

To summarize, countries use their GATS schedule and FTA annexes to record their commitments or non-commitments to market access rules (GATS/FTAs) and national treatment rules (GATS only). Negotiators also use the schedule and annexes to record limits on commitments, which safeguard state and local measures. However, a note of caution is appropriate even if the United States were to exclude an entire level of government or a state agency. The exclusion would only apply to limit the commitments on market access and national treatment. In order to safeguard state measures from the general trade rules, negotiators would have to either make the coverage of general rules negotiable or limit the terms of those rules. Negotiations on the latter are still active as explained further below.

### **i. Levels or Agencies of Government**

Both GATS and the FTAs cover lawmaking at all levels of government – national, state and local.<sup>20</sup> As a general provision on coverage, the FTAs do not apply market access rules to local measures that existed at the time of the agreement.<sup>21</sup> (The FTAs still apply the general trade rules – transparency and domestic regulation – to all local measures.) In effect, existing local measures are “grandfathered” with respect to market access. The lesson here is that if an FTA can generally grandfather all local measures, it could do the same for state measures.

It is also possible to use the process for negotiating specific commitments to exclude or “carve out” entire subnational levels of government from coverage under particular trade rules. This is easiest to explain under the FTAs, but the lesson applies to GATS negotiations as well.

In the Chile FTA Annex I, the United States had the option of grandfathering *any* state (“regional”) measure with respect to market access rules. Moreover, the United States could have excluded any level of government (or any individual state or local government) by listing them in Annex II.<sup>22</sup> Thus far, U.S. trade negotiators are not willing to exclude an entire level of government with respect to future lawmaking authority. This would be a much broader safeguard than merely to grandfather existing measures.

There are also less dramatic options for excluding parts of state or local government. For example, in the Government Procurement Agreement of the WTO and the procurement chapter of the FTAs, the United States has included some states and excluded others. Even for individual states, the United States has included some agencies and excluded others.<sup>23</sup> A similar approach could be to list certain state agencies such as those implementing the CZMA as excluded from coverage under both GATS and the FTAs. This could be done either across the board (“horizontally” in GATS parlance) or with respect to specific sectors such as water, construction or environmental services.

### **ii. Service Sectors**

As noted above, the United States has negotiated additional commitments under GATS based upon a “positive list” of sectors and subsectors in the U.S. schedule of commitments. Desalination is not a service category *per se*. Rather, there are generic services in the GATS schedule that are linked with stages of the development of a desal facility –

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<sup>20</sup> See U.S.-Chile FTA, art. 11.2(b), 11.3.

<sup>21</sup> U.S.-Chile FTA, art. 11.6(a)(ii).

<sup>22</sup> U.S.-Chile FTA, art. 11.6 (2); U.S.-Singapore FTA, art. 8.7. See also U.S. House Ways and Means Cmte., “U.S.-Singapore Free Trade Agreement—Impact on State Governments” at paragraph 8, “U.S.-Chile Free Trade Agreement—Impact on State Governments” at paragraph 8. Market Access will be discussed in more detail shortly.

<sup>23</sup> See U.S. Annex 2, WTO Doc. WT/Let/431, October 16, 2002; U.S.-Chile FTA at pp. 9-26 to 9-30.

- *Construction services* – e.g., a service provider designs and builds the facility.
- *Mitigation services* – e.g., during and after construction, a service provider mitigates environmental harm that construction or operation of the facility might have on the coastal environment.
- *Water and wastewater services* – e.g., the operator of the plant provides water services as a principal output of the facility. The United States has offered to expand its commitment from “sewerage” services to “wastewater,” which would take affect if Congress approves the current round of negotiations. A wastewater commitment could cover desalination because the process produces concentrated brine, which must be disposed as waste.

However, to the extent that State Coastal Agencies are charged with regulating any of these sorts of activities as part of their implementation of the CZMA, any attempt to exercise such regulatory authority in the context of the creation and operation of a desalination facility could subject the agencies to questions regarding the consistency of their actions with GATS provisions on market access and national treatment.

On the surface, the GATS “positive list” categories are not relevant to negotiated FTA commitments. This is because the FTAs apply market access rules to all services unless the United States decides to exclude a particular measure in its “negative list” appendix.<sup>24</sup> However, the United States has linked its FTA commitments with its GATS commitments by including the following language in Annex II – “The United States reserves the right to adopt or maintain any measure that is not inconsistent with the United States’ obligations under Article XVI [Market Access] of the General Agreement on Trade in Services.”<sup>25</sup> A reasonable translation is that whatever non-commitments or limits on commitments that the United States makes in its GATS schedule under market access will apply to exclude measures from the FTA as well.

#### Oversight Question

- **FTA market access.** In the Chile and Singapore FTAs, the U.S. Annex II provides that the United States reserves the right to adopt or maintain measures that are “not inconsistent” with U.S. obligations under GATS market access. Does this operate to keep the market access commitments of the FTAs in sync with GATS commitments?

In short, the following analysis of service categories applies to both GATS and the FTAs. The purpose of the analysis is twofold. First, it identifies categories of state measures that the agreements cover. Second, in doing so, it reveals the mechanism for excluding state measures from market access and national treatment coverage in the ongoing negotiations. However, we want to repeat the note of caution – even if a measure is excluded from market access coverage, the general trade rules still apply. Excluding a measure from general coverage requires a different safeguard, which we discuss in Section B(1).

<sup>24</sup> See U.S.-Chile FTA, art. 11.6; U.S.- Singapore FTA, art. 8.7.

<sup>25</sup> U.S.-Chile FTA at II-U.S.-7; U.S.-Singapore FTA, at 8A-United States-15.

## Water Services

Desalination falls under the “water services” category in the GATS schedule of commitments, which is not included in the current U.S. schedule of commitments; nor is it covered indirectly by another commitment. This may not always be the case in the future. Multinationals based in Europe seek to expand their U.S. market in water services, and the European Union has requested that the United States commit the sector.<sup>26</sup> The United States may or may not agree to Europe's demand as part of a future trade deal. The United States has asserted that it will not currently commit water under the GATS but was unwilling to promise to refuse future requests from GATS parties.<sup>27</sup>

## Sewage and Wastewater Services

The United States has an existing GATS commitment in “Sewage Services,” which probably does not apply to desal facilities. Sewage services appear to be limited to processing wastewater from households or industry collected by sewer systems.<sup>28</sup> The current U.S. offer for the GATS negotiations replaces the old category of “sewage services” with “wastewater management excluding water for human use: Wastewater services.”<sup>29</sup> This change may bring desalination facilities into GATS coverage.<sup>30</sup>

### Oversight Questions

- **Water commitment.** Will U.S. negotiators promise not to commit water services under GATS in current and future rounds of negotiations?
- **Wastewater sector.** Is handling the brine discharge of a desal facility classified under the GATS schedule as “wastewater services,” “water for human use,” or both?
- **Services contracted by private industry.** The United States limits its present commitment for sewage services and its proposed commitment for wastewater services to services “contracted by private industry.” Does “contracted by” refer to private contractors that provide services to another private industry, private contractors that provide services to government agencies (sometimes referred to as public-private partnerships), or both?

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<sup>26</sup> See RWE, “Strategy,” available at <http://www.rwe.com/generator.aspx/templateId=renderPage/id=800>; Suez Annual Report, 2000, available at [http://www.suez.com/documents/english/annual\\_report\\_2000.pdf](http://www.suez.com/documents/english/annual_report_2000.pdf).

<sup>27</sup> USTR, Fact Sheet “Free Trade in Services: Opening Dynamic New Markets, Supporting Good Jobs,” March 31, 2003, available at <http://www.ustr.gov/sectors/services/2003-03-31-services-tradefacts.pdf>, at 3; Memorandum from Robert Stumberg on meeting with Peter Collins, Director of Services Negotiations, Office of U.S. Trade Representative, and the board of directors of the Association of Metropolitan Water Agencies (AMWA), September 10, 2002 (on file at the Harrison Institute).

<sup>28</sup> While “sewage services” is not specifically defined in the original U.S. schedule of commitments, the definition of “sewage” seems to be similar to the colloquial use of the term. CPC Prov. Code 94010 found at <http://unstats.un.org/unsd/cr/registry/regcs.asp?Cl=9&Lg=1&Co=94010>. The provision’s Explanatory Note states as follows: “Sewage removal, treatment and disposal services. Equipment used are waste pipes, sewers or drains, cesspools or septic tanks and processes utilized may be dilution, screening and filtering, sedimentation, chemical precipitation, etc.”

<sup>29</sup> USTR, “The United States of America—Initial Offer,” March 31, 2003, available at [http://www.ustr.gov/sectors/services/2003-03-31-consolidated\\_offer.pdf](http://www.ustr.gov/sectors/services/2003-03-31-consolidated_offer.pdf) (Services Offer) at 59.

<sup>30</sup> The U.S. Services Offer does not specifically define either “wastewater management” or “water for human use.” *Services Offer* at 59. However, the Services Offer’s nomenclature is very similar to that provided by the EU in its proposed revision to the GATS classification scheme for environmental services. See Communication from the EU, “Classification Issues in the Environmental Sector,” WTO Doc. S/CSC/W/25 (99-4001), September 28, 1999, at 3; Communication from the EU, “GATS 2000: Environmental Services,” WTO Doc. S/CSS/W/38 (00-5633),

Desalination facilities produce and discharge large quantities of concentrated and possibly polluted brine as a byproduct of the operation. The present text of the U.S. offer on services does not make clear whether this brine discharge is part of the service of producing “water for human use,” or rather falls under the “wastewater services” commitment.

Further adding to the complexity is the possibility of co-location of desalination facilities with existing power plants to share water intakes, heat exchange, and to dilute the brine discharge by mixing desalination effluent and plant cooling water. Desalination facilities that co-locate in this manner may desalinate part of the power plant’s water discharge before releasing it into the environment. This discharge is arguably wastewater from production of electricity.

The U.S. offer on services does not clearly indicate whether desalinating this cooling water is a wastewater service (as output of the power plant), the production water for human use (as input for desalination), or both. As such, if the United States agrees to change the current sewage commitment to wastewater as requested by the European Union, desalination might be committed inadvertently.

Finally, both the present sewage services commitment and the proposed wastewater services commitment limit coverage to services “contracted by private industry.”<sup>31</sup> However, the schedules do not make clear whether this commitment includes such entities as public-private partnerships, nor whether this phrasing gives GATS coverage to situations where the government purchases services by contract from a private entity.<sup>32</sup>

The change from “Sewage” to “Wastewater services”, could expand the scope of GATS coverage to cover a wide range of CZMA-related measures dealing with restricting wastewater discharges harmful to the aquatic ecosystem and with spillage of hazardous substances.

### Construction Services

The United States has specifically committed construction services.<sup>33</sup> The construction services commitment specifically excludes “Marine Dredging” from the overall commitment.<sup>34</sup> The U.S. schedule of commitments does not clarify whether this exclusion only covers removal of the seabed’s top layers or if it covers more extensive reshaping of the seabed. Thus, while there is some uncertainty regarding dredging,<sup>35</sup> GATS presumably covers most of construction relevant to developing a desal facility. To the extent that a

#### Oversight Question

- **Construction sector.** Under a commitment in the construction sector, does GATS cover only regulation of foreign construction companies, foreign companies that that hire domestic construction companies, or both?

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December 22, 2000, at 6. These EU submissions both define “waste water services” as including “removal, treatment and disposal of ... commercial and industrial ... waste waters.” *Id.*

<sup>31</sup> The other relevant commitment limitation, applying to both the sewage service and wastewater services, is found at footnote 19 in the U.S. schedule of commitments, and footnote 21 on the proposed new schedule. Services Offer at 59, footnote 21. This limitation appears to have no effect in the context of brine discharge handling; both “implementation and installation of new...systems for environmental cleanup, remediation, prevention and monitoring” and “implementation of environmental quality control and pollution reduction services” are committed, either of which is likely to cover brine discharge handling —although this is not absolutely certain.

<sup>32</sup> This latter problem is important for desalination, as this might indicate coverage where a public water utility is purchasing desalinated water from a private desalination plant.

<sup>33</sup> See Services Offer at 56.

<sup>34</sup> See Services Offer at 56.

<sup>35</sup> See *Draft Desalination Report* at 42-45.

State Coastal Agency's charge may involve regulation of construction services, such regulation of the construction sector<sup>36</sup> would be covered by the GATS commitment.<sup>37</sup>

In defining construction services, the WTO Secretariat seems to distinguish between the construction service provider and the party who hires it to build the project, although this reading is not certain.<sup>38</sup> This distinction may mean that another country's ability to challenge a construction measure under GATS would depend on whether the construction is done by a U.S. firm or a firm based in the other country.

### Other Environmental Services

The United States has specifically committed the category of "Other Environmental Services," which includes "Nature and landscape protection services."<sup>39</sup> The U.S. schedule of commitments includes a footnote that limits the scope of this commitment to "implementation and installation of new or existing systems for environmental cleanup, remediation, prevention and monitoring" and "implementation of environmental quality control and pollution reduction services."<sup>40</sup> There is no definition of "system," so implementation of a system could be the beginning of a process or manual labor. "Installation" suggests fixtures or temporary equipment.

#### Oversight Question

- Regarding the U.S. commitment to "other" environmental services, footnote 19 in the U.S. schedule refers to "new and existing systems" for remediation, mitigation and monitoring. Do the environmental services related to developing and operating a desal facility constitute a "system" for purposes of GATS coverage?

The USTR released an offer to clarify and expand this commitment to include:

1. Remediation and cleanup of soil and water: Treatment, remediation of contaminated, polluted soil and water;
2. Protection of biodiversity and landscape: Nature and landscape protection services; and
3. Other environmental and ancillary services: Other services not classified elsewhere.<sup>41</sup>

Many State Coastal Agencies implementing the CZMA are statutorily mandated (by the state law under which they function) to protect a broad range of coastal zone resources (*e.g.*, public access, agriculture, urban-rural boundaries, scenic resources, land and water habitats). Such measures regularly

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<sup>36</sup> Examples of relevant regulations are "controls on land use, building regulations...building permits...[and] environmental regulation," with aims as diverse as "implement[ation] of urban and land use planning...[and] environmental quality." Background Note by the WTO Secretariat, "Construction and Related Engineering Services," WTO Doc. S/C/W/38 (98-2325), June 8, 1998, at 5.

<sup>37</sup> See, *e.g.*, European Union, "GATS 2000: Construction and Related Engineering Disciplines," WTO Doc. S/CSS/W/36 (00-5629), December 22, 2000, at 3.

<sup>38</sup> The WTO Secretariat speaks of "contractors who ... work for the proprietor of the project," *id.* at 4, and the standard classification system for GATS discusses construction services as "work ... carried out either by general contractors ... for the owner of the project, or on own account." CPC Prov. Code 51 ("Construction Work").

<sup>39</sup> The WTO defines this sector to include "services ..., including natural disaster assessment ...and landscape protection services not elsewhere classified." Note by the WTO Secretariat, Services Sectoral Classification List, WTO Doc. MTN.GNS/W/120 (98-0000), July 10, 1991; CPC Prov. Code 94060.

<sup>40</sup> See footnote 19 in the U.S. schedule of commitments and footnote 21 on the proposed new schedule; Services Offer at 59, footnote 21.

<sup>41</sup> See Services Offer at 60-62.

require the employment of mitigation measures, environmental restoration, or environmental cleanup, or else they require minimization of environmental impact in development during both the construction and the operation of the desalination plant.

To summarize, the following chart shows the status of existing commitments and current negotiations with respect to sectors that relate to regulation of desal facilities.

### Negotiated Commitments that Affect Regulation of Desal Facilities

Service Sectors	Status of U.S. Commitments	
	Existing (1994 round)	Pending (2004 round)
<b>Water services</b>	No	Request by EU
<b>Sewage / wastewater services</b>	Yes – services contracted by industry	Request by EU to cover “wastewater”
<b>Construction services</b>	Yes	Retained
<b>Other environmental services</b>	Yes – implement remediation systems	Retained

### B. Services Rules and Potential Conflicts

As noted above, GATS and the FTAs share a common framework of trade rules and coverage that applies them to state measures.

- **General rules** – that could apply to all measures covered by the agreement. These rules include transparency and domestic regulation.
- **Additional rules** – that apply based on specific commitments, either the positive list approach of GATS or the negative list approach of the FTAs. The additional rules that are relevant to regulation of desal facilities include market access and national treatment.

This part of our paper explains these trade rules and identifies potential conflicts with regulation of desal facilities by State Coastal Agencies. As the following chart illustrates, GATS and the FTAs apply the same rules to regulation of services that are provided through commercial presence in California, except that only GATS applies national treatment.<sup>42</sup>

<sup>42</sup> U.S.-Chile FTA, art. 11.1(3), U.S.-Singapore FTA, art. 8.2(2).

## Trade Rules Relevant to Regulation of Desal Facilities

GATS Rules	FTA Rules <sup>43</sup>
General Rules- apply to all measures	
Transparency	Transparency
Domestic Regulation	Domestic Regulation
Additional Rules - coverage is negotiated	
Market Access	Market Access
National Treatment	Not applicable to commercial presence

In this part of the paper, we describe each of these trade rules, which are almost identical in GATS and the FTAs. We then analyze whether State Coastal Agencies are likely to exercise their authority to regulate desalination facilities in a manner that conflicts with the rule based upon its plain language and available interpretations.

### 1. General Rules

#### a. Transparency

The GATS transparency rule requires government authorities to publish measures that affect trade in services and to report annually to the WTO any major changes to those measures.<sup>44</sup> Each country must designate a contact point for questions regarding measures affecting trade in services and respond promptly.<sup>45</sup> The FTA transparency rules are much more detailed and invite foreign comment into the legislative process.<sup>46</sup> The FTA transparency requirements mandate regulatory practices similar to what is found in the U.S. Administrative Procedure Act: notice and comment rulemaking with impartial review available for the results.<sup>47</sup>

The transparency rule is designed to ensure that measures affecting trade in a particular service are publicly available. Public access to the measures and the decision-making process informs potential investors or service suppliers of the level of regulation, in this case, the criteria for attaining approval for desal facilities in the coastal zone. This sets expectations and provides the basis for deciding whether to enter a services market.

One could therefore make an argument that State Coastal Agencies' permitting processes would conflict with the transparency rule if they:

- use broad criteria,

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<sup>43</sup> Please note that this only refers to the trade rules applied to desalination under the FTAs' services chapters. Trade rules applied under the FTAs' investment chapters may still apply.

<sup>44</sup> GATS, art. III: 1, 2, 3.

<sup>45</sup> GATS, art. III: 4. The U.S. Trade Representative is the designated contact person for the United States.

<sup>46</sup> Please note that the FTA transparency discipline is split between the Services chapter and a separate, general transparency chapter. *See* U.S.-Chile FTA art. 11.7, U.S.-Singapore FTA, art. 8.12.

<sup>47</sup> *See id.*; *see also* Chile FTA Chapter 20; Singapore FTA Chapter 19; 5 U.S.C. §551 *et. seq.*

- review permit applications on a case by case basis, and
- impose mitigation measures in unique, site-specific ways.

However, it is difficult to predict the likelihood of conflict because the transparency rule itself is so general.

### **b. Domestic Regulation**

Domestic regulation sets standards for the legitimacy of government measures related to “qualification requirements and procedures, technical standards and licensing requirements.”<sup>48</sup> Domestic regulation is a set of several trade rules, which require that measures must be:

- (a) “based on *objective and transparent* criteria,”
- (b) “*no more burdensome than necessary* to ensure *the quality of the service*,” and
- (c) if a *licensing procedure*, “not in itself a restriction on the supply of the service.”<sup>49</sup>

GATS also includes some trade rules relating to appeal and review of decisions under domestic regulation, which the FTAs instead place under the transparency rule.

The FTA rules on domestic regulation are currently effective for all measures covered by the FTAs. The GATS rules on domestic regulation under Article VI:4 are still being negotiated in a WTO working group. The rules will apply to all services after the WTO’s Council on Trade in Services develops the final text.<sup>50</sup> Until then, GATS applies these requirements under Article VI:5 only to service sectors for which there is a negotiated commitment.<sup>51</sup>

#### **Oversight Question**

- **U.S. position.** Will the United States oppose implementing the domestic regulation rules to cover all services? Will the United States support limiting domestic regulation rules to only committed sectors?

Article VI:5 restricts “licensing and qualification requirements and technical standards” that negatively affect committed service sectors, but only to the extent that the measures “could not reasonably have been expected of that Member at the time the specific [GATS] commitment in those sectors were made.”<sup>52</sup> The WTO Secretariat interprets this “unexpected measure” requirement as a grandfather clause “exempt[ing] at least those measures which were already in place in 1995.”<sup>53</sup>

Based on this interpretation, State Coastal Agencies acting under authority of an enabling act adopted prior to 1996 should be exempt under this provision. Moreover, statements made prior to 1996 that provide guidance as to how such State Coastal Agency will handle permit applications for desalination plants arguably provided service providers with additional notice about the application of pre-1996 laws to desalination facilities. Accordingly, the GATS domestic regulation rules regarding licensing and qualification requirements and technical standards probably would not apply to desalination facilities in such states until the WTO implements Article VI:4.

<sup>48</sup> GATS, art. VI:2.

<sup>49</sup> GATS, art. VI:4 (emphasis added); U.S.-Chile FTA, art. 11.8; U.S.-Singapore FTA, art. 8.8.

<sup>50</sup> Note by the WTO Secretariat, “Article VI:4 of the GATS: Disciplines on Domestic Regulation Applicable to All Services,” WTO Doc. S/C/W/96 (99-0769), March 1, 1999, at 4 (Disciplines on Domestic Regulation).

<sup>51</sup> Disciplines on Domestic Regulation at 3.

<sup>52</sup> See GATS, art. VI:5.

<sup>53</sup> Disciplines on Domestic Regulation at 3.

If state and local governments become actively involved in oversight of trade negotiations they still have time to influence the content of trade rules and the scope of measures to which the rules will apply. The WTO is still negotiating the GATS rules on domestic regulation, and Congress has approved only two of the many FTAs being negotiated. Many FTAs are still on the drawing board. Among the options for safeguarding state and local measures are these –

- **GATS.** The United States could just say “no” to implementing the rules in GATS Article VI:4. However, U.S. negotiators have already implemented these rules in two FTAs, which indicates their aim to do so in GATS as well. U.S. negotiators have several other options that would safeguard state and local measures in varying degrees, including–
  - limiting the reach of domestic regulation rules by limiting the scope of the “qualification,” “technical” and “licensing” requirements to which the rules apply,
  - limiting the application of domestic regulation rules to only those sectors in which the United States has a negotiated commitment (which is the *status quo* under GATS Article VI:5), and
  - expanding the scope of legitimate public purposes for measures that affect trade in services.
- **FTAs.** U.S. negotiators have all of the above options with respect to the FTAs.<sup>54</sup> As noted above in the section on coverage, the FTA negotiators can also change a few words to apply the negative list in Appendix II to the general trade rules. This would enable the United States to exclude certain levels of government, state or local agencies, service sectors or types of measures from coverage under domestic regulation rules.

#### **i. Objective and Transparent Criteria**

The first rule under domestic regulation requires that governments base their decisions on objective and transparent criteria. This is a substantive requirement, which is distinct from the procedural requirements of transparency under Article III. The precise requirements of this standard are yet undefined. The United States provides a possible explanation of the standard – “to specify and make publicly available measures relating to the criteria to obtain such a license or qualification and the *terms and conditions under which it is offered or revoked.*”<sup>55</sup> The measures most likely to violate objective and transparent criteria are those with no standards or vague standards.

Any State Coastal Agency that applies broad policies to individual applications on a case-by-case basis could be accused of acting in conflict with the objective and transparent criteria rule. Any time policies are applied in a flexible manner, on a case by case basis, and not pursuant to specific codified guidelines, there is a risk that such action could be interpreted as violating the rule on objective and transparent criteria.

The risk of conflict occurs on two levels. The first level is simply that the criteria for deciding on permits are often general and arguably do not provide enough guidance as service suppliers seek to gain

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<sup>54</sup> Article 11.8.3 of the Chile FTA provides that if the WTO completes negotiations under GATS Article VI:4, then “this Article shall be amended, as appropriate, after consultations between the Parties, to bring those results into effect under this Agreement. The Parties agree to coordinate on such negotiations as appropriate.” This linkage to the GATS negotiations stops short of automatically synchronizing domestic regulation under GATS and the FTAs. Thus, it does not mandate that the FTAs must include desirable changes in the new GATS rules; nor does it preclude desirable changes in the FTAs that are not part of the new GATS rules.

<sup>55</sup> Communication from the United States, “GATS Article VI:4: Possible Disciplines on Transparency in Domestic Regulation Corrigendum,” WTO Doc. S/WPDR/W/4/Corr.1\* (00-2059), May 19, 2000, at 3.

access to the market for desalination and related services. The second level is that some state measures might be in conflict because they involve a degree of subjective judgment. Some states' coastal programs include provisions for the protection of scenic resources. The protection of scenic values generally requires evaluation of a proposed facility for compatibility with the surrounding environment comparable to a Historic Preservation zoning regulation. For example, a measure requiring desal facilities to "not look bad" in comparison to its surroundings is arguably not objective enough to provide guidance to applicants. One could argue that virtually any industrial facility looks bad in a pristine coastal environment.

## ii. No More Burdensome than Necessary

The second rule under domestic regulation requires that measures be "no more burdensome than necessary to ensure the quality of the service." This is really a two-part standard, as the WTO Secretariat explains:

"The necessity test has two main aspects of relevance ... the first aspect is the general requirement that *regulations not be more trade restrictive than necessary*; the second aspect is to examine whether an individual measure is actually necessary to achieve the specified legitimate objective."<sup>56</sup>

This test may require a government to prove that the purpose of the measure is related to the *quality of the service*. If so, then it must show that no less burdensome measure was available.<sup>57</sup>

The WTO Secretariat indicates that quality of the service is the only recognized "legitimate policy objective."<sup>58</sup> One reading is that this limits measures to elements directly related to the service. For example, water of a certain quality is the output of a desalination plant. Therefore, government measures with objectives such as protecting scenic value, controlling sprawl, or ensuring public access would be unrelated to the service of producing water and thus would not be legitimate objectives.<sup>59</sup>

Policies relating to, for example, protecting the marine environment could relate to water quality to the extent that they restrict pollutants or protect biodiversity that ensures a high quality of source water for input to the service. However, even this sort of policy standard could be construed to be more burdensome than "necessary" because it is more trade-restrictive than a measure that is specifically focused on a science-based risk assessment regarding the quality of sea water input for a desal facility.

## iii. Licensing Procedures

The third rule under domestic regulation is that licensing procedures must not restrict the supply of a service. This rule applies to procedures and not "licensing requirements."<sup>60</sup> The WTO Secretariat defines licensing requirements as "substantive requirements," other than those showing that the service

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<sup>56</sup> Note by the WTO Secretariat, "The Relevance of the Disciplines of the Agreements on Technical Barriers to Trade (TBT) and on Import Licensing Procedures to Article VI.4 of the General Agreement on Trade in Services," WTO Doc. S/WPPS/W/9 (96-3501), September 11, 1996, (*TBT and VI.4*) at 4.

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> The WTO might add other legitimate policy objectives during the development of the rule, but this has not happened to date. The WTO Secretariat seems to be leaving this debate for the working groups developing the rule rather than leaving it to interpretation in disputes. See Disciplines on Domestic Regulation at 6, *TBT and VI.4* at 4. The EU also seems very interested in expanding the list of 'legitimate policy objectives' beyond 'ensuring the quality of the service.' See Communication from the EC, "Domestic Regulation: Necessity and Transparency," WTO Doc. S/WPDR/W/14 (01-2241), May 1, 2001, at 5.

<sup>60</sup> *TBT and VI:4* at 10-11.

supplier is qualified to perform the desired service, “with which a service supplier is required to comply in order to obtain formal permission to supply a service.”<sup>61</sup> “Licensing procedures,” in turn, are “administrative procedures relating to the submission and processing of an application for a license.”<sup>62</sup>

To the extent that an application process restricts the supply of the service, a review panel could interpret this rule on licensing procedures such that any such application process would be in conflict with the rule. Any aspect of a State Coastal Agency’s procedures that could be considered unpredictable, time consuming, or unreasonably expensive for foreign applicants or applicants using foreign engineering firms and that could therefore be argued to operate to prevent an applicant from becoming licensed, perhaps through an overly long (in the applicant’s view) processing period, could be a basis for asserting a conflict.

## 2. Specific Rules – Coverage is Negotiated

### a. Market Access

Governments have traditionally regulated markets for a variety of objectives, including both promoting competition to achieve lower prices, and forming monopolies to provide basic services. Generally speaking, the market access rules target measures that limit access to service markets by limiting the number of market participants, the total level of market activity, or the varieties of actors that may participate. Market access prohibits several categories of government measures. The prohibitions that relate to desal permits include limits on service suppliers, service operations or output, or types of legal entity.

If applied to desal permits, the measures discussed below could conflict with U.S. GATS and FTA commitments on market access for wastewater, construction, environmental remediation, and potentially water services.

#### i. Number of Service Suppliers

The first market access rule prohibits limits on the number of *service suppliers*, whether in the form of *numerical quotas*, *monopolies*, *exclusive service suppliers* or the requirement of an *economic needs test*.<sup>63</sup> To illustrate, this rule prohibits –

- **a quota** – “only 3 desal firms can operate here,”
- **a monopoly** – “only 1 desal firm can operate here,”
- **an exclusive supplier** – “only this particular desalination firm can operate here,” or
- **an economic needs test** – “only as many desalination firms as we think are economically needed can operate.”

Note that this rule and the one that follows (number of service operations or output) prohibit limits in the form of a quota, *etc.* A debate has emerged as to whether these rules are purely formal, meaning that they only prohibit a measure taking those exact forms.

Some commentators suggest that dispute panels will find that a measure that has the effect of setting a quota or limiting output, *etc.*, violates the market access rules.<sup>64</sup> U.S. trade negotiators maintain

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<sup>61</sup> *Id.* at 3.

<sup>62</sup> *Id.*

<sup>63</sup> GATS, art. XVI:2(a) (emphasis added).

<sup>64</sup> World Wildlife Federation and Center for International Environmental Law, “GATS, Water and the Environment,” (October 2003) at 33-34 (WWF-CIEL).

that the market access rules are formal and not effect tests. What is not always clear, they say, is whether a measure is formally a quota, a limit on output, *etc.*, or not.<sup>65</sup> While the effect of coastal measures does arise in our analysis, we identify most of the potential conflicts under market access using the “formal” standard advocated by USTR.

Even if most State Coastal Agencies would not impose direct numerical quotas on the number of desalination facilities allowed, they might have authority and interest in imposing economic needs tests, limitations on the proliferation of such facilities generally, and the requirement of a showing a particular facility is needed to meet projected water needs. The United Nations cited the following criteria as examples of an economic needs test –

- Population, the number of existing [facilities] and their geographical density.
- Number of and impact on existing [facilities], population density, geographic spread and impact on traffic conditions.
- Employment creation.
- Degree of built-up area, type of neighborhood, tourist interests, number of existing [facilities].<sup>66</sup>

In states where such regulatory policy limitations are authorized, it could be argued that such criteria for proposed desal facilities constitute an economic needs test and would therefore be in conflict with this market access rule.

## ii. Number of Service Operations and Output of Services

The second market access rule prohibits limits on the total number of *service operations* or on the total quantity of *service output* expressed in *terms of designated numerical units in the form of quotas* or the requirement of an *economic needs test*.<sup>67</sup> This subsection of the market access rule contains a footnote that states (for this subsection only) that the rule “does not cover measures of a Member which limit *inputs* for the supply of service.”<sup>68</sup> Neither GATS nor the FTAs define “inputs.”

There are a variety of ways in which a State Coastal Agency’s regulation of desal facilities could affect this rule. For example, a State Coastal Agency could, in order to protect scenic, agricultural, rural or historic values, or other environmental resources, disapprove a desal facility based on findings that its location is “growth inducing” or that the facility must be a minimum distance (*e.g.*, a five-mile radius) from other industrial facilities or from certain ecological zones. If such a proximity or locational standard were based on a set distance, it is arguably a formal quota since it would only permit a limited number of desalination facilities on the coastline. If not a formal quota, then a proximity test is certainly a quota in effect.

### Oversight Question

- **Effect vs. formal limits.** The market access rules refer to measures “in the form of” and “in terms of” certain quantitative limits. Do measures that have the effect of quotas or limits on the number of operations, *etc.* also conflict with this rule?

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<sup>65</sup> Memorandum from Robert Stumberg, Notes on meeting with staff of the USTR, February 20, 2004. Present at the meeting were James Mendenhall (Assistant USTR for Investment, Services and Intellectual Property), Christine Bliss (Director of Services Negotiations), and Carol Balassa (Director of Services Negotiations – Energy).

<sup>66</sup> *Lists of the Economic Needs Tests in the GATS Schedules of Specific Commitments*, The United Nations Conference on Trade and Development. UNCTAD/ITCD/TSB/8, 17 August 1999.

<sup>67</sup> GATS, art. XVI:2(c) (emphasis added).

<sup>68</sup> GATS footnote 9 (emphasis added).

Another potential violation of this rule could occur if a State Coastal Agency attempted to limit the brine discharge from a proposed desal facility. A limit on brine discharge would probably not be construed as a *formal* limit on service output, since brine discharge is a byproduct of the service rather than the service output itself (water). Nonetheless, it could be argued that a limit on brine discharge has the *effect* of limiting water output. Potentially, however, under the footnote to this rule noted above it would be possible to effectively limit brine discharge by limiting seawater *input* into a desal facility.

### iii. Legal Form of Organization

The third market access rule prohibits limits on the types of *legal entity* or joint venture through which a service supplier may supply a service.<sup>69</sup> Increasing attention is being focused on the issue of privatization of water rights, and citizen groups have resisted privatization of water services in many areas of the country and the world, including the use of waters in the public domain for private profit. If a State Coastal Agency were to adopt a preference or policy that limits development of desal facilities to public sector applicants, such a preference for public-sector applicants over private applicants would by definition give better treatment to service suppliers organized as one form of legal entity – public agencies. It would limit private-sector companies to contractor roles. Thus, the risk of conflict based on a formal distinction in legal structure would be high.

#### b. National Treatment

National treatment requires governments to treat a foreign service supplier no less favorably than they would treat a domestic service supplier.<sup>70</sup> GATS defines treatment that modifies the conditions of competition as being less favorable.<sup>71</sup> Thus, national treatment prohibits facially neutral regulation that has the effect of less favorable treatment.<sup>72</sup>

U.S. trade negotiators have the option of safeguarding state and local measures from the national treatment rule by either not making a sector commitment under national treatment or by placing a limit on a sector commitment. A limit might apply to a level of government, a state or local agency, a type of law, or a specific law.

Even if no State Coastal Agency expressly discriminates against foreign applicants, it is important to keep in mind the basic concept of the rule, which applies to measures that change the conditions of competition. For example, as noted above, if a State Coastal Agency were to develop a preference for public-sector development of desal facilities, such a preference or monopoly for public sector development of desal facilities would have the effect of excluding foreign firms from the desal market because they are private sector firms.

A State Coastal Agency could also potentially violate this broad interpretation of the national treatment principle by developing technology standards for the construction or operation of desal facilities.<sup>73</sup> Technology standards could favor domestic firms or place foreign firms at a competitive disadvantage. For example, if foreign construction companies were unable to compete for the project

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<sup>69</sup> GATS, art. XVI:2(e) (emphasis added).

<sup>70</sup> GATS, art. XVII:1. The foreign parties need not be treated identically to domestic service providers, so long as the treatment is not less favorable. GATS, art. XVII:2.

<sup>71</sup> GATS, art. XVII:3.

<sup>72</sup> *Id.*

<sup>73</sup> The United States identifies the most important regulations concerning construction as licensure of construction personnel, insurance and bonding requirements for construction companies, and independent building inspection rules. See Communication from the United States, “Construction and Engineering Services,” WTO Doc. S/C/W/77 (98-5008), December 8, 1998.

because they were unable to meet the technology requirements, a trade conflict might result. The WTO Secretariat notes that regulation of construction “would normally be applied on a non-discriminatory basis,” but “[e]ven if the same measures are applied to all suppliers, domestic or foreign, they may be found to be more onerous to foreign suppliers [and thus in conflict with GATS].”<sup>74</sup>

### C. The Environmental Exception

The agreements contain a few general exceptions, which a dispute panel would consider only if it first finds that there is a conflict between a trade rule and a government measure. One exception is relevant here – a conflict might be excused if the measure is “necessary to protect human, animal or plant life or health.”<sup>75</sup> Dispute panels have applied this exception narrowly on two levels. First, the exception likely covers only direct threats to life or health such as introduction of toxins into the environment<sup>76</sup> and not indirect environmental conservation measures that aim to protect habitat.<sup>77</sup> Second, the “necessary” test means that a measure would have to be the least trade-restrictive alternative.<sup>78</sup> Since dispute settlement panels can usually imagine less restrictive measures, this is a heavy burden of proof.

The environmental exception would not apply to most of the potential conflicts discussed above. For example, some coastal zone management policies that could conflict with the domestic regulation rules – such as guarding against growth inducing impacts, preserving public access, coastal agriculture, or the scenic character of the Coastal zone – are not even primarily concerned with the protection of human, plant or animal life, let alone necessary to achieve that protection.

The environmental exception could apply if a State Coastal Agency were to deny a permit or condition its award based upon environmental criteria – such as limiting discharge of concentrated brine in order to prevent harm to the marine environment. The dispute settlement panel, however, would need to conclude that there were no less restrictive options for preventing the harm.

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<sup>74</sup> Background Note by the WTO Secretariat, “Construction and Related Engineering Services,” WTO Doc. S/C/W/38 (98-2325), June 8, 1998, at 5.

<sup>75</sup> GATS, art. XIV(b); U.S.-Chile FTA, art. 23.1; U.S.-Singapore FTA, art. 21.1. The FTAs add language that the “Parties [to the FTA] understand that the measures referred to in GATS [as “necessary to protect human, animal or plant life or health”] include *environmental measures* necessary to protect human, animal, or plant life and health.” This statement probably has no operative legal effect, though.

<sup>76</sup> The FTAs state that the “Parties [to the FTA] understand that the measures referred to in GATS [as “necessary to protect human, animal or plant life or health”] include *environmental measures* necessary to protect human, animal, or plant life and health.” U.S.-Chile FTA, art. 23.1; U.S.-Singapore FTA, art. 21.1. However, this statement merely reflects previous interpretations of this exception in the WTO agreements. The WTO’s Council for Trade in Services previously stated that “since measures necessary to protect the environment typically have as their objective the protection of human, animal or plant life or health, it is not clear that there is a need to provide more than is contained in paragraph (b) of Article XIV.” Council for Trade in Services, “Decision on Trade in Services and the Environment.”

<sup>77</sup> See Facing the Facts at 38 (GATS exception as continuation of GATT XX(b) exception—not including XX(g) conservation exception); see also Council for Trade in Services, “Decision on Trade in Services and the Environment;” Article XX Practice at 7-10, 12-13 (discussing the distinct application of GATT XX(b), the health exception, and separately discussing GATT XX(g), the conservation exception); Note by the WTO Secretariat, “GATT/WTO Dispute Settlement Practice Relating to GATT Article XX, Paragraphs (b), (d), and (g),” WTO Doc. WT/CTE/W/203 (02-1188), March 8, 2002, at 5-6 (discussing application of GATT Chapter XX general exceptions, which were the model for the GATS general exceptions).

<sup>78</sup> In WTO jurisprudence, a “measure that has the effect of restricting trade is ‘necessary’ only if there is *no alternative measure less disruptive of trade* which a Member may reasonably be expected to employ to achieve the relevant policy objective.” *TBT and VI.4* at 4. See Informal Note by the WTO Secretariat to the Working Party on Domestic Regulation, Job No. 5929, (October 8, 1999).

## II. INVESTMENT RULES

### A. The Relevant Agreements and the Investors that are Entitled to Invoke Them

In addition to being challenged by another country under the services rules discussed above, a State Coastal Agency's refusal to approve a permit for a desalination facility could also be challenged by a foreign investor through a process known as "investor-to-state" dispute settlement. It is important to note that an investor would only be able to invoke international investment rules if the United States were a party to an investment agreement with the home country of the corporation. Over the last several decades, the United States has entered into numerous "Bilateral Investment Treaties" (BITs) with developing countries. Because these countries did not have significant investments in the United States, no United States law has ever been challenged under these agreements.<sup>79</sup> In contrast, since NAFTA came into force in 1994 a number of claims have been brought against the United States under the investor protection provisions of NAFTA Chapter 11, presumably due to the significant levels of Canadian investment in this country.<sup>80</sup>

The Chile and Singapore FTAs contain investment chapters similar to Chapter 11 of NAFTA, and similar provisions will likely be included in the various other FTAs that the United States is currently negotiating. There have also been proposals to negotiate investment rules within the World Trade Organization (WTO). Developing countries, however, have resisted these proposals.<sup>81</sup> The disagreement over investment rules has been widely credited with contributing to the collapse of the recent WTO Ministerial Conference in Cancún, Mexico.<sup>82</sup>

Although attempts to launch negotiations on investment rules in the WTO have thus far failed, the European Union has been advocating an approach to the issue that could permit negotiations to proceed. The EU has proposed that investment negotiations be permitted to proceed on a "plurilateral" basis, meaning that each WTO member country could decide whether it wanted to be bound by the new agreement.<sup>83</sup> This approach, if followed, would likely lead to an investment agreement among the wealthier countries of the world, including the United States, Great Britain, France and Germany. Although it is uncertain what the terms of such an agreement would be, an investment agreement that covered these countries would present the greatest potential for investment rules to be used to challenge a State Coastal Agency's decisions regarding desalination facilities, given that British, French and German

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<sup>79</sup> See J. Carol Williams, *The Next Frontier: Environmental Law in a Trade-Dominated World*, 20 Va. Envtl. L.J. 221, 224 (2001) ("BITs were negotiated with countries with which the investment flows were one way - from the United States to the other country. Thus, whatever protections these BITs provided investors as a practical matter would be used only by U.S. investors against the other countries, not by investors from other countries against the United States.").

<sup>80</sup> See *id.* at 224-225 (unlike under the BITs "the investment flows between the NAFTA parties . . . were not one way. The United States had significant two-way investment flows with Canada prior to 1994, and these flows were to increase substantially after NAFTA entered into force.").

<sup>81</sup> See Inside U.S. Trade, *Developing Countries Maintain Rigid Opposition to Singapore Issues* (Sept. 12, 2003), at <http://www.insidetrade.com>.

<sup>82</sup> See Inside U.S. Trade, *Cancun Ministerial Collapses over Singapore Issues* (Sept. 15, 2003), at <http://www.insidetrade.com>.

<sup>83</sup> See Inside U.S. Trade, *Developing Countries Cool to All Singapore Issues but Trade Facilitation*, (Dec. 19, 2003) at <http://www.insidetrade.com>.

companies – including RWE, Thames Water, Vivendi and Suez – are among the most likely applicants for permits for desalination facilities in the United States.<sup>107</sup>

Even in the absence of a WTO investment agreement, however, British, French and German water companies could gain rights under international investment agreements by transferring ownership of their operations in the United States to a foreign subsidiary in a country that is a party to an investment agreement with the United States. As with the services rules discussed *supra*, investment rules permit corporations to invoke rights through their foreign subsidiaries.

Under Article 1113 of NAFTA, an investor from a non-NAFTA country that owned a Mexican or Canadian corporation, which in turn had an investment in the United States, could bring a NAFTA Chapter 11 claim against the United States with regard to that investment so long as the investor had “substantial business activities” in the country (*i.e.* Mexico or Canada) under whose law the corporation was organized.<sup>84</sup> A similar strategy is being used by two United States corporations – General Electric and Bechtel – in a dispute concerning their investments in the failed Dabhol power project in India. GE and Bechtel are seeking \$1.2 billion from India in an investor-to-state arbitration. Because there is no investment treaty in effect between the United States and India, the two corporations are bringing the arbitration through their subsidiaries based in Mauritius pursuant to a bilateral investment treaty between Mauritius and India.<sup>85</sup>

Thus, for example, Thames Water, a British corporation owned by the German conglomerate RWE, could potentially gain rights under NAFTA Chapter 11 by transferring its interest in the California-American Water Company to a Canadian subsidiary. Similarly, after the ratification of the proposed FTAA, foreign multinationals could organize subsidiaries in Panama in order to be able to invoke the FTAA’s investment rules against the United States.

It is not clear whether under NAFTA a United States corporation could use a Canadian or Mexican subsidiary to bring a Chapter 11 claim based on the subsidiary’s investment in the United States. The Chile and Singapore FTAs, however,

### Oversight Questions

- **Use of NAFTA by European multinationals.** Could a French, British or German corporation that conducts “substantial business activities” in Canada use a Canadian subsidiary to challenge under NAFTA Chapter 11 a State Coastal Agency’s refusal to issue a permit for a desalination project owned by the subsidiary?
- **Use of NAFTA by U.S. multinationals.** Could a United States corporation that conducts “substantial business activities” in Canada use a Canadian subsidiary to challenge under NAFTA Chapter 11 a State Coastal Agency’s refusal to issue a permit for a desalination project owned by the subsidiary?
- **Use of FTAs by multinationals.** Could any multinational corporation that conducts “substantial business activities” in Chile use a Chilean subsidiary to challenge under the investment chapter of the U.S. – Chile Free Trade Agreement a State Coastal Agency’s refusal to issue a permit for a desalination project owned by the subsidiary?

<sup>107</sup> See, e.g., California Coastal Commission, *Seawater Desalination and the California Coastal Act* at 52 (March 2004).

<sup>84</sup> See NAFTA, art. 1113(2).

<sup>85</sup> See Luke Eric Peterson, *India Faces 6 New Investment Treaty Claims in Relation to Dabhol Investment*, in INVESTMENT LAW AND POLICY WEEKLY NEWS BULLETIN (Nov. 14, 2003), available at [www.iisd.org](http://www.iisd.org). See also Bechtel Corporation press release, “Bechtel and GE File Arbitration over Dabhol Power Company,” September 22, 2003, available at <http://www.bechtel.com/newsarticles/398.asp>.

appear to permit this, so long as the U.S. corporation's subsidiary has "substantial business activities" in the country where the subsidiary is located.<sup>86</sup>

## **B. Investment Rules and Potential Conflicts**

No United States law at any level (federal, state or local) has been successfully challenged under NAFTA Chapter 11 or any other investment agreement. Some of the arbitral decisions that have been decided under Chapter 11, however – including claims that have been brought successfully against Canada and Mexico – suggest that investment rules could be used to challenge a State Coastal Agency's decisions regarding desalination projects.

There are at least three investment disciplines in particular that could conflict with a State Coastal Agency's authority to regulate desal facilities. First, investment agreements typically require governments to pay compensation for measures that are found to "expropriate, directly or indirectly" a foreign investor's investment.<sup>87</sup> Second, investment agreements contain a provision that requires governments to provide foreign investors with the "minimum treatment" to which they are entitled under international law.<sup>88</sup> Third, investment agreements contain a national treatment requirement – similar to the provision in GATS discussed *supra* – that prohibits measures that either explicitly or effectively discriminate against foreign investors.<sup>89</sup> As discussed below, each of these provisions could potentially be used by a foreign investor to challenge a State Coastal Agency's actions regarding a proposed desal facility.

### **1. Indirect Expropriation**

The expropriation provision in NAFTA Chapter 11 (and similar provisions in other investment agreements) in many ways resemble the Takings Clause of the U.S. Constitution, which requires government to provide "just compensation" when private property is taken for public use. Like the Takings Clause, Chapter 11's expropriation provision prohibits not only the actual seizure of property, but also any regulatory action that can be considered to have "indirectly" expropriated property by decreasing its value to the extent that it can be considered to have the equivalent effect of an actual seizure of the property.

The standard for regulatory or "indirect" expropriation, however, appears to provide foreign investors with significantly greater rights than the Takings Clause in at least two ways.<sup>90</sup> First, the definition of "investment" that is protected is much broader than the real property rights and other specific interests in property that are protected under the Takings Clause. Second, the degree of diminution of value that a regulation must cause in order for the investor to be entitled to compensation appears to be lower. These aspects of indirect expropriation doctrine could potentially enable a foreign investor to

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<sup>86</sup> See U.S.-Chile FTA, art. 10.11(2); U.S.-Singapore FTA, art. 15.11(2).

<sup>87</sup> See, e.g., NAFTA, art. 1110.

<sup>88</sup> See, e.g., NAFTA, art. 1105.

<sup>89</sup> See, e.g., NAFTA, art. 1102.

<sup>90</sup> Congress attempted to address this problem in the Trade Act of 2002 by instructing USTR to ensure that expropriation provisions in future agreements do not provide foreign investors with greater rights than those afforded to property owners under the Takings Clause. See Trade Act of 2002, H.R. 3009, 107th Cong. § 2102(b)(3) (2002). Despite this provision, however, the expropriation provisions in recently negotiated agreements such as the Chile and Singapore FTAs still appear to grant foreign investors substantially greater rights than those conferred by the Takings Clause. See discussion *infra*; see also Matthew C. Porterfield, *International Expropriation Rules and Federalism*, 23 Stanford Env't'l Law Journal 3 (2004).

bring a successful expropriation claim based on a State Coastal Agency’s refusal to issue a permit for a desalination project when a regulatory takings claim based on the same facts would fail.

**a. The Scope of Covered Investment**

The most obvious way in which international expropriation rules differ from the Takings Clause is that they cover a much broader range of economic interests. The Takings Clause generally applies only to real property and other specific interests in property,<sup>91</sup> typically as defined by state law.<sup>92</sup> More generalized economic interests, such as “business in the sense of the activity of doing business or the activity of making a profit,”<sup>93</sup> are not considered “property” subject to the prohibition on uncompensated takings.

Under Chapter 11 of NAFTA, in contrast, the definition of protected investment is “enormously broad”<sup>94</sup> and encompasses not only businesses (or “enterprises”)<sup>95</sup> but also more generalized economic interests, such as the interest in conducting business or making profit from an investment.<sup>96</sup> The definition of investment in the Chile and Singapore agreements closely tracks the language in NAFTA Chapter 11, encompassing “every asset that an investor owns or controls, directly or indirectly, that has the characteristics of an investment.”<sup>97</sup> The agreements broadly define “characteristics of an investment” in terms that would not be sufficient to establish the existence of a protected property right under the

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<sup>91</sup> See *Eastern Enterprises v. Apfel*, 524 U.S. 498, 541 (1998) (Kennedy, J., concurring in the judgment and dissenting in part) (“[O]ne constant limitation has been that in all of the cases where the regulatory taking analysis has been employed, a specific property right or interest has been at stake”); *Webb’s Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 161 (1980) (“[A] mere unilateral expectation or an abstract need is not a property interest entitled to protection”).

<sup>92</sup> See *Board of Regents of State Colleges v. Roth*, 408 U.S. 564, 577 (1972) (property rights “are created and their dimensions are defined by existing rules or understandings that stem from an independent source such as state law”); see also *Phillips v. Wash. Legal Found.*, 524 U.S. 156, 164 (1998) (“[T]he Constitution protects rather than creates property interests . . .”).

<sup>93</sup> *Coll. Sav. Bank v. Fla. Prepaid Postsecondary Educ. Expense Bd.*, 527 U.S. 666, 675 (1999). See also *Andrus v. Allard*, 444 U.S. 51, 66 (1979):

[L]oss of future profits—unaccompanied by any physical property restriction—provides a slender reed upon which to rest a takings claim. Prediction of profitability is essentially a matter of reasoned speculation that courts are not especially competent to perform. Further, perhaps because of its very uncertainty, the interest in anticipated gains has traditionally been viewed as less compelling than other property-related interests.

Specific funds of money, however, are considered property that is protected under the Takings Clause. See, e.g., *Phillips v. Wash. Legal Found.*, 524 U.S. 156 (1998) (holding interest accrued on funds held in lawyers’ client trust accounts is the private property of the owner of the funds for purposes of the Takings Clause); *Webb’s Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155 (1980) (finding county’s appropriation of interest accrued on court interpleader funds to constitute a taking).

<sup>94</sup> Daniel M. Price, *NAFTA Chapter 11 - Investor-State Dispute Settlement: Frankenstein or Safety Valve?* 26 CAN.-U.S. L.J. 107, 109 (2001).

<sup>95</sup> The term “enterprise” is defined as “any entity constituted or organized under applicable law, whether or not for profit, and whether privately-owned or governmentally-owned, including any corporation, trust, partnership, sole proprietorship, joint venture or other association.” NAFTA, art. 201.

<sup>96</sup> See NAFTA, art. 1139 (defining investment to include, inter alia, “interests arising from the commitment of capital or other resources in the territory of a Party to economic activity in such territory”).

<sup>97</sup> U.S.-Chile FTA, art. 10.27, at 10-24, see also U.S.-Singapore FTA, art. 15.1, at 156.

Takings Clause, including “the commitment of capital, the expectation of gain or profit, or the assumption of risk.”<sup>98</sup>

The decision of a NAFTA tribunal in *Metalclad v. Mexico*<sup>99</sup> illustrates how the broad definition of investment under international investment agreements could provide foreign investors with a favorable alternative to bringing a regulatory taking claim in U.S. courts. The tribunal held that the refusal of the Mexican municipality of Guadalupe and the state of San Luis Potosi to permit a U.S. corporation (Metalclad) to operate a hazardous waste facility effectively expropriated the corporation’s investment in the facility, and awarded Metalclad \$16,685,000.<sup>100</sup>

If a regulatory takings claim were brought in U.S. courts under similar circumstances, the relevant property interest would be the real estate involved, and the focus would most likely be on whether the refusal to permit the development of the hazardous waste facility destroyed all economically viable use of the property. Yet although the assets that Metalclad claimed as its investment included the real property where the project was located,<sup>101</sup> the tribunal made it clear that the relevant “investment” for the purposes of its expropriation analysis was Metalclad’s broader interest in operating a particular type of business—the hazardous waste facility—on that property. The tribunal seemed to acknowledge that the property could be used for other economically beneficial purposes, noting that even such high impact uses as “the exploration, extraction or utilization of natural resources”<sup>102</sup> might be permissible. Nonetheless, the tribunal found that Metalclad’s investment had been effectively expropriated because it could not use the property for the specific type of business enterprise it had intended.

#### Oversight Question

- **Definition of investment.** Would the commitment of capital by a covered foreign investor to a desalination project in the United States constitute a form of “investment” entitled to protection under Chapter 11 of NAFTA or the investment chapters of the Chile and Singapore free trade agreements?

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<sup>98</sup> U.S.-Singapore Free Trade Agreement, at 156, n. 15-1; *see also* U.S.-Chile Free Trade Agreement, at 10-24. The Chile and Singapore agreements do contain some language linking the definition of investment to the concept of property. Both agreements indicate that “[a]n action or a series of actions by a Party cannot constitute an expropriation unless it interferes with a tangible or intangible property right or property interest in an investment.” U.S.-Chile FTA, Annex 10-D, para. 2 at 10-31; U.S.-Singapore Free Trade Agreement, Exchange of Letters on Expropriation at 1. This language, however, begs the question of what types of economic interests will be considered to constitute a “property right” or “property interest,” and how, if at all, these terms differ in meaning from the term “investment.” Other language in the Chile and Singapore agreements suggests that reference to the domestic law of the host country will determine whether certain types of economic interests—including “licenses, authorizations, permits, and similar rights”—constitute a form of covered investment. U.S.-Singapore FTA, art. 15.1, at 156; *see also* U.S.-Chile FTA, art. 10.27, at 10-24 (containing the similar language, “concessions, licenses, authorizations, and permits”). Although this approach is consistent with the approach taken to defining property for the purposes of the Takings Clause, under the Chile and Singapore agreements it is apparently only to be used in determining whether certain forms of economic interests – e.g., licenses and permits – constitute covered investments.

<sup>99</sup> ICSID (W. Bank) Case No. ARB(AF)/97/1 (Arbitral Trib. 2000), *reprinted in* 40 I.L.M. 36 (2000) [hereinafter *Metalclad*].

<sup>100</sup> *Id.*, paras. 102-12, 131.

<sup>101</sup> *See id.* paras. 2, 28.

<sup>102</sup> *Id.* para. 110.

Similarly, the broad definition of investment under international investment agreements could, under the right circumstances, enable a foreign investor in a desalination project to seek compensation if a State Coastal Agency refused to grant it a permit for the project. Although the outcome of any such challenge is highly speculative, it would be relatively easy for the investor to meet the threshold requirement of demonstrating the existence of an investment that was entitled to the protection from indirect expropriation. Any capital investment in the desal project would constitute an investment, and a refusal to permit development of the project would destroy the value of that investment and therefore arguably constitute an act of indirect expropriation. In contrast, it would be extremely difficult to win a regulatory takings claim under the same circumstances. The relevant property interest would be the real estate where the project was to be located, and, as discussed below, the investor would likely need to demonstrate that the permit denial resulted in a complete or near complete destruction of the value of the property.

### **b. The Degree of Diminution of Value Required to Constitute an Act of “Indirect Expropriation”**

As compared with the Takings Clause, international expropriation rules appear to require a lower level of impairment of the value of an investment in order for an investor to be entitled to compensation. In order to establish that a regulatory action has “taken” property within the meaning of the Fifth Amendment, an owner generally must demonstrate that the regulation has destroyed all or nearly all value of the property.<sup>103</sup> Even regulations that destroy all economically viable use of real property will not be treated as subject to the Takings Clause if the regulations merely enforce preexisting common law restrictions on property use.<sup>104</sup>

Under Chapter 11, in contrast, tribunals have suggested that a measure need only cause “significant” or “substantial” impairment of an investment’s value to be considered expropriatory. The tribunal in *Metalclad* characterized the standard for expropriation as follows:

[E]xpropriation under NAFTA includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favour [sic] of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property . . . .<sup>105</sup>

In a decision reviewing the tribunal’s award, the Supreme Court of British Columbia observed that “[t]his definition [of expropriation] is sufficiently broad to include a legitimate rezoning of property by a municipality or other zoning authority.”<sup>106</sup>

In *Pope & Talbot v. Canada*, another Chapter 11 tribunal similarly indicated that a regulation that causes a “substantial deprivation” of a foreign investor’s property constitutes a compensable

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<sup>103</sup> See *Lucas v. South Carolina Coastal Council*, 505 U.S. 1003, 1016 (1992) (“the Fifth Amendment is violated when land-use regulation . . . denies an owner economically viable use of his land”); *id.* at 1019, n. 8 (noting that even a regulatory action that destroys 95 percent of the value of a property may not constitute a regulatory taking).

<sup>104</sup> *Id.* at 1029.

<sup>105</sup> *Metalclad Corp. v. United Mexican States*, ICSID (W. Bank) Case No. ARB(AF)/97/1 (Arbitral Trib. 2000), reprinted in 40 I.L.M. 36 (2000) [hereinafter *Metalclad*] at para. 103 (emphasis added).

<sup>106</sup> See *The United Mexican States v. Metalclad Corporation*, 2001 B.C. Sup.Ct. 664, para. 99 [hereinafter *Metalclad Appeal*]. Mexico challenged the award in the Supreme Court of British Columbia, which had jurisdiction to review the decision under Canada’s International Commercial Arbitration Act (ICAA), because the parties had designated Vancouver, British Columbia as the place of the arbitration. See *id.*, paras. 39-49.

expropriation.<sup>107</sup> Read together, the decisions of the tribunals in *Metalclad* and *Pope & Talbot* suggest that NAFTA’s expropriation provision may entitle an investor to compensation for regulatory measures that decrease the value of an asset but do not reach the threshold required to constitute a regulatory taking (*i.e.*, the destruction of all or nearly all value).

It should be noted that NAFTA tribunals have indicated that exercises of regulatory authority should generally not be considered to constitute acts of indirect expropriation.<sup>108</sup> Similarly, the Chile and Singapore agreements contain language indicating that, “[e]xcept in rare circumstances,” exercises of the police power do not constitute acts of indirect expropriation.<sup>109</sup> Nonetheless, as demonstrated by the *Metalclad* decision, this presumption that regulatory measures do not constitute indirect expropriations does not preclude a tribunal from concluding that the presumption has been rebutted by evidence that a regulatory measure has caused “significant” or “substantial” diminution in the value of an investment.

Whether an international tribunal would find that a State Coastal Agency’s refusal to grant a permit for a desalination project constituted an act of indirect expropriation would turn upon a variety of factors, including whether, in the tribunal’s view, the foreign investor had a reasonable expectation that it would be able to proceed with the project.<sup>110</sup> Such a situation might arise if, for example, a foreign corporation purchased land for a desalination facility and the State Coastal Agency subsequently adopted new policies – or new interpretations of existing policies – that prevented the corporation from obtaining a permit. The denial of a permit application under these circumstances would appear to cause the required level of adverse economic impact on the project – *i.e.* a “significant” or “substantial” adverse effect – given that the project could not go forward without the agency’s approval.

#### Oversight Question

- **Indirect Expropriation.** If a State Coastal Agency refused to issue a permit to a foreign investor for a desalination facility, and that refusal caused a “significant” or “substantial” adverse effect on the value of the investor’s investment in the desalination project, could the refusal be found to constitute an act of “indirect expropriation”?

## 2. Minimum Treatment

“Minimum treatment” provisions are another type of investment rule that potentially could be used to challenge a State Coastal Agency’s decisions regarding desalination projects. Article 1105 of NAFTA states that “[e]ach party shall accord to investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment . . . .” Minimum treatment has

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<sup>107</sup> *Pope & Talbot Inc. v. Canada*, Interim Award by the United Nations Commission on International Trade Law (UNCITRAL) Arbitral Tribunal (June 26, 2000) [hereinafter *Pope & Talbot Interim Award*], at para. 102; *see also id.* para. 96 (characterizing the question of expropriation as depending upon whether there has been a “substantial enough” interference with an investment).

<sup>108</sup> *See, e.g., S.D. Myers v. Canada*, Partial Award by the United Nations Commission on International Trade Law (UNCITRAL) Arbitral Tribunal, Doc. 742416:01 (Nov. 13, 2000), para. 281 (“[t]he general body of precedent usually does not treat regulatory action as amounting to expropriation”) (emphasis added). *But see Pope & Talbot Interim Award*, para. 99 (rejecting argument that there is a police power exception to expropriation and arguing that “a blanket exception for regulatory measures would create a gaping loophole in international protections against expropriation.”)

<sup>109</sup> U.S.-Chile FTA, Annex 10-D, para. 4(b), at 10-31 (“Except in rare circumstances, nondiscriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations.”); *see also* U.S.-Singapore FTA, Exchange of Letters on Expropriation, at 2 (same language).

<sup>110</sup> *See Metalclad*, para. 103.

many aspects, but at its core it resembles an international version of both substantive and procedural due process.<sup>111</sup> The Singapore and Chile FTAs – which are likely to be the models for future agreements – emphasize this aspect of minimum treatment, stating that “fair and equitable treatment” includes the obligation not to deny justice in “criminal, civil, or administrative adjudicatory proceedings in accordance with the principle of due process embodied in the principal legal systems of the world . . .”<sup>112</sup>

As with expropriation, too few tribunals have interpreted the standard for minimum treatment under NAFTA to clarify the exact nature of the rights it confers on foreign investors.<sup>113</sup> It appears, however, to constitute a relatively open-ended mandate that could be interpreted to allow arbitral tribunals to pass judgment on the fairness of government actions affecting foreign investments.

The United States is presumably one of the “principal legal systems” of the world referred to in the text of the Chile and Singapore FTAs. The arbitral decisions that have interpreted Article 1105 of NAFTA, however, suggest that minimum treatment could potentially provide greater rights than the due process clauses of the Fifth and Fourteenth Amendments of the U.S. Constitution, particularly with regard to substantive due process. The standard for substantive due process review of economic regulations under the Constitution is extremely deferential and requires only that legislation bear some rational relationship to the objectives of the legislature.<sup>114</sup> A court will not use substantive due process review to “sit as a superlegislature” and strike down legislation that it considers to be unwise or inefficient.<sup>115</sup>

The standard for “fair and equitable treatment” under NAFTA is less clear, but appears to permit a more aggressive review of economic legislation. Some early decisions indicated that violations of other provisions of NAFTA constituted violations of minimum treatment as well. In *Metalclad*, for example, the tribunal indicated that a violation of NAFTA’s transparency provisions in and of itself constituted a

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<sup>111</sup> Minimum treatment also includes the obligation to provide foreign investment with “full protection and security.” See NAFTA, art. 1105. Full protection and security refers to the obligation to provide foreign investment with “reasonable” police protection under the circumstances, but does not require governments to guarantee the safety of investment. See RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 711 comment e (1987) [hereinafter RESTATEMENT]. See also U.S.-Singapore FTA, art. 15.5(2)(b); (“the obligation . . . to provide ‘full protection and security’ requires each party to provide the level of police protection required under customary international law”); U.S.-Chile FTA, art. 10.4(2)(b) (same).

<sup>112</sup> U.S.-Singapore FTA, art. 15.5(2)(a); U.S.-Chile FTA, art. 10.4(2)(a).

<sup>113</sup> *ADF Group Inc. v. United States*, Award (Jan. 9, 2003, NAFTA/ICSID Ad'l Facility), para. 183 (“the structure and content of the customary international law minimum standard of treatment has not been adequately litigated...”)

<sup>114</sup> See *Concrete Pipe and Prods. of Cal. v. Constr. Laborers Pension Trust for S. Cal.*, 508 U.S. 602, 639 (1993) (“[U]nder the deferential standard of review applied in substantive due process challenges to economic legislation there is no need for mathematical precision in the fit between justification and means”); *United States v. Carolene Prods.*, 304 U.S. 144, 152 (1938) (“[R]egulatory legislation affecting ordinary commercial transactions is not to be pronounced unconstitutional unless in the light of the facts made known or generally assumed it is of such a character as to preclude the assumption that it rests upon some rational basis within the knowledge and experience of the legislators.”)

<sup>115</sup> See *Exxon Corp. v. Governor of Maryland*, 437 U.S. 117, 124-25 (1978) (“the Due Process Clause does not empower the judiciary to sit as a superlegislature to weigh the wisdom of legislation”) (citation and quotation marks omitted); *Williamson v. Lee Optical of Oklahoma*, 348 U.S. 483, 488 (1955) (“The day is gone when this Court uses the Due Process Clause of the Fourteenth Amendment to strike down state laws, regulatory of business and industrial conditions, because they may be unwise, improvident, or out of harmony with a particular school of thought.”)

violation of minimum treatment.<sup>116</sup> Similarly, in *S.D. Myers v. Canada*, the tribunal indicated that a violation of Chapter 11's nondiscrimination standards constituted a violation of minimum treatment.<sup>117</sup>

In response to the controversy generated by these decisions, on July 31, 2001, NAFTA's Free Trade Commission issued an "Interpretive Note" indicating that "fair and equitable" treatment refers only to the customary international law standard of treatment of aliens and does not cover breaches of other provisions of NAFTA or provisions of other international agreements.<sup>118</sup> The Interpretive Note, however, has done little to clarify the standard for fair and equitable treatment.

Recently, for example, the tribunal in *The Loewen Group v. United States* defined minimum treatment in the context of judicial proceedings as requiring "manifest injustice in the sense of lack of due process leading to an outcome which offends a sense of judicial propriety."<sup>119</sup> Similarly, in *Mondev v. United States*, the tribunal characterized the standard for fair and equitable treatment as follows:

the question is whether . . . a tribunal can conclude in the light of all the available facts that the impugned decision was clearly improper and discreditable, with the result that the investment has been subjected to unfair and inequitable treatment. This is admittedly a somewhat open-ended standard, but it may be that in practice no more precise formula can be offered to cover the range of possibilities.<sup>120</sup>

The vagueness of the standard for minimum treatment suggests that it does not constitute a specific legal standard in and of itself, but rather represents a delegation of authority to arbitral tribunals to determine in any given case what constitutes "fair" and "equitable" treatment of a foreign investor. Some arbitral tribunals have rejected the idea that minimum treatment permits broad, subjective review of government treatment of foreign investment.<sup>121</sup> Yet, according to a former President of the American

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<sup>116</sup> See *Metalclad*, paras. 74-101.

<sup>117</sup> *S.D. Myers v. Canada, Partial Award by the United Nations Commission on International Trade Law (UNCITRAL) Arbitral Tribunal*, Doc. 742416:01 (Nov. 13, 2000) at para. 266 ("on the facts of this particular case Canada's breach of Article 1102 [regarding national treatment] essentially establishes a breach of Article 1105 as well.")

<sup>118</sup> *Free Trade Commission Clarifications Related to Chapter 11* (July 31, 2001), available at <http://www.ustr.gov/regions/whemisphere/nafta-chapter11.PDF>.

<sup>119</sup> ICSID (W. Bank) Case No. ARB(AF)/98/3 (Arbitral Trib. 2003), reprinted in 42 I.L.M. 811 (2003) at para. 132. Applying this standard, the tribunal concluded that a Mississippi jury trial in which a local funeral home operator had been awarded \$500 million in damages in a commercial dispute with a Canadian corporation violated the minimum standard of treatment because the award was excessive and the trial had been tainted by appeals to racial, class-based and anti-Canadian prejudice. *Id.* paras. 54-70, 119-23, 136-37. Nonetheless, the tribunal concluded that the claim should be dismissed because the corporation had failed to exhaust all reasonably available domestic judicial remedies. See generally *id.* paras. 142-217. The tribunal also concluded that the claim should be dismissed because Loewen had transferred its assets to a new United States corporation as part of its bankruptcy reorganization, and thus had destroyed the diversity of nationality necessary to pursue the claim under NAFTA Chapter 11. See *id.* paras. 220-38.

<sup>120</sup> *Mondev Int'l, Ltd. v. United States, Final Award*, ICSID (W. Bank) Case No. ARB(AF)/99/2 (October 11, 2002), at para. 127 (emphasis added). *Mondev* involved a dispute over a failed development project between a Canadian corporation, the City of Boston and the Boston Redevelopment Agency. The corporation brought a claim under NAFTA chapter 11 arguing, *inter alia*, that a ruling by the Massachusetts Supreme Court that the Redevelopment Authority enjoyed statutory immunity from suit over the dispute violated minimum treatment. The NAFTA tribunal rejected this claim, but indicated that under some circumstances a government's granting immunity from suit to a public agency could constitute a violation of minimum treatment. See *id.* paras. 151-54.

<sup>121</sup> See, e.g., *Mondev*, para. 119 ("Article 1105(1) did not give a NAFTA tribunal an unfettered discretion to decide for itself, on a subjective basis, what was 'fair' or 'equitable' in the circumstances of each particular case"); *S.D.*

Society of International Law, fair and equitable treatment is “an intentionally vague term, designed to give adjudicators a quasi-legislative authority to articulate a variety of rules necessary to achieve the treaty's object and purpose in particular disputes.”<sup>122</sup> This view that minimum treatment provisions authorize arbitral tribunals to develop a body of rules delineating the rights of foreign investors is supported by language in several arbitral decisions noting that the standard for minimum treatment continues to evolve.<sup>123</sup>

It is possible that this evolutionary process could eventually result in a coherent and well-defined body of law indicating what constitutes fair and equitable treatment. Currently, however, the standard remains extremely vague and tribunals appear to engage in *ad hoc* decision making based on their view of the “fairness” of the government’s treatment of a foreign investor in any given case.

Consequently, it is impossible to predict whether in a given case a tribunal would find that a State Coastal Agency’s treatment of a foreign investor in a desalination project violated minimum treatment. The resolution of such a claim would depend not only on the particular facts of the case, but also on the tribunal’s inevitably subjective evaluation of whether the agency’s actions were fair and equitable. For example, a tribunal could conclude in a particular case that the process for reviewing permit applications violated the standard for fair and equitable treatment because it was not transparent, criteria for approval were not being applied consistently, or the treatment of the foreign investor was arbitrary or unfair.

#### Oversight Question

- ***Fair and Equitable Treatment.*** Under what circumstances could a State Coastal Agency’s permitting procedures be found to violate the standard for “fair and equitable treatment”?

### 3. National Treatment

#### a. The Grandfathering of Existing Measures from National Treatment

Investment agreements, like services agreements, generally contain a national treatment provision that prohibits discrimination against foreign investors. Existing non-conforming state or local measures are grandfathered from the national treatment provisions of the NAFTA and the Chile and Singapore FTAs so long as they are not amended in a manner that “decrease[s] the conformity” of the measure with national treatment.<sup>124</sup> Under NAFTA, state measures were originally grandfathered from national

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*Myers*, para. 261 (“a Chapter 11 tribunal does not have an open-ended mandate to second-guess government decision-making.”)

<sup>122</sup> See Charles H. Brower II, *Investor- State Disputes under NAFTA: A Tale of Fear and Equilibrium*, 29 Pepp. L.Rev. 43, 78 (2001) *citing, inter alia*, J.G. Merrills, *INTERNATIONAL DISPUTE SETTLEMENT* (3d ed. 1998) (“When an arbitrator is asked by the parties to have regard to equitable considerations... he... begins to assume the role of a legislator, creating law for the case in hand”); United Nations Centre on Transnational Corporations, *BILATERAL INVESTMENT TREATIES* 41 (1988) (“It is in the nature of a very general concept like fair and equitable treatment that there can be no precise definition. What is fair and what is equitable may largely be a matter of interpretation in each individual case.”)

<sup>123</sup> See, e.g., *ADF*, para.179 (“what customary international law projects is not a static photograph of the minimum standard of treatment . . . [f]or both customary international law and the minimum standard of treatment of aliens it incorporates, are constantly in a process of development.”) See also *Pope & Talbot, Inc. v. Canada, Damages Award*, NAFTA/UNCITRAL Tribunal (May 31, 2002) at paras. 57-65 (rejecting “static” view of the standard for minimum treatment.)

<sup>124</sup> See NAFTA, art. 1108(1)(a); *id.*, art. 1108(1)(b) & (c) (grandfathering of existing measures includes the “continuation or prompt renewal” of non-conforming measures, or amendments to such measures that do not decrease their conformity); U.S.-Chile FTA, art. 10.7(1)(a) & (b), and *id.* Annex II, at I-US-14; U.S.- Singapore FTA, art. 15.12(a) & (b), and *id.* Annex 8A at 8A-United States-14.

treatment challenges for two years after the agreement entered into force.<sup>125</sup> Thereafter, only state measures that the federal government listed in Annex II of NAFTA were to be grandfathered.<sup>126</sup> Eventually, however, all existing state measures were permanently grandfathered.<sup>127</sup> According to one of the USTR negotiators involved in the process, this decision was made because “we were unable to negotiate and come to terms with the further liberalization, and we were unable to do so, in my estimation, largely because we found, when we got right down to it, we really did not understand what these commitments meant.”<sup>128</sup>

The grandfathering applies to existing “measures,” which are defined as “any law, regulation, procedure, requirement or practice.”<sup>129</sup> It is unclear whether a specific application of an existing measure – such as a decision on an application for a permit – could be considered a new “measure” outside the scope of the grandfathering.

USTR could have asserted a general reservation from national treatment for all *future* measures by state and local governments, but chose not to do so.<sup>130</sup> Certain types of future state measures, however, including government procurement decisions and the award of subsidies or grants, are exempt from the national treatment rule.<sup>131</sup>

#### **b. Explicit or Intentional Discrimination**

NAFTA Chapter 11’s national treatment provision, Article 1102, states that governments must generally provide foreign investors with treatment “no less favorable than it accords, in like circumstances, to its own investors . . . .”<sup>132</sup> It also states specifically that governments may not require that a minimum level of ownership in a business in its territory be held by its own nationals.<sup>133</sup> Consequently, if a State Coastal Agency were to adopt a policy of only approving permits for domestically owned desalination facilities, that policy could be challenged as a violation of national treatment.

#### **Oversight Questions**

- **Grandfathering.** Does the grandfathering of existing measures from national treatment preclude challenges to specific applications of existing measures – such as a decision on an application for a permit?
- **Future Measures.** In future investment agreements, will USTR assert a general reservation from national treatment for future measures by state and local governments?

<sup>125</sup> *Id.* art. 1108(1)(a)(ii).

<sup>126</sup> *Id.*

<sup>127</sup> See Inside U.S. Trade, *NAFTA Partners to Protect Sub-Federal Measures from NAFTA Challenges* (April 5, 1996) at <http://www.insidetrade.com>.

<sup>128</sup> *The Impact of Federalism: Border Issues in Canadian and U.S. Relations, Discussion Following the Remarks of Mr. Southwick and Ms. McGuire*, 27 Can.-U.S. L.J. 249, 254 (2001) (remarks of James Southwick).

<sup>129</sup> NAFTA, art. 201.

<sup>130</sup> See NAFTA, art. 1108(3) and Annex II; U.S.-Chile FTA, art. 10.7(2) and Annex II; U.S.-Singapore FTA, art. 15.12((2) and Annex 8B.

<sup>131</sup> See NAFTA, art. 1108(7); U.S.-Chile FTA, art. 10.7(5); U.S.-Singapore FTA, art. 15.12(5).

<sup>132</sup> NAFTA, art. 1102. See also U.S.-Chile FTA, art. 10.2; U.S.-Singapore FTA, art. 15.4.

<sup>133</sup> NAFTA, art. 1102(4). State governments are required to treat foreign investors no less favorably than in-state investors, meaning that each state must treat foreign corporations as well as it treats in-state corporations. See *id.*, art. 1102(3) (state and provincial governments must provide foreign investors with treatment “no less favorable than the most favorable treatment accorded, in like circumstances, by that state or province to investors of the party of which it forms a part.”)

### c. De Facto Discrimination

In addition to intentional or explicit discrimination against foreign investors, national treatment also prohibits some measures that have a discriminatory impact on foreign investors, as noted by the tribunal in *S.D. Myers v. Canada*. The tribunal held that Canada had violated Article 1102 of NAFTA by prohibiting the exportation of PCB waste to the United States. Citing evidence that Canada was motivated by a desire to protect the Canadian hazardous waste disposal industry, the tribunal concluded that the ban discriminated against S.D. Myers, a United States hazardous waste disposal corporation that wanted to export PCBs from Canada into the United States for disposal.<sup>134</sup>

Although the tribunal indicated that it based its decision on its finding that Canada acted with a discriminatory motive, it stressed that national treatment also precludes measures where “the practical effect of the measures is to create a disproportionate benefit for nationals over non nationals . . . .”<sup>135</sup> The standard for de facto violations of national treatment, however, is not clear. The analysis depends upon a variety of factors, including the determination of which domestic investors are “in like circumstances” with the foreign investor, a phrase which the tribunal in *S.D. Myers* acknowledged was “open to a variety of interpretations in the abstract and in the context of a particular dispute.”<sup>136</sup>

Accordingly, it is difficult to predict under which circumstances a tribunal might find that a decision by a State Coastal Agency to reject a foreign investor’s application for a permit for a desalination project would constitute a de facto violation of national treatment. As discussed in the services section of this paper, however, one example of a potential de facto violation of national treatment would be a policy requiring public ownership of desalination facilities, given that foreign corporations would not be eligible.<sup>137</sup>

#### Oversight Question

- **Public Ownership.**  
Would a policy requiring public ownership of desalination facilities constitute a de facto violation of national treatment?

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<sup>134</sup> See *id.*, paras. 114, 116, 255 and 256.

<sup>135</sup> *S.D. Myers*, para. 252.

<sup>136</sup> *Id.* para. 243. The tribunal did indicate, however, that the standard for determining whether a foreign investor was “in like circumstances” with a domestic investor generally refers to whether the investors are operating within the same business or economic sector. See *id.*, paras. 248, 250-51.

<sup>137</sup> See *supra* Section I(B)(2)(b). Conceivably a policy permitting only public ownership of desalination facilities “in any relevant market” could be implemented in the form of the designation of a monopoly, which NAFTA explicitly permits. See NAFTA, art. 1502(1) (“[n]othing in [NAFTA] shall be construed to prevent a party from designating a monopoly”); see also *id.*, art. 1505 (defining monopoly as “an entity, including a consortium or government agency, that in any relevant market in the territory of a Party is designated as the sole provider or purchaser of a good or service . . . .”) The Chile and Singapore FTAs similarly appear to permit monopolies. See U.S.–Chile FTA, art. 16.3 (“Nothing in this Chapter shall be construed to prevent a Party from designating a monopoly”); U.S.–Singapore FTA, art. 12.3(1) (a) (“Nothing in this Chapter shall be construed to prevent a Party from designating a monopoly”). Note, however, that the Chile and Singapore FTAs, unlike NAFTA, state only that the provisions of a particular chapter of each of the agreements, not the entire agreements, do not prohibit the designation of a monopoly.

A pending challenge being brought by the United Parcel Service (UPS) against Canada under Chapter 11 of NAFTA could help to clarify the status of government monopolies under National Treatment. The case concerns Canada Post Corporation, a state enterprise that has a monopoly over first class mail delivery within Canada. UPS is arguing that Canada is violating national treatment by permitting Canada Post to gain a competitive advantage in non monopoly sectors of the postal market, such as parcel delivery, by using the infrastructure that was built for its

## C. Exceptions and Waivers

### 1. Environmental Exceptions in Investment Agreements

Article 2101 of NAFTA incorporates by reference the exceptions contained in Article XX of the GATT, which include two so-called “environmental exceptions.”<sup>138</sup> Article 2101, however, clearly states that these exceptions are only applicable to NAFTA’s provisions regarding Trade in Goods and Technical Barriers to Trade, *not* to Chapter 11’s provisions regarding investor protection.<sup>139</sup> Chapter 11 of NAFTA also contains circular language which states that NAFTA’s investor protection provisions should not be construed to prohibit environmental measures that are “otherwise consistent with this Chapter.”<sup>140</sup> Similar language is contained in the U.S.-Chile FTA and the U.S.- Singapore FTA.<sup>141</sup> This provision does not provide any meaningful protection given that it does not apply to measures that are *inconsistent* with the relevant investment rules.

### 2. Attempts to Waive Rights under Investment Agreements

It has been suggested that a State Coastal Agency could limit its exposure to claims under investment agreements by requiring permit applicants to consent to the agency’s jurisdiction, presumably by waiving their right to invoke international dispute settlement procedures with regard to the regulatory actions of the agency. It is unlikely, however, that a tribunal convened pursuant to an international investment treaty would recognize the validity of such a waiver agreement.

This issue was recently addressed in the context of a bilateral investment treaty (BIT) between Argentina and France in *Compania de Aguas de Aconquija and Vivendi v. Argentina*.<sup>142</sup> The case involved a concession contract pursuant to which an Argentinean subsidiary of the French company Vivendi would operate the water system of the Argentine province of Tucuman. Vivendi brought a claim before an ICSID tribunal arguing that the province had acted in a manner that effectively denied it the benefits of the contract and violated Argentina’s obligations under the BIT.

Argentina argued that the ISCID tribunal did not have jurisdiction to hear the claim because the concession contract explicitly stated that all disputes concerning the contract would be decided exclusively by the administrative courts of Tucuman.<sup>143</sup> The tribunal essentially treated the exclusive

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monopoly mail service. The case has not yet been resolved. The tribunal, however, has rejected a jurisdictional challenge to UPS’s National Treatment claim, noting that UPS has “alleged facts which are capable of constituting a violation of Article 1102.” *See United Parcel Service v. Canada*, Award on Jurisdiction, para. 102 (November 22, 2002).

<sup>138</sup> *See* GATT, arts. XX(b) (providing an exception for measures “necessary to protect human, animal or plant life or health”), and XX(g) (providing an exception for measures “related to the conservation of exhaustible natural resources. . . .”)

<sup>139</sup> *See* NAFTA, art. 2101. The environmental exceptions in the Chile and Singapore FTAs are similarly limited. *See* U.S.-Chile FTA, art. 23.1; U.S.- Singapore FTA, art. 21.1. Article 1106 of NAFTA also contains environmental exceptions which apply only to NAFTA’s provisions on performance requirements. *See* NAFTA, art. 1106(6).

<sup>140</sup> NAFTA, art. 1114.

<sup>141</sup> U.S.-Chile FTA, art.10.12; U.S.- Singapore FTA, art. 15.10.

<sup>142</sup> *Decision on Request for Annulment*, Case No. ARB/97/3, 41 I.L.M. 1135 (2002) [hereinafter *Vivendi Annulment Decision*].

<sup>143</sup> *See id.* para. 11.

jurisdiction clause as requiring that Vivendi exhaust domestic remedies, upholding its jurisdiction to hear the claim but rejecting the claim on the merits.<sup>144</sup>

Reviewing the tribunal’s decision pursuant to a request for partial annulment filed by Vivendi, an *ad hoc* Committee established by ICSID affirmed the tribunal’s finding of jurisdiction, but rejected the tribunal’s conclusion that Vivendi’s claim failed on the merits because it had not pursued the claim before the domestic courts of Tucuman. The Committee indicated that the effect of an exclusive jurisdiction clause depends upon whether the investor is asserting a breach of the contract containing the clause, or asserting that its rights under an international investment agreement have been violated. An exclusive jurisdiction clause in a contract between a foreign investor and a government that states that disputes concerning the rights and obligations of the parties under the contract must be brought in the domestic court system will be given effect, except to the extent that enforcing such a provision would be inconsistent with the terms of the relevant investment treaty.<sup>145</sup> However, an exclusive jurisdiction clause will not preclude an international tribunal from hearing an investor’s claim when the basis of the claim is a violation of an investment treaty rather than breach of contract.<sup>146</sup> Moreover, an exclusive jurisdiction clause cannot preclude an investor’s government – as opposed to the investor itself – from asserting claims based upon violations of an international investment agreement.<sup>147</sup>

Accordingly, if a State Coastal Agency were to require a foreign permit applicant to agree to waive its ability to invoke any rights that it might have under an investment agreement, it is unlikely that an international tribunal would enforce such an agreement and decline to hear a claim by the investor. Although the waiver would arguably be contractual in nature, the claims asserted by the investor would be based upon the alleged violations of the terms of the investment

#### Oversight Question

- **Waivers of investors’ rights.** Could a State Coastal Agency require foreign investors to waive their rights under international investment agreements as a condition of receiving a permit?

<sup>144</sup> See *Compañía de Aguas del Aconquija S.A. v. Argentine Republic*, Case No. ARB/97/3, 40 I.L.M. 426 (2001), para. 78:

[T]he Tribunal holds that, because of the crucial connection in this case between the terms of the Concession Contract and these alleged violations of the BIT, the Argentine Republic cannot be held liable unless and until Claimants have, as Article 16.4 of the Concession Contract required, asserted their rights in proceedings before the contentious administrative courts of Tucumán and have been denied their rights, either procedurally or substantively. (§78).

See also Emmanuel Gaillard, *‘Vivendi’ and Bilateral Investment Treaty Arbitration*, NEW YORK LAW JOURNAL, Vol. 229 (February 6, 2003) (noting that the tribunal’s decision “would amount to reintroducing the obligation to exhaust local remedies before proceeding to international arbitration”).

<sup>145</sup> See *Vivendi Annulment Decision*, para. 98 and note 69 (“In a case where the essential basis of a claim brought before an international tribunal is a breach of contract, the tribunal will give effect to any valid choice of forum clause in the contract . . . unless the treaty in question otherwise provides”) (citations omitted).

<sup>146</sup> See *Vivendi Annulment Decision*, para. 101 (“where the fundamental basis of the claim is a treaty laying down an independent standard by which the conduct of the parties is to be judged, the existence of an exclusive jurisdiction clause in a contract between the claimant and the respondent state or one of its subdivisions cannot operate as a bar to the application of the treaty standard.”) Accordingly, even when a contractual dispute between a foreign investor and a government has been adjudicated in domestic courts, the investor could seek review of the domestic court proceedings before an international tribunal, arguing that the domestic court proceedings violated the investor’s rights under the relevant investment agreement.

<sup>147</sup> See *Vivendi Annulment Decision*, para. 99 (noting that an agreement between an investor and a government “could not preclude a claim by [the investor’s] government in the event that the treatment accorded to him amounted to a breach of international law”).

agreement – *e.g.*, expropriation or minimum treatment – rather than on any contractual breach by the agency.

### III. THE LEGAL EFFECT OF INTERNATIONAL SERVICES AND INVESTMENT RULES

#### A. The International Legal Effect

Under the doctrine of state responsibility, national governments are generally responsible under international law for the actions of subnational governments within their territory.<sup>148</sup> Both the GATS and NAFTA explicitly incorporate this rule.<sup>149</sup> Thus if a State Coastal Agency's actions concerning a proposed desalination facility were challenged as a violation of either international investment or services rules, the United States would be the "defendant" in the dispute settlement proceeding.

A challenge under the GATS (or other services rules) to a State Coastal Agency's actions concerning a proposed desalination facility could only be brought by the home government of an adversely affected corporation. The process for resolving such trade disputes between countries is known as "state-to-state" dispute settlement. If the challenge were successful, the complaining country would be entitled to compensation in the form of authorization to "suspend benefits" that the United States enjoys under the WTO. The suspension of benefits would most likely take the form of the imposition of retaliatory tariffs on U.S. products, or authorization for the complaining country to discriminate against U.S. service suppliers.<sup>150</sup>

The laws implementing the WTO agreements (including the GATS), NAFTA and the bilateral FTAs bar private parties from suing to preempt state and local laws based on their inconsistency with trade rules. Significantly, however, these laws permit the federal government to bring such actions.<sup>151</sup> The implementing legislation appears to contemplate that the appropriate form of relief in such an action would be a declaratory judgment concerning the invalidity of the state or local measure; the legislation

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<sup>148</sup> See RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 207(b) ("A state is responsible for any violation of its obligations under international law resulting from action or inaction by . . . the government or authorities of any political subdivision of the state. . .").

<sup>149</sup> See NAFTA, art. 105 ("[t]he Parties shall ensure that all necessary measures are taken in order to give effect to the provisions of this Agreement, including their observance, except as otherwise provided in this Agreement, by state and provincial governments"); GATS, art. I(3) ("[i]n fulfilling its obligations and commitments under the Agreement, each Member shall take such reasonable measures as may be available to it to ensure their observance by regional and local governments and authorities and non-governmental bodies within its territory.")

<sup>150</sup> See Understanding on Rules and Procedures Governing the Settlement of Disputes, Apr. 15, 1994, WTO Agreement, Annex 2, Legal Instruments – Results of the Uruguay Round vol. 31, 33 I.L.M. 1226 (1994) [hereinafter DSU], art. 22.

<sup>151</sup> See North American Free Trade Agreement Implementation Act § 102(b)(2), 19 U.S.C. § 3312(b)(2) (1993) ("No State law, or the application thereof, may be declared invalid as to any person or circumstance on the ground that the provision or application is inconsistent with the Agreement, *except in an action brought by the United States for the purpose of declaring such law or application invalid*" (emphasis added)); *id.*, § 102(c), 19 U.S.C. § 3312(c) (1993) ("No person other than the United States . . . may challenge, in any action brought under any provision of law, any action or inaction by any department, agency, or other instrumentality of the United States, any State, or any political subdivision of a State on the ground that such action or inaction is inconsistent with [NAFTA] . . ."); Uruguay Round Agreements Act (URAA) § 102(b)(2)(A), 19 U.S.C. § 3512(b)(2)(A) ("No State law, or the application of such a State law, may be declared invalid as to any person or circumstances on the ground that the provision or application is inconsistent with any of the [WTO agreements], *except in an action brought by the United States for the purpose of declaring such law or application invalid*"). See also URAA § 102(c)(1), 19 U.S.C. § 3512(c)(1).

does not explicitly address whether the federal government could also seek monetary damages to indemnify it for any liability it incurred pursuant to Chapter 11.<sup>152</sup>

The dispute settlement process under investment agreements such as Chapter 11 of NAFTA, in contrast, differs both with regard to the parties to the dispute and the remedies that are available if a violation is found. A Canadian or Mexican corporation that invested in a desalination project in the United States could bring a claim before an international tribunal in a process known as “investor-to-state” dispute settlement.<sup>153</sup> If the investor were to prevail, the remedy would take the form of the United States paying monetary damages to the investor rather than the imposition of retaliatory tariffs.<sup>154</sup>

## B. The Domestic Legal Effect

A decision by the WTO or a NAFTA tribunal holding that a State Coastal Agency had violated a services or investment rule, however, would not directly preempt the relevant provisions of the statute pursuant to which the agency had acted or otherwise directly invalidate the agency’s action as a matter *United States law*. Trade rules generally do not have any direct domestic legal effect, but rather only define the obligations of the United States to our trading partners as a matter of *international law*.

Even if the federal government did not exercise this authority, a decision by the WTO’s Dispute Settlement Body (DSB) or a NAFTA tribunal holding that a State Coastal Agency had violated an international rule could undermine the agency’s authority in a variety of ways. Congress

### Oversight Questions:

- **Preemption under trade rules.** Under what circumstances would the federal government exercise its authority to sue to preempt an application of a state law that was found to violate international trade in services or investment rules?
- **Indemnification under trade rules.** If an international tribunal found that an application of a state law had violated a foreign investor’s right under an international investment agreement and ordered the United States to pay damages to the investor, could the federal government sue the state to seek indemnification for the damages?
- **Federal funding and trade rules.** If an application of a state law were found to violate an international services or investment rule, could the federal government require the state to either amend or stop enforcing the offending measure as a condition of receiving federal funds?

<sup>152</sup> See Vicki Been, *NAFTA’s Investment Protections and the Division of Authority for Land Use and Environmental Controls*, 32 *Envtl. L. Rep. (Envtl. L. Inst.)* 11,001, 11,012 (Sept. 2002) (“Nothing in the legislation passed to implement NAFTA clearly authorizes the federal government to sue a state or locality to recover damages imposed upon the federal government for a state or locality’s violation of NAFTA.”); René Lettow Lerner, *International Pressure to Harmonize: The U.S. Civil Justice System in an Era of Global Trade*, 2001 *BYU L. REV.* 229, 279-81 (2001) (discussing potential for federal government to sue states for indemnification for NAFTA violations under federal common law principles). If permitted under the implementing legislation, an action for damages against a state by the federal government would not be barred by the Eleventh Amendment. See *Seminole Tribe of Fla. v. Florida*, 517 U.S. 44, 71 n.14 (1996) (finding that the Eleventh Amendment does not bar federal government from bringing suits against states in federal court); Been, *supra*, at 11,013 (arguing that Eleventh Amendment should not bar the federal government from suing a state to recover funds that the federal government, as a result of the state’s violation of NAFTA, had been required to pay to a foreign investor).

<sup>153</sup> See, e.g., NAFTA, Chapter 11, Section B (Settlement of Disputes Between a Party and an Investor of Another Party). In a departure from the NAFTA model, the recently completed U.S. - Australia Free Trade Agreement does not contain an investor-to-state dispute settlement mechanism. See Inside U.S. Trade, *U.S. Australia FTA Falls Short on U.S. Investment Demands* (Feb. 13, 2004), at <http://www.insidetrade.com>.

<sup>154</sup> See NAFTA, art. 1135.

could – in order to avoid the imposition of trade sanctions authorized by the DSB – pass legislation preempting the measure. Congress could also condition federal grants to the state on the state’s agreement to either amend or stop enforcing the offending measure. Even in the absence of any action by Congress, the prospect of federal preemption or the loss of federal funds could have a chilling effect that would cause state legislators to amend the relevant statute in response to an adverse decision by the WTO or a NAFTA tribunal.<sup>155</sup>

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<sup>155</sup> See Vicki Been & Joel C. Beauvais, *The Global Fifth Amendment? NAFTA’s Investment Protections and the Misguided Quest for an International “Regulatory Takings” Doctrine*, 78 N.Y.U. L. REV. 30, 132-35 (2003) (discussing potential chilling effect of NAFTA’s expropriation provision).

## IV. OPTIONS FOR DEALING WITH POTENTIAL CONFLICTS

As discussed above, our analysis has identified a range of potential conflicts between state regulation of desalination facilities pursuant to the CZMA and state coastal management statutes and trade and investment rules. The states have several options for responding to these potential conflicts.

### A. Do Nothing at this Time

The states could opt to do nothing at this time. There is no imminent threat of a trade dispute based on any of the potential conflicts noted above. However, in five or ten years, another country or a foreign investor might have an economic interest in using international trade or investment rules to challenge state authority.

The problem with doing nothing is that now is the time when state and local governments have an opportunity to influence the contents of trade rules and the scope of state measures that they cover. If the states wait until there is an imminent threat of a trade dispute, it will be too late to influence the trade negotiations. The only option at that point would be to choose between enduring economic sanctions or repealing the noncompliant state measure.

### B. Oversee Trade Negotiations

Alternatively, State Coastal Agencies could engage in oversight of trade negotiations by posing questions to trade negotiators and by identifying safeguards that could be used to protect their regulatory authority.

#### 1. Asking Oversight Questions

Many provisions of trade agreements are vague, which makes it difficult to analyze their potential impact on state and local governments. This paper identifies questions about those provisions that can be posed to U.S. trade negotiators in order to clarify the risk of conflict between trade rules and the states' regulatory authority. The questions are set out in text boxes throughout the report and are collated in the Appendix.

#### 2. Identifying Safeguards

In addition to posing questions, the states can also act to protect their authority by identifying safeguards that would either avoid or mitigate the consequences of conflicts between trade rules and their state laws. Examples of potential safeguards include –

- **Limiting the substantive and procedural provisions** of trade agreements. Examples of changes that could be made to the current models for services and investment rules include–
  - requiring foreign investors to exhaust all reasonably available domestic remedies before bringing an investor-to-state claim,
  - revising the standard for minimum treatment and expropriation to preclude challenges to nondiscriminatory regulatory measures,
  - revising the domestic regulation rule to expand the scope of public purposes beyond merely ensuring the quality of a service, and

- limiting application of the domestic regulation rules to only those sectors to which the United States has negotiated commitments.
- **Limiting the scope** of state measures that the trade and investment rules cover. This can be accomplished by –
  - excluding entire levels of government or specific government agencies (such as coastal management agencies),
  - excluding types of laws (such as coastal protection measures), and
  - excluding specific laws (such as the state laws that implement the CZMA).
- **Expanding general exceptions** to cover conservation measures, as found in other treaties to which the U.S. is a party.<sup>156</sup>
- **Structuring the implementing legislation** so as to limit relevant domestic enforcement sanctions, such as preemption or the withholding of federal funds.

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<sup>156</sup> *E.g.*, General Agreement on Tariffs and Trade (GATT), art. XX(g).

## APPENDIX

### Questions Regarding Services Rules

1. What is the threshold for a company foreign to Chile or Singapore to establish “substantial business activities” thereby earning the same trade rights as a corporation domestic to Chile or Singapore?
2. In the Chile and Singapore FTAs, the U.S. Annex II provides that the United States reserves the right to adopt or maintain measures that are “not inconsistent” with U.S. obligations under GATS market access. Does this operate to keep the market access commitments of the FTAs in sync with GATS commitments?
3. Will U.S. negotiators promise not to commit water services under GATS in current and future rounds of negotiations?
4. Is handling the brine discharge of a desal facility classified under the GATS schedule as “wastewater services,” “water for human use,” or both?
5. The United States limits its present commitment for sewage services and its proposed commitment for wastewater services to services “contracted by private industry.” Does “contracted by” refer to private contractors that provide services to another private industry, private contractors that provide services to government agencies (sometimes referred to as public-private partnerships), or both?
6. Under a commitment in the construction sector, does GATS cover only regulation of foreign construction companies, foreign companies that that hire domestic construction companies, or both?
7. Regarding the U.S. commitment to “other” environmental services, footnote 19 in the U.S. schedule refers to “new and existing systems” for remediation, mitigation and monitoring. Do the environmental services related to developing and operating a desal facility constitute a “system” for purposes of GATS coverage?
8. Will the United States oppose implementing the domestic regulation rules to cover all services? Alternatively, will the United States support limiting domestic regulation rules to only committed sectors?
9. The market access rules refer to measures “in the form of” and “in terms of” certain quantitative limits. Do measures that have the effect of quotas or limits on the number of operations, etc. also conflict with this rule?

## Questions Regarding Investment Rules

1. Could a French, British or German corporation that conducts “substantial business activities” in Canada use a Canadian subsidiary to challenge under NAFTA Chapter 11 a State Coastal Agency’s refusal to issue a permit for a desalination project owned by the subsidiary?
2. Could a United States corporation that conducts “substantial business activities” in Canada use a Canadian subsidiary to challenge under NAFTA Chapter 11 a State Coastal Agency’s refusal to issue a permit for a desalination project owned by the subsidiary?
3. Could any multinational corporation that conducts “substantial business activities” in Chile use a Chilean subsidiary to challenge under the investment chapter of the U.S. – Chile Free Trade Agreement to challenge a State Coastal Agency’s refusal to issue a permit for a desalination project owned by the subsidiary?
4. Would the commitment of capital by a covered foreign investor to a desalination project in a coastal state constitute a form of “investment” entitled to protection under Chapter 11 of NAFTA or the investment chapters of the Chile and Singapore free trade agreements?
5. If State Coastal Agency refused to issue a permit to a foreign investor for a desalination facility, and that refusal caused a “significant” or “substantial” adverse effect on the value of the investor’s investment in the desalination project, could the refusal be found to constitute an act of “indirect expropriation”?
6. Under what circumstances could a State Coastal Agency’s permitting procedures be found to violate the standard for “fair and equitable treatment”?
7. Does the grandfathering of existing measures from national treatment preclude challenges to specific applications of existing measures – such as a decision on an application for a coastal permit?
8. In future investment agreements, will USTR assert a general reservation from national treatment for future measures by state and local governments?
9. Would a policy requiring public ownership of desalination facilities constitute a de facto violation of national treatment?
10. Could a State Coastal Agency require foreign investors to waive their rights under international investment agreements as a condition of receiving a coastal permit?
11. Under what circumstances would the federal government exercise its authority to sue to preempt an application of a state coastal management law that was found to violate international trade in services or investment rules?
12. If an international tribunal found that an application of a state coastal management law had violated a foreign investor’s right under an international investment agreement and ordered the United States to pay damages to the investor, could the federal government sue the state to seek indemnification for the damages?
13. If an application of a state’s coastal management law were found to violate an international services or investment rule, could the federal government require the state to either amend or stop enforcing the offending measure as a condition of receiving federal funds?