

Dilemma of and China's Response to the Application of the Rules on Investors' Reasonable Expectations from the Perspective of International Investment Arbitration

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Abstract: The rule on investors' reasonable expectation aims to protect the rights and interests of foreign investors, which is often cited by arbitral tribunals in the practice of international investment arbitration in recent years. It can be divided into different categories according to its different bases. However, there are many problems in the application of this principle in the practice of international investment arbitration. Based on its significance in protecting the legitimate rights and interests of investors as well as the universality of the use of arbitral tribunals, the improvement of relevant clauses and due diligence and specific written commitments are the focus of countries and investors. It is also necessary for all host countries and investors to properly handle and break through this dilemma. If China is the host country, relevant applicable risk plans should be given to implement the national strategy of "going global" for Chinese enterprises.

Keywords: Investors' reasonable expectations; Fair and equitable treatment; International investment arbitration; International Investment Law.

1. Proposed Questions

1.1. Lack of Relevant Provisions of Rules on Investors' Reasonable Expectations in the Investment Treaty

As the direct basis that investors can invoke to settle international investment disputes, international investment agreements are also a vital foundation for host countries to defend themselves. At present, there are a large number of investment treaties in various countries worldwide. However, they fail to pay enough attention to investors' reasonable expectations, which is mainly reflected in no provisions on the relationship between fair and equitable treatment and investors' reasonable expectations in the treaties as well as lacking regulatory provisions of host countries that can limit investors' reasonable expectations.

From the perspective of lacking relevant provisions of investors' reasonable expectations in the fair and equitable treatment clause, it has experienced a development trend from non-stipulation and unlimited general provisions to restrictive provisions with certain extensions. Although the provisions on fair and equitable treatment demonstrate a gradual development trend, the provisions on fair and equitable treatment clauses in current investment agreements are still relatively simple and general without clear consideration of investors' reasonable expectations. In fact, independent fair and equitable treatment has a wide range without clear protection boundaries, which provides room for investors to broadly invoke reasonable expectations. However, it greatly increases the difficulty for the arbitral tribunal to make a satisfactory explanation of this issue. In addition, for the two most common provision modes of fair and equitable treatment clauses nowadays, neither the restrictive provision mode nor a normative model containing a specific listing of elements of obligations, the concept of investors' reasonable expectation and its related legal status are not specified in the clauses. Taking China's recent investment-related treaty as an example, according to the preamble of the Regional Comprehensive Economic Partnership (RCEP) signed in 2020, it is necessary to build a "predictable, transparent and stable business environment", while the investment chapter does not stipulate the reasonable expectations of investors.

From the perspective of insufficient regulatory power of the host country in investment agreements to limit investors' reasonable expectations, the game process between investors' legitimate rights and interests and the host country's legitimate supervision power are embodied in the terms of international investment agreements. As for the international investment agreements signed by China in recent years, although more attention is paid to the supervision power of the concerned host country in the overall trend, the regulations are not detailed enough, with a complete regulatory system on the supervision power not being formed. For example, Article 4 of the 2020 China-Turkey BIT (China-Turkey Investment Agreement) stipulates a general exception clause, which takes the protection of human beings, animals, plants, the environment and exhaustible natural resources as exceptions. However, the implementation and limitation of exceptional measures are not further stipulated. The concept of regulatory authority is also not clearly stated in the preamble clauses of the whole agreement.

1.1. Dependence of Internal Logic of Rules on Investors' Reasonable Expectations

Compared with investment contracts with clearer rights and obligations, most current international investment agreements (IIA) only make ambiguous descriptions of the treatment that should be given by the host country, which is also the case for bilateral investment treaties. Specifically, a bilateral investment treaty results from negotiation between the host country and the investor's home country, which is a game of interests between both parties. However, it is usually more cautious to determine the rights and obligations of both parties. For example, only the basic rights and obligations of both parties are stipulated, but more specific expressions are rare. Meanwhile, as a model treaty used for a long time after signing, most of the clauses in the bilateral investment agreement are pre-commitments made by the host country to indicate the long-term willingness to accept investment. When implemented in specific investment projects, the rights and obligations of the counterparty are still in an uncertain state without specific commitment. Thus, the commitment made by the host country in the bilateral investment agreement fails to be the reason for investors to have reasonable expectations, which in turn leads to the uncertainty of the applicable basis of investors' reasonable expectations.

In addition to depending on the specific commitment to specific objects, the normative expression of rules on investors' reasonable expectations also relies on the social structure that endorses the commitment. From the perspective of jurisprudence, the social dependence of rules on reasonable expectations has been reflected in the early legal schools. For example, Rawls, the representative of the positive law school, believes that the expectation obligation caused by promise is rooted in the rules of social practice, which also constitutes the normative system of the whole society [1]. Pound, a representative of the modern social law school, holds that the reason why people keep their promises results from "the urgent need of common collective moral sense and economic order" [2]. Hence, investors' reasonable expectations that the legal logic within the rules itself needs to be explained through social norms. The social background of different countries will inevitably have an impact on the substantive connotation of the rule on investors' reasonable expectations in the investment treaties involving that country, which largely leads to various provisions of reasonable expectations in different countries. Meanwhile, obstacles are created to the application of investors' reasonable expectations in international investment arbitration.

1.2. Dilemma of Balancing Interests During the Application of Rules on Investors' Reasonable Expectations

When the arbitration tribunal considers whether the host country protects investors' reasonable expectations in specific cases, how to judge the balance between the interests of the host country and investors' reasonable expectations, that is, how to judge whether the methods adopted by the arbitration tribunal to protect the public interests of the host country are reasonable is a dilemma. The arbitration tribunal tends to adopt the principle of proportionality for analysis, which usually includes judgment criteria: applicability, necessity and balance. Applicability requires a reasonable connection

between the method adopted by the host country for the protection of public interests and its purported objectives. Necessity requires the host country to adopt the most necessary alternative method that does not interfere with the interests of investors less to protect the public interest of the host country. Balance requires the arbitral tribunal to measure the conflict of interest between the host country and investors, so as to judge whether the impact of the measures taken by the host government is proportional to the goal desired by its measures. Based on the principle of proportionality, arbitrators should measure whether the importance of the subjective purpose of the host country's measures exceeds the interference with investors' interests. It also leads to many subjective factors in the arbitrator's review and further interferes with the exercise of autonomy in the host country, which is even more detrimental to the stable operation of the international arbitration mechanism. Moreover, there is a general understanding in arbitration tribunals of the International Centre for Settlement of Investment Disputes (ICSID) that international investment agreements are not insurance clauses, and the arbitration tribunals will not support investors' claims for compensation for losses caused by unwise commercial investment decisions made by investors [3]. The host country is responsible for ensuring a stable business and legal investment environment, but the social and legal environment of the host country is constantly changing laws. Hence, it is unrealistic to require the economic and legal policies of the host country to remain unchanged. When judging the impact of changes in the laws of the host country on investors' interests, the arbitral tribunal generally believes that investors should not have reasonable expectations for appropriate foreseeable changes. From the perspective of the subject definition, if the host country is only recognized as an ordinary consumer, and the violation of the investment contract only constitutes an ordinary breach of contract, it is a predictable business risk for investors. But the default of the host country involves the exercise of national sovereignty, and the business risks it brings to investors cannot be predicted by investors when investing. Thus, it should be borne by the host country. For example, in the *Biwater v. Parkering* cases, the arbitration tribunal found that the host country's breach of contract did not relate to the exercise of sovereignty or violate the principle of investors' reasonable expectations. However, it is only an analysis of "predictability" from one perspective, and the rationality degree still needs to be considered.

2. Historical Development and Type Analysis of Investors' Reasonable Expectations

2.1. Historical Development of Investors' Reasonable Expectations

Although the rule of investors' reasonable expectation has been widely applied to international investment arbitration, it originates from the relevant rules of domestic law. From an etymological perspective, the term "legitimate expectation" originally came into being in domestic administrative law and was later introduced into international investment law. It was first introduced into the judgment in *Schmidt v. Secretary of State for Home Affairs* by a British judge Lord Denning [4], intending to illustrate that the intended holder of property enjoys a special procedural right. After that, the scope of application of this rule in judicial practice gradually expanded to the field of substantive rights. In practice, the concept of "expectation" was first applied in the *SPP v. Egypt* case for the first time. In this case, the arbitration tribunal held that although the decree violated Egypt's municipal legal system, it still had the expectation of being protected by the established principles of international law, and investors needed to be protected [5]. However, the arbitral tribunal did not further explain this concept. Later, in the case of *Metalclad v. Mexico* in 2000, the arbitration tribunal of the ICSID put forward the rule on "investors' reasonable expectations" completely and clearly for the first time [6]. In addition, the case of *Tecmed v. Mexico* in 2003 further developed investors' reasonable expectations, which clarifies the content of investors' reasonable expectations for the first time "according to the Good Faith Principle of international law, that is, the investment treatment provided by the host country cannot frustrate the basic expectations on which investors invest. It includes that the host country will adopt a consistent approach and always maintain a clear and completely transparent relationship with investors, so that investors can understand and abide by the rules and regulations related to investment in advance" [7]. After this case, a large number of cases

have quoted similar arguments to explain the specific content and applicability of investors' reasonable expectations.

2.2. Type Analysis of Investors' Reasonable Expectations

Investors' reasonable expectations can be divided into three categories according to the different commitments of the host country on which they are generated. The first category is the reasonable expectation based on the investment contract, which means that investors have the right to expect a return from the investment after signing the investment contract. Such a contract should be consistent with the contract terms, investment nature, market conditions and the risk and income distribution agreed by both parties. The second category is based on the reasonable expectation of the host government's behavior, which refers to the behavior of administrative organs representing the state and using state power. It can be divided into formal government behavior and informal government behavior according to different legal effects. The third category is reasonable expectations based on laws and regulations. Generally applicable laws and some specially applicable laws can become the basis for investors' reasonable expectations.

3. Possibility of Solving the Application of Investors' Reasonable Expectations in International Investment Arbitration

3.1. Legitimate Source of Rules on Investors' Reasonable Expectations

3.1.1. Analysis of Legitimacy from the Perspective of Treaty Law

In recent years, investment treaties have begun to show reasonable expectations. For example, in Article 812, Paragraph 1 of the Canada-Peru Free Trade Agreement and Article 9, Paragraph 3 of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, reasonable expectations are both regarded as one of the elements to determine whether there is indirect expropriation. According to Article 2, Paragraph 4 of the EU-Singapore Investment Promotion Agreement, it is stipulated that specific or explicit statements made by the government to investors can lead to the generation of reasonable expectations. In Article 15 of Chapter 17 of the Investment Chapter of the EU-Mexico Free Trade Agreement, the concept of investors' reasonable expectations is explicitly mentioned. Notably, Annex 3 of the Investment Agreement on the Closer Economic Partnership Arrangement Between the Mainland and Hong Kong (Macao), which was implemented in 2018 and issued by the Ministry of Commerce of China, also mentions reasonable expectations and regards them as one of the elements for judging indirect expropriation. Therefore, although there are still a few investment treaties that incorporate reasonable expectations into specific clauses and focus on the issue of indirect expropriation, it is undeniable that in the foreseeable future, investors' reasonable expectations will be included in more investment clauses.

3.1.2. Legitimacy Analysis from the Perspective of General Legal Principles

According to Article 38, Paragraph 3 of the Statute of the International Court of Justice, general legal principles can be used as the legal basis for the principle of reasonable expectation in practice. Fair and equitable treatment in investment treaties is a concept derived from international customary law, rather than the product of domestic law. Therefore, the arbitral tribunal can give full play to its discretion and invoke different forms of international legal sources to interpret and apply similar concepts. Some scholars believe that the principle of reasonable expectation was introduced by the arbitration tribunal based on comparative administrative law. Trevor Zeyl proposed in this regard that it is necessary to rely on general legal principles based on comparative law to complete the introduction of reasonable expectations in the field of international law [8]. In addition, Michael Byers, a Canadian international law scholar, argued that treaty rules necessarily contain the principle of reasonable expectation, because they are all based on the general customary rule "pacta sunt servanda" [9]. Western academia generally agrees that reasonable expectation is a general principle

of international law. At the same time, judges are believed to use this principle when judging specific cases *ex officio*.

3.1.3. Analysis of Legitimacy from the Perspective of Customary International Law

According to Article 38, Paragraph 1 of the Statute of the International Court of Justice, the International Court of Justice can make judgments on the basis of customary international law. Hence, customary international law can be applied by international courts and international arbitration as a source of law in international law to fill the vacancy of laws dealing with practical situations. In fact, there are two main argumentation paths in Chinese academia for the reasonable expectation of the origin of customary international law. The first one is to demonstrate the rationality of introducing the principle of reasonable expectation into international investment law based on the principle of good faith in customary international law, which is supported by many arbitral tribunals. Most scholars who agree with the second one believe that reasonable expectation is similar to estoppel in customary international law and the binding rules of some unilateral acts in international law. Thus, when the host government unilaterally breaks the contract or abolishes the commitment, changes the administrative decision, etc., the principle of reasonable expectation is well-founded in customary international law [10].

3.2. Rules on Investors' Reasonable Expectations Can Promote International Investment

3.2.1. Assistance of Fair and Equitable Treatment Clauses

In the field of contemporary international investment law, the fair and equitable treatment clause has been the standard in bilateral and multilateral investment agreements. Although the ambiguity of its expression gives rise to the diversity of interpretation and the continuous expansion of scope, this clause still occupies a core position in international investment arbitration cases. When assessing whether the host country's behavior violates fair and equitable treatment, the arbitration tribunal generally considers whether the host country's behavior violates the reasonable expectations of investors based on contracts or laws. For instance, in the *Saluka v. Czech Republic* case, the arbitration tribunal regarded the protection of investors' reasonable expectations as a "core element" of the principle of fair and equitable treatment [11]. In another *Electrabel v. Hungary* case, the arbitral tribunal further emphasized that protection was the "most important function" of measuring the standard of treatment [12]. Although academia and some arbitration experts have reservations or even criticisms about the concept of over-reliance on investors' reasonable expectations, it cannot be ignored that numerous established cases have confirmed the importance of safeguarding investors' reasonable expectations under investment treaties. According to the practice of international investment arbitration, once certain adjudication ideas are initially adopted, subsequent arbitration tribunals tend to follow precedents to ensure the consistency of judgments, thus safeguarding the legitimate expectations of the state and investors for legal stability and predictability, just as the principle embodied in the case of *Saipem SpA v. People's Republic of Bangladesh*. In other words, by following the settlement path established by the settled cases, the trust of both parties in legal certainty is guaranteed from damage [13].

3.2.2. Collaboration of Indirect Expropriation

Expropriation is an act in which a country confiscates and deprives private property based on the needs of public interests, including direct expropriation such as confiscation and deprivation, as well as indirect expropriation that affects the value of private property through indirect means. When the arbitration tribunal measures whether the host government's behavior constitutes an indirect expropriation of foreign investors, the degree of intervention of its behavior on investors must be considered. The criterion for judging the intervention degree is whether the behavior damages investors' reasonable expectations [14]. In practice, investors' reasonable expectations are not used as independent factors to judge indirect expropriation, but the arbitration tribunal regards it more as a factor to judge the effect of expropriation by the host country. Although investors' reasonable expectations play a limited role in determining indirect expropriation, it is still one of the elements

considered by the arbitral tribunal when making relevant awards. It also makes joint efforts to promote the determination of indirect expropriation.

4. China's Response to the Dilemma of the Application of Investors' Reasonable Expectations

4.1. Supplementation of Relevant Provisions of Rules on Investors' Reasonable Expectations in Investment Treaties

Because the provisions of the fair and equitable treatment clause in the investment agreements concluded by China with foreign countries are relatively broad, it gives the arbitration tribunal sufficient discretion to interpret this clause, which makes the application of the principle of investors' reasonable expectation uncertain and puts China in a passive position. Therefore, it is necessary to improve the design of clauses related to investors' reasonable expectations in China's foreign investment agreements. Specifically, it can be started from the following two aspects.

One is to improve the design of the preamble. The preamble of the investment agreement mainly plays a role in clarifying the background and purpose of signing the agreement by both parties. According to the requirements of the Vienna Convention on the Law of Treaties, the interpretation of the treaty by the parties should be consistent with the object and purpose of the treaty. Therefore, in the arbitration of a specific case, the arbitral tribunal will take into account the expression in the preamble of the investment agreement on which the disputing parties rely. If there are only expressions such as "protecting investors" in the preamble without mentioning the protection of the host country's rights and interests, then the arbitral tribunal will tend to make an interpretation in favor of investors when interpreting the relevant provisions in the investment agreement. Hence, to better balance the rights and interests of China as a host country with those of other countries' investors, and take into account the legitimate rights and interests of Chinese investors when investing overseas, China should pay attention to the design of preamble clauses when concluding foreign investment agreements. At the same time, the protection of investors' and host countries' interests should be clearly defined in the preamble to show the purpose of investment agreements more comprehensively. For example, in the preamble, an expression similar to "for the better protection of investors' interests and promote the economic development of the host country" should be added.

The other is to supplement provisions on investors' reasonable expectations to the fair and equitable treatment clauses. As mentioned earlier, most of the contents involving investors' reasonable expectations in the investment agreements concluded with foreign countries can be seen in the indirect expropriation clauses, but rarely in the fair and equitable treatment clauses. Such a situation in China shares similarities. However, this situation easily results in too broad provisions on fair and equitable treatment in investment agreements concluded by China with foreign countries, which makes the application of investors' reasonable expectations more uncertain, thus leading to China's passiveness in arbitration. Hence, it is suggested that when China concludes or amends investment agreements with foreign countries in the future, the supplement of relevant provisions on investors' reasonable expectations to the fair and equitable treatment clause should be considered, such as referring to relevant statements in RCEP that clarify the constituent elements of investors' reasonable expectations. It aims to limit the interpretation room of the arbitral tribunal and increase the predictability of arbitration.

4.2. Logic of Deeply Integrating Investors' Reasonable Expectations from the Perspective of Benefiting China

Given the ambiguity of bilateral investment treaties, characteristics of pre-commitment and the insufficient definition of rights and obligations in individual cases caused by the uncertain application in specific investment situations due to dependent internal logic, together with the influence of different social backgrounds on the substantive connotation of rules, China needs to adopt a series of comprehensive strategies from aspects of domestic and foreign legal environment, economic

development goals, and national interest protection mechanism under the framework of international investment treaties.

Specifically, China should take the initiative to participate in the shaping of international rules and promote the modernization and revision of investment treaties through multilateral and bilateral channels. For example, in newly signed or updated treaties, the specific standards of fair and equitable treatment should be clarified, and factors of investors' reasonable expectations should be concrete. Meanwhile, a reasonable boundary of the supervision power of the host country should be set to ensure the balance between the interests of investors and the host country. It is necessary to supplement a clear definition of investors' reasonable expectations. In addition, the host country can adopt a specific framework to protect public interests, so as to enhance the operability of the treaty. Besides, it is of importance to strengthen the domestic legal system to ensure the consistency and complementarity of domestic laws and international investment treaties. By amending the Foreign Investment Law and corresponding supportive regulations, the scope of investors' reasonable expectations can be clearly defined with an established transparent and predictable regulatory system, thus providing an effective dispute settlement mechanism. Furthermore, international cooperation and dialogue should be promoted. The international community should form a consensus on the principle of investors' reasonable expectations. In other words, international platforms should be utilized, such as the United Nations Conference on Trade and Development, the World Trade Organization, etc., so as to discuss with other countries the international standards of investors' reasonable expectations, share practical experience, and seek to a unified or at least compatible rule system [15]. Undoubtedly, the capacity of domestic arbitration and judicial institutions should be strengthened. Moreover, enhancing China's professionalism and credibility in international investment arbitration is the best business path. It is also crucial to set up a special center for international investment arbitration, cultivate a team of high-quality arbitrators, and provide excellent legal services to intensify China's role and influence in resolving international investment disputes.

4.3. Exploration of the Way to Balance Interests in the Application of Rules on Investors' Reasonable Expectations

When it comes to how the arbitration tribunal judges whether the host country's protection of investors' reasonable expectations is reasonable in specific cases when China signs an investor contract with foreign investors, it can stipulate in the contract that the host country is only a general consumer as a party to the contract, and its behavior does not involve the exercise of national sovereignty, so as to rule out the possibility of violating investors' reasonable expectations in possible contract breach. Flexibility is also important at the time when the contract is signed. That is, the host country can negotiate the effective date of the contract until the investor makes the investment behavior, so the investor cannot have reasonable expectations according to the investment agreement, thereby reducing the responsibility of the host country. Moreover, we should fully avoid making special commitments to investors on specific matters too early. After all, if the commitment of the host country is made to many investors, rather than just specific objects, it can undercut the possibility that the commitment will be deemed as one with reasonable expectations. Meanwhile, when China is the host country, the standard of investors' reasonable expectations can be shown by enumeration, thus limiting investors' reasonable expectations to the enumeration clauses. In addition, when China formulates relevant foreign investment laws and regulations from the domestic legislative aspect in the future, it is necessary to try its best to avoid too specific and definite statements, so as to avoid the risk that the arbitration tribunal will interpret China's laws and regulations as specific commitments made by China to investors when investment arbitration disputes arise in the future. It is also suggested that Chinese investors should entrust professional institutions to conduct due diligence on the political, social and economic conditions and relevant legal systems of the host country before deciding to invest in the host country.

5. Conclusion

With the in-depth globalization nowadays, international investment activities are becoming increasingly frequent. As a vital tool to protect the rights and interests of foreign investors, rules on investors' reasonable expectations play a crucial role in the practice of international investment arbitration. However, this rule faces many difficulties in its application, such as the lack of relevant provisions in investment treaties, the dependence of internal logic and the dilemma of balancing interests. As a responsible major country, China should actively respond and seek breakthroughs. By improving the relevant provisions in investment treaties and clarifying the constituent elements and scope of applying investors' reasonable expectations, investors' rights and interests can be better safeguarded in the international investment arena. The stability and growth of foreign investment also can be promoted. In addition, it is necessary to strengthen the domestic legal system and promote international cooperation and dialogue. In the future, with the continuous changes in the international investment environment and the in-depth development of investment arbitration practice, the application of rules on investors' reasonable expectations will become more complex and diverse. China should not only constantly uphold an open and cooperative attitude, but also participate in the formulation and revision of international investment rules, thus contributing Chinese wisdom and solutions to the promotion of constructing an international investment environment that is fairer, more transparent and predictable.

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