

# Compensation Under Investment Treaties: What are the problems and what can be done?

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Investment treaties allow covered foreign investors to bring claims that a host state has breached the treaty to international arbitration. If the arbitral tribunal concludes that the host state has breached the treaty, it will order the host state to compensate the investor. The legal principles governing compensation—and the way tribunals have interpreted and applied these principles—determine the amount the host state must pay. In this way, the principles governing compensation have direct, practical implications for states, investors, and other participants in the investment treaty regime.

Despite its immense practical importance, the question of compensation (or “damages”) under investment treaties has received surprisingly little attention to date. In this note, we identify key concerns with tribunals’ current approach and suggest a range of reforms that states could adopt to address these concerns.<sup>1</sup>

## What Are the Problems?

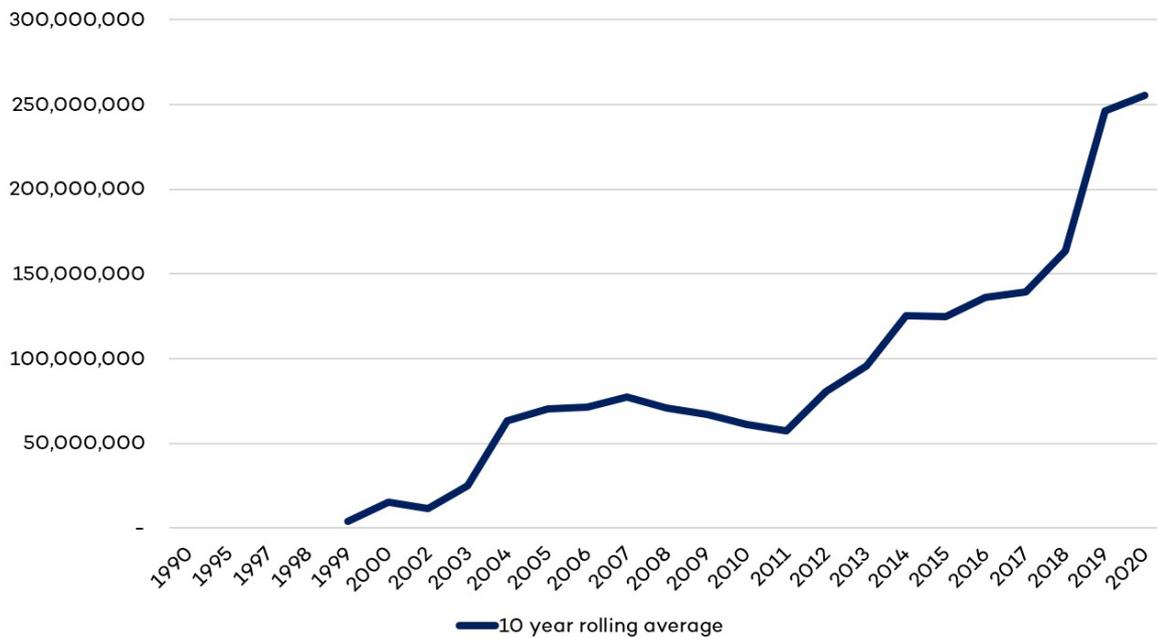
### 1. The Amounts of Compensation Being Awarded Are Large—and Are Increasing

In the early 2000s, awards of compensation in the tens of millions of USD were considered large. These sums seem quaint in retrospect. Today, the largest award of compensation in investment treaty arbitration is the USD 40 billion awarded in *Hulley v. Russia*. (This was the largest of several related claims arising out of the nationalization of Yukos, in which a total of USD 50 billion was awarded.) There are now 50 known cases in which a tribunal has awarded compensation over USD 100 million, including eight known cases in which a tribunal has awarded more than USD 1 billion.

<sup>1</sup> Readers interested in a deeper exploration of these issues are invited to read the authors’ publication, Bonnitcha, J. & Brewin, S. (2020). *Compensation under investment treaties*. IISD Best Practices Series. <https://www.iisd.org/publications/iisd-best-practices-series-compensation-under-investment-treaties>.



**Figure 1.** Arbitral awards 1990 to 2019 - Rolling 10-year average (USD)



Data source: UNCTAD & Italaw.

## 2. Large Awards of Compensation Are Made in Regulatory Disputes, Even If the Investment Continues to Operate Profitably

Existing treaty provisions on compensation have their roots in the decolonization era of the 1960s and 1970s. At that time, there were stark disagreements between developed and developing countries about the standard of compensation that should be paid for the expropriation of foreign-owned assets. Ultimately, the provisions of investment treaties on compensation for expropriation reflected the view of developed countries: that compensation should equal the fair market value of an expropriated asset, regardless of the circumstances in which the asset had been acquired or the host state’s ability to pay.<sup>2</sup> Notwithstanding this fundamental disagreement, the assumption of both developed and developing countries was that investment disputes generally involved the seizure of foreign-owned assets by the host state.

In contrast, most modern investor–state disputes arise from regulatory interactions between the state and the investor, rather than from asset-seizure. An example is the series of arbitrations against Spain in response to changes to the tariffs paid to generators of solar electricity. The outcomes of these cases are inconsistent, ranging from dismissal of investors’ claims in their entirety in some cases, to large awards of compensation in other cases. In *NextEra v. Spain* for example, the tribunal awarded USD 327 million to the investor, on the basis that it was entitled to the above-market rate of return it would have obtained without the regulatory change.<sup>3</sup>

<sup>2</sup> Bonnitca, J., Poulsen, L. N. S., & Waibel, M. (2017). *The political economy of the investment treaty regime*. Oxford University Press, 199.

<sup>3</sup> *NextEra Energy Global Holdings B.V. and NextEra Energy Spain Holdings B.V. v. Kingdom of Spain*, ICSID Case No. ARB/14/11. Decision on Jurisdiction, Liability and Quantum Principles, paras 651–666.



### 3. Large Amounts of Compensation Are Awarded for Interference With Planned Investments That Were Never Built

Another problem in recent arbitral practice is tribunals' growing willingness to grant large amounts in compensation for state interference with planned investments that were never actually built. In such cases, there can be a vast discrepancy between the amount of money actually invested by the investor and the amount obtained in compensation. In *Tethyan Copper v. Pakistan*, an investor was awarded USD 4 billion plus interest for Pakistan's failure to grant the necessary approvals for the investor to build and operate a mine—even though the mine was never built. The tribunal based this compensation on its estimation of the income the investment would have earned over its entire 50-year operating cycle if it had been built.<sup>4</sup> This award is almost as large as the International Monetary Fund's bailout that had been agreed two months earlier with the intention of saving the Pakistani economy from collapse.<sup>5</sup>

The possibility of large payouts of compensation, particularly for interference with planned investments that are never actually built, also risks encouraging serious corruption.<sup>6</sup> This is because the possibility of large awards of compensation increases the potential payoffs for an unscrupulous investor to enter into corrupt investment contracts with a host state, even if the investor never intends to perform the contract.

### 4. Tribunals' Practice Departs From Previously Accepted Principles of International Law and the Practice of Other National and International Courts

Several factors are responsible for the increase in the amount of compensation being awarded in investment treaty arbitrations. But the most significant factor is probably tribunals' increasing willingness to base compensation on projections of an investment's expected future income across its entire life cycle. The most common valuation technique used to calculate compensation on this basis is the discounted cash flow (DCF) method. Tribunal practice in this regard departs from previously accepted principles of international law,<sup>7</sup> as well as World Bank's guidelines on the valuation of foreign investment.<sup>8</sup>

Arbitral practice also differs from comparable practice of other international courts and tribunals. It is well known that the World Trade Organization (WTO) dispute settlement system does not ordinarily lead to compensation for successful claimants. The European Court of Human Rights (ECtHR) is an example of an international legal regime that, like the investment treaty regime,

<sup>4</sup> *Tethyan Copper Company Pty Limited v. Islamic Republic of Pakistan*, ICSID Case No. ARB/12/1, Award, para. 278 (July 12, 2019).

<sup>5</sup> Masood, S. (2019, May 12,). Pakistan to accept \$6 billion bailout from I.M.F. *The New York Times*. <https://www.nytimes.com/2019/05/12/world/asia/pakistan-imf-bailout.html>

<sup>6</sup> The USDD 9.6 billion award in *PE&ID v Nigeria*, although a contract-based ISDS claim, is an example where this has been alleged. See further Amin, K. (2020, October 23). Did an alleged corrupt natural gas contract rob Nigeria of US\$9.6 billion? Transparency International. <https://www.transparency.org/en/blog/did-an-alleged-corrupt-natural-gas-contract-rob-nigeria-of-9-6-billion>

<sup>7</sup> International Law Commission. (2001). *Text of the articles on the responsibility of states for internationally wrongful acts*. Yearbook of the International Law Commission, 2001, II (Part Two). UN Doc. A/56/10, art. 36, cmt. 26

<sup>8</sup> General Counsel of the World Bank. (1992) *Legal framework for the treatment of foreign investment: Volume II*. World Bank, 26. <http://documents1.worldbank.org/curated/en/955221468766167766/pdf/multi-page.pdf>



does allow private actors to sue states for monetary compensation. Nevertheless, compensation awards accorded in such disputes are far lower than those under investment treaties.<sup>9</sup>

## 5. Existing Approaches Are Complex and Expensive

The complexity of jurisprudence on compensation increases costs and disadvantages countries that lack in-house capacity to engage in detailed arguments about the intricacies of different valuation methods. The DCF method is especially complex, as it relies on a complex set of interlocking forecasts and assumptions about the future of the investment for its entire lifespan. Foreign investors almost always argue for the use of this method, as it tends to lead to larger compensation awards. Claimant investors usually rely on specialized financial consultancies to provide expert evidence in support of their proposed valuations. Host states must then retain financial experts of their own to rebut the valuation evidence of the investor. The complexity of the DCF method and the parties' reliance on expert witnesses drive up litigation costs. In *Tethyan Copper v. Pakistan*, the claimant spent USD 4.5 million on financial experts and USD 17.5 million on legal fees for the compensation phase of proceedings alone.<sup>10</sup> Pakistan spent almost USD 10 million defending the compensation phase, including both financial experts and legal fees.<sup>11</sup>

## 6. Arbitral Jurisprudence Is Inconsistent

Arbitral jurisprudence on compensation is inconsistent, especially in terms of:

- The circumstances in which it is appropriate to calculate compensation based on an investment's expected future income.
- The quality of evidence needed to back up the projections that underpin future income-based calculations of compensation (like DCF).
- The way tribunals account for risks to an investment's projected income stream across its entire life cycle.

Although these debates are technical, there can be hundreds of millions of dollars at stake in tribunals' choice of one approach over another. For example, the choice between different valuation methods in *Bear Creek v. Peru* made the difference between USD 500 million in compensation claimed by the investor and USD 18 million in compensation awarded by the tribunal.<sup>12</sup> In *Tethyan Copper v. Pakistan*, the tribunal confronted essentially the same question as to the appropriate valuation technique and sided with the investor, resulting in the USD 4 billion plus interest award mentioned above.

<sup>9</sup> Shelton, D. (2015). *Remedies in international human rights law*. Oxford University Press, 338; Allen, T. (2006). Compensation for property under the European Convention on Human Rights. *Michigan Journal of International Law*, 28(2), 330. <https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1176&context=mjil>

<sup>10</sup> *Supra* note 4.

<sup>11</sup> *Ibid*, para. 1831.

<sup>12</sup> *Bear Creek Mining Corporation v. Republic of Peru*, ICSID Case No. ARB/14/21, Award, para. 596 (Nov 30, 2017).



## 7. Tribunals Do not Take Important Contextual Factors Into Account

Existing principles on compensation under investment treaties are “all or nothing” in character. If a tribunal concludes that a host state’s change in the regulatory arrangements governing investment does not breach an investment treaty, the investor receives no compensation. If the tribunal concludes that the change does breach the investment treaty, the investor is awarded compensation for its loss caused by the regulatory change under the principle of “full reparation.” Contextual factors are not relevant in the determination of compensation, with some limited exceptions. For instance, tribunals do not consider:

- **The strength of the public interest rationale justifying interference with the investment.** For example, a German investor is currently using an investment treaty to sue the Netherlands for its decision to shut down all coal power plants by 2030 as part of its clean energy transition.<sup>13</sup> If the tribunal rules that the shutdown breached the investment treaty, the environmental justification for the measure would not be relevant to the determination of compensation under existing jurisprudence.
- **Misconduct on the part of the investor, subject to limited exceptions.** For example, the fact that the foreign investor in *Unión Fenosa Gas v. Egypt* had obtained its gas supply contract through “influence ... over senior decision-makers at the Ministry of Petroleum and EGPC [the Egyptian General Petroleum Company]” was not taken into consideration in the calculation of compensation.<sup>14</sup>
- **The host state’s ability to pay,** even in circumstances where payment of the amount of compensation in question would be crippling for the host state.<sup>15</sup>

## What Can Be Done?

Almost all existing investment treaties specify that compensation for an expropriation should equal the fair market value of the expropriated investment. But investment treaties fail to set out how compensation should be determined for breaches of other provisions of the treaty. In the absence of textual guidance, arbitral tribunals have applied the principle of “full reparation” for other treaty breaches. Arbitral tribunals have then been free to develop their own jurisprudence on the interpretation and application of these principles, unconstrained by states’ treaty language providing clear guidance.

The principles governing compensation are too important to be left to arbitrators. Hundreds of millions or billions of dollars are often at stake. States should consider whether existing jurisprudence governing compensation reflects the way they intended the investment treaty system to function. If it does not, they should consider options for reform.

<sup>13</sup> Charlotin, D. (2020, May 12). The Netherlands is put on notice of a treaty-based dispute. *Investment Arbitration Reporter*. <https://www.iareporter.com/articles/netherlands-put-on-notice-of-a-treaty-based-dispute/>

<sup>14</sup> *Unión Fenosa Gas, S.A. v. Arab Republic of Egypt*, ICSID Case No. ARB/14/4, Award, para. 7.109 (Aug. 31, 2018).

<sup>15</sup> In a recent article, Paparinskis argues that states should not be required to pay an amount in compensation that would be “crippling” for the state in question. Paparinskis, M. (2020). A case against crippling compensation in the international law of state responsibility. *Modern Law Review*, 83(6), p. 1251.



There are at least four options for new approaches to compensation that states might consider. In brief, they are:<sup>16</sup>

1. **Requiring that compensation reflect a balance between a range of competing factors**, rather than being determined solely by the value of the investor's loss. An example of this approach is found in the South African Development Community (SADC) Model bilateral investment treaty, the Common Market for Eastern and Southern Africa (COMESA) Common Investment Area Agreement (the CCIA) and the Pan African Investment Code (PAIC).<sup>17</sup>
2. **Capping compensation at the amount the investor actually invested** (and excluding, for example, how much income the investor expected the investment to generate over its lifetime).
3. **Requiring a tribunal to consider whether the host state has obtained any benefit** from allowing the investment to proceed and then breaching its obligations under the investment treaty. If yes, the compensation would be capped at whichever amount is lower between the host state's gain and the investor's expenditure in making the investment. If no, then no compensation would be owed.
4. **Requiring the tribunal to determine the amount of compensation in accordance with the laws of the host state**, which should reflect the host state's view about the appropriate balance to be struck between competing interests in the regulation of private property with respect to all investors.

## Why Is It Crucial for Concerned States to Propose and Champion Reform?

Concerns about compensation under investment treaties are not going to fix themselves; on the contrary, these problems have become more acute over time. This is partly because many of the actors in the investment treaty regime—including investors themselves, party-appointed arbitrators who preside over claims that only investors can initiate, specialized financial consultancies, and third-party funders—share an interest in maintaining a system that generates large payouts of compensation.

Many states find the technical complexity of existing jurisprudence on compensation daunting. But it is not necessary to understand the detail of every technical debate in the jurisprudence to consider whether the outcomes of disputes under investment treaties reflect how states intended the investment treaty system to operate. Tribunals' approach to compensation has immense practical implications for states. If the investment treaty system is not operating as intended, states should prioritize compensation as an area for reform.

<sup>16</sup> Each of these potential reform options is explained in further detail in Bonnitche & Brewin (2020), *supra* note 1, including treaty language that could be used to implement the options, and a discussion of potential instrumentalities for achieving that reform.

<sup>17</sup> SADC Model BIT (2012), art. 6.2.; PAIC (2016), art. 12(2); CCIA (2017), art. 20. This requires compensation to reflect:

*an equitable balance between the public interest and interest of those affected, having regard for all relevant circumstances and taking into account the current and past use of the property, the history of its acquisition, the fair market value of the property, the purpose of the expropriation, the extent of previous profit made by the foreign investor through the investment, and the duration of the investment.*

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