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Local Content Requirements: Assessment from Investment Law

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Abstract: *Local content requirement (LCR) is one of several economic instruments used by governments for various purposes, including to protect infant domestic industries or to generate employment. Indonesia uses LCR policies in several sectors. However, LCRs are often found to be inconsistent with a country's WTO commitments. Additionally, free trade agreements could also have provisions that regulate the implementation of LCRs. This paper seeks to assess whether Indonesia's free trade agreements have provisions on LCRs, and, if so, whether its LCR regulations are consistent with those provisions.*

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1. Introduction

Many governments believe that employing local content requirements (LCRs) is a way to promote domestic industry and employment or encourage domestic innovation. Many papers have been written to assess the pros and cons of having LCRs for the growth of an economy (UNCTAD, 2003). The Organisation for Economic Co-operation and Development (OECD) finds that while the short-term impact of LCR measures seems politically attractive, governments also hope that the protected industry will be sustainable and generate growth and jobs in the long term (OECD, 2019). It has been suggested that LCR policies make the protected industries uncompetitive and less innovative over time. In turn, the policies can have economy-wide spillover effects that can be long-lasting and extremely difficult to undo over time (OECD, 2019). However, in a few cases, LCR policies turned out to be successful, provided certain conditions exist (Johnson, 2016), e.g. China's policy to develop the wind turbine industry succeeded because of a robust domestic market.

LCRs essentially create discrimination against foreign investors and foreign goods and/or services. Accordingly, certain rules have been introduced to regulate LCRs from international trade and international investment law perspectives. This paper analyses LCRs from the investment law perspective as found in the World Trade Agreement (WTO) Agreement on Trade Related Investment Measures (the TRIMs Agreement), General Agreement on Trade in Services (GATS), and bilateral investment treaties (BITs) or other international investment agreements (IIAs).

Section 2 analyses several cases brought to international dispute resolution fora, namely, investor–state dispute settlement mechanism (ISDS) and the WTO dispute settlement mechanism (DSM). Section 3 reviews certain LCR policies and regulations in the United States (US), several members of the European Union (EU), India, and China (and some of the major economies)[1] and analyses their compliance with investment law rules in the TRIMs Agreement, GATS, and the IIAs. Section 4 provides suggestions for Indonesia based on lessons learned from the previous cases and the reviewed LCRs. Section 5 concludes.

[1] The authors could not find any existing LCRs imposed by Japan and Korea as they appear to pursue different economic policies to bolster their domestic industries.

2. Cases Involving LCR Policies and Regulations before International Dispute Resolution Fora

This section explains the investment law rules applicable to the LCRs and reviews their application in the WTO DSM and the ISDS through several cases (see Annex for the list of reviewed cases).

A. Rules on LCRs under International Investment Law

1) TRIMs Agreement

The TRIMs Agreement contains disciplines applicable to WTO member states for their investment measures (affecting trade in goods only) that can have trade-restrictive and distorting effects.

Article 2.1 of the TRIMs Agreement prohibits any investment measures or requirements imposed on investors to allow them to invest or operate in the host state. Such measures fall within the scrutiny of Articles III and XI of the 1994 General Agreement on Tariffs and Trade (GATT). Further, the Annex to the TRIMs Agreement contains an illustrative list of TRIMs (the Illustrative List) considered inconsistent with GATT Articles III: 4 and XI: 1, including LCRs in the form of measures that are mandatory, enforceable, or compliance of which is necessary to obtain an advantage, and measures which require the purchase or use domestic products. If such measures fall within the coverage of paragraph 1(a) of the Illustrative List, they are automatically inconsistent with the correlating GATT provision (Hestermeyer and Nielsen, 2014). This understanding has been confirmed in WTO case law. The Panel in *Canada – Renewable Energy* (also cited in the Panel Report, *India – Solar Cells*) stated that:[2]

> Article 2.2 of the TRIMs Agreement does not impose any obligations on Members, but rather informs the interpretation of the prohibition set out in Article 2.1. In particular, Article 2.2 explains that the TRIMs described in the Illustrative

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[2] Panel Report, *Canada–Measures Affecting the Renewable Energy Generation Sector*, WT/DS412/R, 19 December 2012 (Panel Report, *Canada – Renewable Energy*), para 7.119. See also Panel Report, *India–Solar Cells and Modules*, WT/DS456/R, 24 February 2016 (Panel Report, *India–Solar Cells*), para 7.53.

List of the Annex to the TRIMs Agreement are to be considered inconsistent with Members' specific obligations under Articles III: 4 and XI: 1 of the GATT 1994.

This demonstrates that LCRs may also breach GATT Article III: 4 or GATT Article XI: 1. However, the authors will not discuss these potential breaches because they are more relevant for discussing LCRs from the trade law perspective.

Only WTO member states (not individual investors) can claim a breach of the TRIMs Agreement to the WTO Dispute Settlement Body (DSB). As provided under the WTO Dispute Settlement Understanding (DSU), the remedy from the WTO DSM is limited to a recommendation for the breaching state to bring its measure to comply with the WTO Agreements. No direct compensation is given to any individual investor who may suffer damages from the measure.

2) GATS

While the TRIMs Agreement regulates investment measures affecting trade in goods, GATS covers trade in services (Mode 3 on the commercial presence of foreign direct investment). GATS Article XVI particularly prohibits LCRs on foreign investors seeking to gain market access through (i) restriction or requirement of certain types of legal entities or joint ventures or (ii) limitation of foreign capital participation. In addition, certain LCRs can also breach GATS Article XVII (national treatment). Nevertheless, these prohibitions apply only to the committed sectors of the relevant WTO member, i.e. if included in its schedule of commitments, and certain exceptions under the GATS remain applicable. Similar to the TRIMs Agreement, only WTO member states can claim any GATS breaches.

3) Provisions in IIAs

LCRs are expressly regulated in IIAs' performance requirements (PR) provisions and can also breach the national treatment (NT) provisions. Nevertheless, to bring an NT claim, the investor must demonstrate that it is or its investments are in 'like circumstances' as other investors or investments who receive more favourable treatment. This is not necessarily simple especially if the LCRs are targeted towards raw or intermediate materials rather than the final product of the manufacturers. Foreign manufacturers may

find that domestic manufacturers are treated similarly. This paper mainly focuses on PR provisions as many LCRs were brought to ISDS under such provisions.

The PR provision in the North American Free Trade Agreement (NAFTA) Chapter 11 is similar to the TRIMs Agreement. The provision prohibits the host state from imposing or enforcing any requirements in connection with the establishment, acquisition, expansion, management, conduct, or operation of an investment or conditioning the receipt or continued receipt of advantage based on compliance with any requirements to have a certain level of domestic content or to use or accord a preference to domestic goods or services.

Nevertheless, NAFTA Articles 1106(3)(a) and (b) do not prohibit the host state from conditioning the advantage on compliance with a requirement to locate production; provide service; construct or expand particular facilities; or carry out research and development in its territory (NAFTA Article 1106[4]). Further, certain exceptions are available, including:

1) measures (including environmental measures) necessary to secure compliance with laws and regulations consistent with NAFTA; necessary to protect human, animal, or plant life or health; or necessary for the conservation of living or non-living exhaustible natural resources, provided they are not applied arbitrarily or unjustifiably, or do not constitute a disguised restriction on international trade or investment (NAFTA Article 1106[6]);
2) non-conforming measures listed in the schedule of the host state (NAFTA Article 1108[1] and [2]);
3) qualification requirements imposed for goods or services concerning export promotion and foreign aid programs (NAFTA Article 1108[8][a]);
4) procurement by a Party or a state enterprise (NAFTA Article 1108[8][b]);
5) requirements imposed by an importing party relating to the content of goods necessary to qualify for preferential tariffs or preferential quotas (NAFTA Article 1108[8][c]); and
6) measures necessary to protect essential security interests (NAFTA Article 2102).

Similar to NAFTA, Article 10.6 of the Investment Chapter of the Regional Comprehensive Economic Partnership (RCEP)[3] explicitly prohibits LCRs in their PR provision along with certain exceptions. However, this discipline is not subject to the ISDS because RCEP does not have such a mechanism yet, and the parties plan to negotiate this in the future (Ewing-Chow and Losari, 2020).

Another approach seen in other IIAs is the incorporation of the provisions of the TRIMs Agreement, e.g. Article 7 of the ASEAN Comprehensive Investment Agreement (ACIA). However, unlike NAFTA, Article 32(a) of ACIA excludes the possibility of bringing any breach of the PR provision to the ISDS. This means that investors who enjoy protection under ACIA can neither bring a case directly against the host state nor obtain direct compensation from the host state even if the measure incurred losses on the investors. Instead, the investors must request their home states to bring the claim through the state-to-state dispute settlement mechanism provided under the agreement. Besides RCEP and ACIA, Indonesia has other IIAs with PR provisions discussed further below in section 4.A.

PR provisions can also be found in many BITs, e.g. the United States–Uruguay BIT (2005), the Japan–Peru BIT (2008), and the Canada–Senegal BIT (2014). Similar to NAFTA, these BITs allow investors to bring such PR claims to the ISDS directly.

B. WTO DSB Cases

This section looks into a few WTO disputes where WTO panels or the Appellate Body (AB) assessed disputed LCRs based on the TRIMs Agreement. Notably, disputes, where the complainants had argued breach of the TRIMs Agreement, are numerous. But the WTO panels or the AB decided not to make any finding under the TRIMs Agreement based on the principle of judicial economy when GATT Article III was found to have been breached.

1) India – Solar Cells

India's LCR measures (Jawaharlal Nehru National Solar Mission [NSM]) required solar power developers to purchase and use domestic solar cells and solar

[3] At the time of writing of this paper, the RCEP has not entered into force.

modules to enter into and maintain certain power purchase agreements under the NSM or with a specific local company. The solar power developers also received certain benefits and advantages, e.g. long-term tariffs for electricity if they bought and used domestic solar cells and solar modules.

The US complained to the WTO DSB, arguing that the measures were 'investment measures' because their objective was to encourage the production of solar cells and modules in India. And these were related to trade in goods because they imposed domestic content requirements related to the purchase, sale, or use of goods. The panel agreed and found that the measures constituted TRIMs. Further, given the measures required the use of solar cells and/or modules manufactured in India, they were TRIMs that required the use of domestic products. Finally, since compliance was necessary to have an advantage of being eligible for bidding and potential contractual benefits of obtaining guaranteed long-term tariffs, the measures were in breach of Article 2.1 of the TRIMs Agreement. Although India attempted to argue that its LCR measures were justified by GATT Article III: 8(a), the panel and the AB rejected the argument.

This case involves a *de jure* LCR measure that can be easily shown to breach the TRIMs Agreement.

2) Canada – Certain Measures Affecting the Renewable Energy Generation Sector and Canada – Measures Relating to the Feed-In Tariff Program (FIT) (Canada–Renewable)

The relevant LCR measures in dispute were the requirements to purchase or use equipment and components for renewable energy (solar or wind power) generation facilities from Ontario to qualify for guaranteed electricity prices offered under the FIT program, along with individual FIT and micro-FIT contracts implementing the requirements.

The panel found that Canada's measures were TRIMs because one of the aims was to 'encourage investment in the local production of equipment' in Ontario and compelled solar photovoltaic (PV) and wind power electricity generators to purchase and use certain types of equipment sourced in Ontario.

The main contentious question was whether the measures could be justified by GATT Article III: 8(a) (measures on certain government procurement). If the TRIMs fell under GATT Article III: 8(a), it would not breach Article 2.1 of the TRIMs Agreement.

The panel found that although the measures governed procurement of electricity by the government of Ontario and involved procurement by government agencies, the measures were undertaken with a view to commercial resale; thus, they did not fall under GATT Article III: 8(a). The panel subsequently found that the measures were TRIMs; therefore, they were inconsistent with GATT Article III: 4 and Article 2.1 of the TRIMs Agreement. While the AB reached the same conclusion, the AB disagreed with the panel's finding that the measures concerned electricity procurement. The AB considered the measures concerned discrimination to renewable energy generation equipment and, hence, not covered by GATT Article III: 8(a).

Similar to *India – Solar Cells,* the de jure LCR measures breach the TRIMs Agreement. However, the case highlights that certain exceptions may apply to LCR measures if the conditions are satisfied.

3) China – Measures Affecting the Imports of Automobile Parts

China's measures in relation to the import of automobiles and auto parts were brought to the DSB because they allegedly impacted imports of auto parts by (i) imposing on imported auto parts a charge equivalent to the tariff rate applicable to motor vehicles if the parts were characterised as complete motor vehicles according to the criteria set out in the measures, and (ii) imposing burdensome administrative procedures on automobile manufacturers importing auto parts to determine the applicability of the charge and govern the imposition of such charge.

The complainants argued that the measures favoured domestic auto parts over imported auto parts and constituted TRIMs in breach of Article 2 of the TRIMs Agreement. However, the panel exercised judicial economy and only found that China had breached GATT Article III: 4, as upheld by the AB.

This case highlights that LCR measures are often assessed from the trade rule of NT at the WTO level.

4) China – Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products (China – Audiovisual)

In this case, besides claiming breach of NT under GATS Article XVI, the US specifically argued that China's limitation on the participation of foreign capital in contractual joint ventures (JVs) engaging in the distribution of audiovisual home entertainment (AVHE) products was inconsistent with GATS Article XVI: 2(f). The panel found that China had made commitments in this sector without any reservation regarding the level of foreign equity participation for contractual JVs. Since the relevant measure provided that the Chinese JV partner should hold no less than 51% of any equity in a contractual JV engaging in the distribution of AVHE products, the panel found that the measure was inconsistent with GATS Article XVI: 2(f).

This measure demonstrates that LCR measures also exist in the services sector, e.g. market access for foreign direct investment, and it may be subject to the discipline of the GATS.

India – Measures Affecting the Automotive Sector

India introduced measures requiring motor vehicle manufacturing firms to achieve specified levels of local content. Further, import licences for certain motor vehicle parts and components would not be given to companies that did not sign and comply with a memorandum of understanding regulating certain export obligations. India used the term 'indigenisation', which required automobile manufacturers to use local parts and components (and purchase such local parts and components). The US disputed the measures at the DSB, and the panel report was issued on 21 December 2001. The panel found that the 'indigenisation' constituted a breach of GATT Article III: 4 but exercised judicial economy. The panel did not make any findings regarding the alleged breach of Article 2 of the TRIMs Agreement. Although India filed an appeal, it was eventually withdrawn.

C. ISDS Cases

This section analyses ISDS tribunal findings and legal analyses regarding LCRs.

- **NAFTA cases**

1) *Mobil Investments Canada Inc. and Murphy Oil Corporation v the Government of Canada*

The case involves American investors, Mobil Investments Canada Inc. (Mobil) and Murphy Oil Corporation (Murphy), that were investing in the Hibernia and Terra Nova oil field development projects in Newfoundland (NL) and Labrador, Canada (the Projects). The case was brought against Canada under NAFTA, alleging that the enforcement of guidelines on research and expenditure (the Guidelines) by the Canadian NL and the Labrador Offshore Petroleum Board (the Board) constituted a breach of the PR provision in NAFTA Article 1106(1) but no claim for breach of the NT provision.

The Guidelines required investors to spend a fixed percentage of project revenues on research and development (R&D) and education and training (E&T) in NL. The Tribunal assessed whether (i) the R&D and E&T requirements constitute 'services' within the meaning of Article 1106, and (ii) the Guidelines compel spending on R&D and E&T such that they constitute a 'requirement' to 'purchase, use, accord a preference to goods produced or services provided in its territory, or purchase goods or services from persons in its territory'. The Tribunal found that the term 'services' was broad enough to encompass R&D and E&T, and this was supported by the NAFTA classification system in the procurement chapter, which includes a category R&D and E&T. The Tribunal also found that the Guidelines were 'designed to be applied as a matter of legal obligation by means of Benefits Plans' to introduce 'an obligatory expenditure requirement'.

Canada argued that the requirement to carry out R&D or E&T in the province did not compel the investors to purchase, use, or accord a preference to any particular domestic goods or services. There were alternative ways to comply. However, the Tribunal was not convinced because, in reality, the implementation of the Guidelines would require local expenditures. And certain actions could not be implemented without according a preference to services provided in the province, e.g. endowing a university chair, furnishing a classroom, providing scholarships and in-house research facility. Such

actions would require according a preference to local goods and services to undertake their construction and operation. Accordingly, the Guidelines breached Article 1106.

This case demonstrates that the coverage of PR provisions in the IIAs is broader than the TRIMS Agreement and the GATS because it includes both goods and services. In addition, even though a measure does not expressly require consumption of domestic goods or services, it may still be caught by a PR provision if the measure de facto or by its design in practice requires or compels such consumption.

2) *The Corn* Products *Cases (Archer Daniels Midland Company (ADM) v Mexico; Cargill, Inc. v Mexico;* and *Corn Products International, Inc. (CPI) v Mexico)*

In two out of the three cases brought by US investors against Mexico, the Tribunals found that Mexico breached the PR provision in NAFTA Article 1106(3) for imposing a 20% tax on beverages and other products that contained sweeteners – i.e. high fructose corn syrup (HFCS) – other than cane sugar. At the time, HFCS was produced either outside of Mexico or by primarily foreign-owned firms in Mexico. Cane sugar was produced by Mexican-owned companies in Mexico. The Tribunal in *ADM* considered the structure of the Mexican sugar industry and the intent of the additional tax conferred on HFCS to finally find that the tax conferred advantages on the sugar industry in Mexico and had a detrimental effect on the claimant's investments. Further, the Tribunals in *ADM* and *Cargill* also found that the advantage given to cane sugar (which the Tribunal considered essentially domestic) discriminated against the HFCS industry and, thus, was inconsistent with NAFTA Article 1106(3). In contrast, the Tribunal in *CPI v Mexico* found there was no requirement for local procurement by the imposition of the tax on soft drinks using HFCS as a sweetener. Further, the Tribunal opined that the tax that reduced the use of CPI's product, if considered PR, was placed on the soft drink manufacturers; it was not even mandatory.

As regards the NT provision under NAFTA Article 1102, the tribunals in *ADM v Mexico, Cargill v Mexico, and CPI v Mexico* found that the additional tax on HFCS amounted to a breach of the provision as the HFCS suppliers were 'in like circumstances' and the domestic sugar suppliers to the soft drink industry.

Similar to the Tribunal in *Mobil v Canada,* the Tribunals in *ADM* and *Cargill* found that *de facto* measures could still amount to a breach of the PR provision. In those

cases, even though the tax was not imposed directly on the investors (HFCS manufacturers and distributors in Mexico) but soft drink bottlers, it affected the investors. The finding of the Tribunal in *CPI v Mexico* was rather curious because it seemed to limit the applicability of the PR provision to the investors who produced the final products (in that case, the soft drink bottlers), while nothing in NAFTA Article 1106 suggested such limitation. It was also curious that the Tribunal found that the tax was not mandatory. In reality, fulfilling the requirement was necessary to obtain such an advantage, i.e. not being taxed 20%.

3) SD Myers, Inc. v Canada

The dispute involved SD Myers, Inc. (SDMI), an American company, and Canada before a NAFTA tribunal. SDMI conducted the business of polychlorinated biphenyl (PCB) remediation, which included disposal of PCBs. PCBs are waste materials extracted from analysing equipment and oil. SDMI's treatment facility was located in the US. It invested in Canada by creating Myers Canada, which did the marketing, customer contact, testing, and assessment of oil and other like services before transporting to and treating the waste in the US.

Canada has prohibited the use of PCBs in new products manufactured in or imported into Canada since 1977. Subsequently, it banned the export of PCB waste from Canada to all countries except the US. When SDMI entered the Canadian market in 1993, it only faced one credible competitor. The US allowed SDMI to import PCBs and PCB waste from Canada for disposal from November 1995 to December 1997, although the access was closed again in July 1997 by a decision of the US courts. Around the same period, Canada introduced regulations banning the export of PCBs and PCB waste (including to the US). At the same time, SDMI already had seven contracts for exporting those products out of Canada. The ban effectively prevented SDMI from exporting.

SDMI argued that the export ban amounted to a breach of NAFTA Articles 1102 (NT) and 1106 (PR) because SDMI and Myers Canada were treated discriminatorily compared to Canadian operators who provided PCB waste remediation services. The export ban effectively required SDMI to carry out a major part of its proposed business in Canada. Hence, it was required to consume goods and services in Canada.

In assessing the claim of Article 1102 breach, the Tribunal found that SDMI and Myers Canada were 'in like circumstances' with Canadian operators as they engaged in providing PCB waste remediation services. The Tribunal also found that while Canada had a legitimate goal, it could have achieved it through several legitimate ways, but the export ban. Accordingly, the Tribunal found that Canada breached Article 1102.

As for the Article 1106 breach (PR provision), the majority of the Tribunal found that based on the substance and effect of the export ban, no 'requirements' as defined in Article 1106 were imposed on SDMI. However, one of the Tribunal members considered that the effect of the export ban was to require SDMI to undertake all of its operations in Canada, hence, breaching subparagraph (b) of Article 1106. Accordingly, by a majority, the Tribunal concluded that there was no breach of Article 1106. This finding is rather curious because the Tribunal did not see the measure's effect or analyse the de facto measure, unlike the Tribunal in *Mobil v Canada* as explained in section C.1 above. In fact, one of the Tribunal members voiced his dissenting opinion and stated that '[t]he practical effect of the export ban was contrary to Article 1106(b); SDMI and its affiliate Myers Canada were effectively required to carry out a major step in the remediation process, the physical disposal of the waste, in Canada'.[4]

This case illustrates that an LCR may also be captured by the NT provision of an IIA, particularly when it can be established that the relevant investors are 'in like circumstances'.

4) Merrill & Ring Forestry LP v Canada

Merrill & Ring Forestry LP (Merrill) argued that Canada's implementation of its log export regime breached NAFTA Articles 1102 (NT) and 1106 (PR) by imposing certain harvesting requirements, the surplus test, and other rules for properties located in remote areas.

Regarding the NT breach claim, the Tribunal considered that log producers in 'like circumstances' were those investors in identical circumstances, e.g. operating on lands under the same federal jurisdiction. Given that investors in British Colombia were

[4] *SD Myers Inc. v the Government of Canada,* Separate Opinion by Dr Bryan Schwartz, concurring except with respect to performance requirements, in the partial award of the tribunal, 12 November 2020 (*SD Myers v Canada*, Separate Opinion), para 193.

identically treated as Merrill, the Tribunal found no breach. This emphasises the different criteria that investment tribunals may apply regarding 'in like circumstances' (Algazzar, 2021), making it challenging for investors to claim a breach of NT.

The Log Export Control regime imposed PRs in the form of the obligation to cut and sort timber according to 'normal market practices' to scale timber rafts metrically and follow additional rules for properties located in the remote coastal region. Merrill argued that these measures impacted its investments, particularly its log exports. The requirements to cut, sort, and scale logs according to certain specifications breached NAFTA Article 1106(1)(c) because preference was accorded to goods that met the domestic market's requirements. The Tribunal considered that the requirements did not fall under the provision. Although there were effects on Merrill's exports, the Tribunal found that the effects were incidental and not prohibited by Article 1106(1).

Merrill could perhaps argue that by having such a requirement, Canada required Merrill to use domestic services in Canada to conduct the cutting, sorting, and scaling according to the requirement, without which it could not export the logs. With this argument, if the Tribunal adopted the approach in *Mobil v Canada,* the measure would more likely fall under NAFTA Article 1106(1)(c) due to its effect.

5) ADF Group Inc. v United States of America

ADF Group Inc. claimed against the US measures requiring steel materials to be 100% produced and fabricated in the US if they were to be used in constructing a highway interchange in Northern Virginia. The investor argued that the measures breached NAFTA Article 1102 (NT) and NAFTA Article 1106 (PR). However, the Tribunal found no breach of the NT provision because the investor could not prove that the measures constituted less favourable treatment to the investor nor to its steel vis-à-vis other similarly situated US steel fabricators or their manufactured steel.

Regarding NAFTA Article 1106, the US did not dispute that the measures constituted an LCR within the meaning of NAFTA Article 1106(1)(b) and a requirement to accord preference to goods produced or services provided in the US. However, the US argued that NAFTA Article 1108 provided an exemption to Article 1106 in cases of 'procurement by a Party'. After interpreting the phrase, the Tribunal found that the construction project of the highway interchange constituted or involved governmental

procurement covered under Article 1108 even if the federal government procured it; hence, there was no breach of Article 1106.

This case is an example of a *de jure* LCR policy that expressly obliged investors to use domestic products, but it did not amount to a breach given the existing exception.

- **BIT Case**

Joseph Charles Lemire v Ukraine[5]

Mr Lemire, an American, brought the case against Ukraine for alleged breach of the US–Ukraine BIT and the Settlement Agreement between Mr Lemire and Ukraine due to Ukraine's new laws on radio broadcasting. Previously, Mr Lemire already brought an ISDS case against Ukraine, which the Settlement Agreement resolved.

Mr Lemire argued that the amendment to the Ukrainian Law on TV and radio broadcasting (LTR), which required the fulfilment of 50% local music requirement by radio stations, breached Article II.6 of the US–Ukraine BIT prohibiting the host state from imposing performance requirements. However, the Tribunal found that the 50% requirement did not specify that radio stations must purchase any goods or services locally, but de facto the market for Ukrainian-authored, -composed, or -produced music was in Ukraine. Further, the Tribunal found that Article II.6 was trade-related, namely, 'to avoid that States impose local content requirements as a protection of local industries against competing imports', while the underlying reason of the amendment to the LTR (including the 50% requirement) was to promote Ukraine's cultural inheritance. This purpose was compatible with Article II.6. Accordingly, the Tribunal found that the 50% requirement did not amount to a violation of the local content rule in the BIT.

This case is rather curious. While the LCR *de facto* constitutes a PR provision, the Tribunal considered the objective of the LCR and found that the measure did not breach the BIT. This is understandable if the PR provision in the BIT provides that exception, but it does not seem to be the case. This shows the diverging approaches that tribunals often take in interpreting BITs.

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[5] *Joseph Charles Lemire v Ukraine,* ICSID Case No. ARB/06/18, Decision on Jurisdiction and Liability, 14 January 2010 (*Lemire v Ukraine*).

3. LCR Policies and Regulations: an International Tour

In this section, the authors identify past and current LCR policies and regulations of several countries. However, given the numerous LCRs available (in their 2013 paper, Hufbauer et al. identified more than 100 LCRs were applied since 2008 (Hufbauer et al., 2013)), the authors limit the observation to LCRs of several major economies and developing countries, namely, the US, a few EU member states, China, and India.

A. United States

The US maintained certain LCRs, particularly in the renewable energy sector, and the requirements were introduced by various states rather than by the federal government. India brought a case to the DSB against the US for these measures in September 2016. The panel issued its report in June 2019 with a finding that the US had breached its GATT Article III: 4 obligation.[6] However, the panel exercised judicial economy regarding India's claims on the US breaches of the TRIMs Agreement because Article 2 of the Agreement only concerns TRIMs inconsistent with GATT Article III: 4. Hence, any steps taken by the US to bring its measures to comply with GATT Article III: 4 would also eliminate non-conformity with obligations under the TRIMs Agreement. Notably, an appeal against the report is currently pending.

In August 2018, China followed India's footsteps and requested consultation for certain LCR measures of the US, some of which were already included in India's complaint.[7] Table 1 sets out some samples of LCR measures complained by China and/or India.

Table 1: Samples of the US' LCR Measures

Measure	Summary	Notes
Renewable Energy Cost Recovery Incentive Payment Program (Washington)	Incentives for: - customers of light and power businesses for generating electricity from a customer-generated electricity renewable energy system (RES); and	India and China lodged complaints.

[6] Panel Report, *United States – Certain Measures Relating to the Renewable Energy Sector,* DS510, 27 June 2019 (*US-REC*), paras 7.339–7.341.

[7] See WTO, *US – Certain Measures Related to Renewable Energy, Request for Consultations by China*, WT/DS563/1, 16 August 2018.

	- customers from relevant utilities for electricity generated by a RES. The incentive rate increases where the RES uses specified parts manufactured in the State of Washington.	
Self-Generation Incentive Program (California)	Incentives to users that install renewable energy distributed generation technologies to meet the electricity needs of a facility. An additional incentive is provided for the installation of eligible distributed generation resources manufactured in California	India and China lodged complaints.
Solar PV Incentive Program (Los Angeles)	One-time incentives to customers who purchase/lease and install solar PV equipment manufactured in Los Angeles.	China lodged a complaint.
Renewable Energy Credit (REC) requirements (Michigan)	One REC is granted to an owner of a RES for each megawatt-hour of electricity generated from the system. Additional RECs are granted for electricity generated from a RES constructed using equipment made in Michigan.	China lodged a complaint.
Experimental Advanced Renewable Program (Michigan)	Consumers Energy, Michigan's largest utility provider, offers a fixed rate for electricity transmitted from a customer and grants an extra incentive to the customer who installs and operates an eligible solar PV electricity generating system constructed using Michigan workforce or equipment made in Michigan.	China lodged a complaint.
Renewable Energy Standards Program (Michigan)	Requirement for electric providers to achieve a REC portfolio at levels specified by legislation Additional credits are available for electricity generated from a RES constructed using equipment made in Michigan or a workforce composed of Michigan residents.	A panel report was issued for India's complaint. The report also discussed measures taken by other US states, e.g. Montana, Connecticut, Delaware, and Minnesota.

<u>Brief Analysis</u>

From the perspective of the TRIMs Agreement, these measures appear to be TRIMs, hence, falling under paragraph 1 of the Illustrative List Annex of the TRIMs Agreement. The measures are similar to those assessed by the DSB in *India – Solar* and *Canada – Renewable*. Certain incentives are given only to renewable energy electricity generators who use products or components produced domestically in their generation. Accordingly, these measures are likely inconsistent with Article 2.1 of the TRIMs Agreement.

From the perspective of IIAs, these measures arguably constitute LCRs that are inconsistent with NAFTA Article 1106. Indeed, they are similar to the US measures in *ADF v USA*. However, these measures are linked to incentives rather than an eligibility requirement for a government procurement (exempted under NAFTA Article 1108). The US may have to argue that certain exceptions are applicable to justify these measures.

B. European Union

The EU Members do not seem to apply many LCRs, and we identify a few relating to the renewable energy sector below.

1) *Italy (Italian Gestore Servizi Energetici (Regole Applicative per l'Iscrizione ai Registri e per l'Accesso alle Tariffe Incentivanti)*

The program relates to administering Italy's feed-in tariff for electricity produced from solar PV installations. Under the program, a certain premium is granted for installations that use main components made in EU/European Economic Area states.[8] Although China requested consultation on this measure in 2012, it has not requested establishing a panel to adjudge the dispute.

2) *Greece*

In 2012, Greece had a program that incentivised renewable energy operators who use 70% or more components sourced from the EU or the EEA (OECD, 2015).

Brief Analysis

The measures introduced by Italy and Greece are very similar to the US measures as described in section 3.A above. Hence, the same analysis applies to these measures.

C. China

1) *Purchases of Technology by the Banking Sector*

In December 2014, China issued guidelines relating to information technology in the banking sector (the Guidelines). The US was concerned that the Guidelines' definition of 'secure and controllable' technology would limit access to China's commercial

[8] WTO, *European Union and Certain Member States – Certain Measures Affecting the Renewable Energy Generation Sector*, Request for Consultations by China, 7 November 2012, WT/DS452/1.

banking sector for many foreign information and communication technology products and services and technologies, and would dictate the business decisions of financial institutions, including foreign financial institutions investors. In addition, the policy also appeared to require indigenous intellectual property rights and new purchase of the banking industry of computer servers, desktop computers, laptops, tablets, and smartphones that must meet specific 'security and controllability' requirements.[9]

The measure itself does not appear de jure to be LCR. However, if it de facto requires the use or purchase of domestic products, it could potentially be inconsistent with the TRIMs Agreement, GATS, or PR provisions in the IIAs. Moreover, depending on the purpose of such measure, China could potentially argue certain justifications, e.g. measures necessary to ensure essential security interest.

2) 'Ride the Wind' Program for Wind Turbines

The program started in 1997, which required a 20% LCR for two joint ventures. Subsequently, in 2003, the LCR increased to 50%, and further increased in 2005 to 70%. LCR percentages were key in the evaluation of project bids. The program provides that only wind power plant projects with over 70% facilities manufactured domestically can be issued construction permits. In 2008, new products of wind turbine facilities and installation kits developed and produced by Chinese manufacturers were eligible for certain subsidies. However, China eventually revoked its LCR for wind farm projects in November 2009. The measure was never brought to the DSB (Xianqiang, 2013; Wang et al., 2016).

Like renewable energy–related measures, the program is likely inconsistent with the TRIMs Agreement and PR provisions in IIAs.

D. India

In February 2012, India's Department of Information Technology issued a policy requiring the purchase of domestically manufactured electronic products for government procurement and electronic products with security implications for the country. Hence,

[9] Questions from the United States, 'China-Local Content Requirements for Purchases of Technology by the Banking Sector', G/TRIMS/W/150.

the same obligation was imposed on telecom licensees without regard to the government or private ownership. The US[10] questioned the measure but never brought it to the DSB.

This measure would likely fall under Article 2.1 of the TRIMs Agreement. However, the measure could likely be justified by GATT Article III: 8 if it was applied only in relation to government procurement, as could be seen in *Canada – Renewable*. To benefit from exemption under GATT Article III: 8(a), one must demonstrate that the discriminated goods are procured for government purposes. In this case, the procurement of electronic products, which had security implications for the country, may not necessarily fall under the definition of government procurement, especially if private telecom companies obtained the goods. Hence, the measure may breach the TRIMs Agreement.

From the perspective of IIAs, the measure appears to be *de jure* inconsistent with most PR provisions as it expressly requires the purchase of domestic products. However, many PR provisions have certain exceptions, e.g. for government procurement or necessary for an essential security interest. Therefore, while the threshold is not necessarily low, if India could prove that the measure is designed with such purpose, the measure might be exempted.

4. Lessons Learned for Indonesia

A. Indonesia’s International Obligations Relating to LCRs (Investment Perspective)

As seen in the cases before the WTO DSB and ISDS tribunals, LCRs may breach certain provisions of the TRIMs Agreement and GATS, as well as the NT and PR provisions in various IIAs. Indonesia is a WTO member bound by those agreements and a party to many IIAs. Accordingly, Indonesia’s LCRs are also subject to those rules.

Certain WTO members have often questioned Indonesia’s LCRs at the meetings of the Committee on TRIMs; one of its LCRs had been deemed inconsistent with Article

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[10] Questions from the US, ‘India – Certain Preferences to Domestically Manufactured Electronic Goods’, G/TRIMS/W/94, 20 April 2012.

2.1 of the TRIMs Agreement.[11] The elaboration in section 2 above shows that WTO members will not hesitate to complain to the DSB against LCRs if such policies harm their nationals (investors in host states and their manufacturers in the home countries). If an LCR is inconsistent with the WTO law by the AB or a panel, the relevant WTO member must bring the measure to compliance, e.g. by removing the LCR or modifying the measure. No compensation is directly awarded to the businesses that may suffer from the policies.

Some IIAs, on the other hand, expressly regulate LCRs through the NT and PR provisions, and any allegations of breach of such provisions may be brought to the ISDS (where the dispute resolution provisions expressly stipulate so). This enables affected foreign investors to claim compensation against the host state for its LCR, which breaches the relevant NT or PR provision and causes damages to the investors. While none of Indonesia's remaining BITs contain any PR provisions, Indonesia has several investment agreements with PR provisions. We list these IIAs below in Table 2, along with the relevant DSM applicable to them. In addition, almost all of Indonesia's IIAs (including BITs) include the NT provisions, which could also be used to claim against LCRs, although with certain limitations.

Table 2: Indonesia's IIAs with PR Provisions and their Applicable DSMs

IIA Name	PR Provision	DSM (ISDS/SSDS)
Regional Comprehensive Economic Partnership (signed on 15 November 2020, not yet in force)	Chapter 10, Article 10.6	SSDS
ASEAN Comprehensive Investment Agreement (in force)	Article 7	SSDS
ASEAN–Japan CEPA (First Protocol amending the investment chapter was signed on 2 March 2019, and entered into force on 3 August 2020 for Japan, Singapore, Thailand, Lao PDR, Myanmar, and Viet Nam)	Chapter 7, Article 51.5	ISDS
ASEAN–Australia New Zealand Free Trade Agreement (in force)	Chapter 11, Article 5	SSDS

[11] Panel Report, *Indonesia – Certain Measures Affecting the Automobile Industry*, DS54/DS55/ DS59/ DS64, 2 July 1998.

ASEAN–Korea Agreement on Investment (in force)	Article 6	SSDS
Indonesia–South Korea CEPA (signed on 18 December 2020, not yet in force)	Chapter 7, Article 7.8	SSDS
Indonesia–Australia CEPA (in force)	Chapter 14, Article 14.6	SSDS
Indonesia–Japan EPA (in force)	Chapter 5, Article 63	ISDS

CEPA = comprehensive economic partnership agreement, DSM = dispute resolution mechanism, EPA = economic partnership agreement, ISDS = investor–state dispute settlement, SSDS = state-to-state dispute settlement.
Source: Authors' compilation.

Table 2 shows that most of Indonesia's IIAs do not allow individual investors to bring a claim of PR breach to ISDS, save for the IIAs entered into with Japan and other ASEAN members. This means that Indonesia remains exposed to the possibility of compensating those relevant investors if its LCRs are found to be in breach of the PR provision. Notably, unlike NAFTA Article 1106, LCRs subject to ISDS under Indonesia's IIAs with Japan are limited to LCRs requiring mandatory compliance of foreign investors and not LCRs, which provide incentives or advantages upon compliance.

B. Recommendations and Lessons Learned for Indonesia

Upon understanding the rules applicable to Indonesia under the TRIMS Agreement, GATS, and its IIAs, Indonesia should carefully consider these rules when formulating its economic policies, including LCRs, to ensure that the LCRs do not breach such obligations.

We set out below several non-exhaustive points that the government should consider in their policymaking as regards LCRs:

1. Object and Purpose of the Measure

The case of *Lemire v Ukraine* demonstrates how investment tribunals may look into the object and purpose of the relevant measure to observe whether the measure has a justifiable policy objective or fall under certain exception (e.g. government procurement as in the case of *ADF v US).* Similarly, the WTO DSB analysed the objectives of the measures in *India – Solar Cells* and *Canada – Renewable.* Therefore, the government

should consider the object and purpose of the measure and set it out clearly, bearing in mind that if the object and purpose are merely to protect domestic industries, the measure may likely amount to a breach. Still, it may be justifiable if it falls under certain exceptions expressly set out in the relevant agreement.

2. *Design of the Measure*

The government should ensure that the measure is genuinely designed to meet its object and purpose and not too restrictive or discriminatory in practice. Again, if the object is to protect domestic industries, it may likely amount to a breach unless justifiable by an expressed exception.

Some governments have designed their measures in a way that does not explicitly appear as LCR measures. However, if the measures have the same effect as LCR measures prohibited under the NT or PR provision of an IIA, they may still amount to breaches. This could be seen in *Mobil v Canada, CPI v Mexico, ADM v Mexico, Cargill v Mexico, SD Myers v Canada*, and, to an extent, *Lemire v Ukraine* (although the Tribunal eventually found no breach). Therefore, the government should comprehensively analyse the effect of its proposed measures.

At the same time, the government may consider the following points relating to LCRs for its future negotiation of IIAs:

- Map the LCRs currently in place in the country, the necessity, and the duration needed for the measures to assist the domestic industry;
- If the government considers certain measures necessary, it should negotiate for inclusion into the non-conforming measures list or it should request for certain flexibilities; and
- Negotiate for resolution of PR-related breaches by the SSDS rather than ISDS to minimise potential exposure to costly compensation orders.

5. Conclusions

The LCR is one of the policy tools that governments have used to build their domestic industries' capacities. However, governments should properly assess whether

the LCR is the most appropriate and effective policy tool in the long run, given that numerous studies have suggested otherwise. Suppose a government wishes to continue implementing this policy. It should carefully consider the potential implications and conduct proper cost and benefit analysis, considering the government's commitments under the TRIMs Agreement, GATS, and its IIAs.

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Annex

List of LCR Disputes (selected)

A. LCR Disputes Involving the TRIMs Agreement and the GATS (*selected*)

No.	Name	Agreement (TRIMs Agreement/GATS)	WTO DSB's Finding
1.	*European Communities – Regime for the Importation, Sale and Distribution of Bananas* (DS 27)	TRIMs Agreement	Breach of GATT Article III: 4, but exercised judicial economy on the TRIMs Agreement claim
2.	*Indonesia – Certain Measures Affecting the Automobile Industry* (DS 54, 55, 59, and 64)	TRIMs Agreement	Breach of Article 2.1 of the TRIMs Agreement
3.	*Canada – Certain Measures Affecting the Automotive Industry* (DS 142)	TRIMs Agreement	Breach of GATT Article III: 4, but exercised judicial economy on the TRIMs Agreement claim
4.	*India – Measures Affecting the Automotive Sector* (DS 175)	TRIMs Agreement	Breach of GATT Article III: 4, but exercised judicial economy on the TRIMs Agreement claim
5.	*Turkey – Measures Affecting the Importation of Rice* (DS 334)	TRIMs Agreement	Breach of GATT Article III: 4, but exercised judicial economy on the TRIMs Agreement claim
6.	*China – Measures Affecting Imports of Automobile Parts* (DS 339, 340, and 342)	TRIMs Agreement	Breach of GATT Article III: 4, but exercised judicial economy on the TRIMs Agreement claim
7.	*China – Measures Affecting Trading Rights and Distribution Services for Certain Publications and*	GATS	Breach of GATS Article XVI

	Audiovisual Entertainment Products (DS 363)		
8.	*European Union and its Member States – Certain Measures Relating to the Energy Sector* (DS 476)	GATS	No breach of GATS Article XVI: 2(f)
9.	*Canada – Certain Measures Affecting the Renewable Energy Generation Sector* and *Canada – Measures Relating to the Feed-In Tariff Program* (DS 412 and 426)	TRIMs Agreement	Breach of GATT Article III: 4 and Article 2.1 of the TRIMs Agreement
10.	*India – Solar Cells and Modules* (DS 456)	TRIMs Agreement	Breach of the TRIMs Agreement
11.	*Brazil – Certain Measures Concerning Taxation and Charges* (DS 472 and 497)	TRIMs Agreement	Breach of the TRIMs Agreement
12.	*United States – Certain Measures Relating to the Renewable Energy Sector* (DS510)	TRIMs Agreement	Breach of GATT Article III: 4, but exercised judicial economy on the TRIMs Agreement claim

DSB = Dispute Settlement Body, GATS = General Agreement on Trade in Services, GATT = General Agreement on Tariffs and Trade, TRIMs = Trade-Related Investment Measures.
Source: Authors' compilation.

B. LCR Disputes involving PR provisions in IIAs (selected)

No.	Name	Agreement	Tribunal's Finding of Breach (Yes/No)
1.	*SD Myers v Canada*	NAFTA	No
2.	*ADF v USA*	NAFTA	No, because the LCR involved government procurement.
3.	*ADM v Mexico*	NAFTA	Yes
4.	*CPI v Mexico*	NAFTA	No
5.	*Cargill v Mexico*	NAFTA	Yes
6.	*Lemire v Ukraine*	US–Ukraine BIT	No
7.	*Merrill & Ring v Canada*	NAFTA	No
8.	*Mobil and Murphy v Canada*	NAFTA	Yes

BIT = bilateral investment treaty, LCR = local content requirement, NAFTA = North American Free Trade Agreement.
Source: Authors' compilation.

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