Compensation under international investment law arbitration in investor-state infrastructure contracts

Candidate number: 716
Submission deadline: 25.11.2017
Number of words: 14247
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1 Compensation under international investment law.

1.1 Introduction

International Investment Law provides an alternate dispute settlement framework to remedy situations where a foreign investor suffers a monetary or non-monetary injury due to breach of international law by a State. The ultimate utility of the remedy for the investor depends on the compensation it receives from the State. Once the issues about jurisdiction and merits of the case have been decided and the liability of the state is established; the main question for the parties concerns “how much”, in other words the amount that is awarded for the breach of standard.

“… the question of compensation and damages, is often the poor cousin when the battle royal rages first about jurisdiction and then about the merits. For the lawyers, the question of win or lose is easily about these questions, with only an afterthought for ‘how much’. It is the same with academic study and professional comment. International lawyers and academics are also interested in creating new legal doctrines. Clients who have the key interest, by contrast, are not interested in building legal norms; they simply hope to get their grievance remedied, often by getting paid as much as possible”1

1.2 Research problem

There are no binding rules in international investment law for assessment of compensation. Arbitration awards in public domain can provide useful information to understand the development of doctrinal frameworks governing the award of compensation and damages by arbitral tribunals. Further, the liability to compensate for non-performance creates an incentive for the parties to perform their promissory obligations. From an economic point of view, how promissory obligations are fulfilled depends on the quantum of compensation awarded for non-performance.

This thesis examines recent arbitral practice using two approaches; the traditional legal method and a law and economics approach to understand the jurisprudence of arbitration tribunals with respect to award of compensation for injury due to breach of international investment “The international investment regime is currently encountering an unprecedented level of

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public scrutiny. Investment regulation has, in recent years, received attention far beyond the confines of a small group of investment negotiators, practitioners and academics. This is because the law of foreign investment is in a state of flux and the investor-state dispute settlement (ISDS) mechanism has been criticized for producing inconsistency and confusion in jurisprudence, resulting in public backlash against ISDS.”

The purpose of using the two approaches is also to provide a comprehensive understanding of the arbitral awards from two different angles with an objective of contributing to the current debate.

1.3 Scope of the analysis: Investor-state infrastructure projects

The scope of this thesis is limited to investor-state disputes concerning infrastructure projects such as in power generation and distribution, oil and gas sectors. Foreign private investment has played an important role in development of public infrastructure in many countries. For example in Norway, prior to the passing of the so-called “Panic Law” – the temporary Konsesjonslov of 1906, over three fourths of the hydropower assets were owned by foreign private investors. The legislation from 1906 was replaced by Konsesjonsloven av 1909, followed by Industrikonisesjonsloven og Vassdragsreguleringsloven 1917; all of which resulted in greater role of state regulation and ownership of hydropower assets.  

The role of state regulation in infrastructure sector arises due to what economists describe as “natural monopoly” characteristics of this sector. The main implication of these characteristics is that it is more economical for a single firm as compared to many competing firms to supply infrastructure services. For example, in the electricity sector, it is economical to have a single distribution network, rather than a number of competing networks to supply electricity in a given geographic area. The need for state regulation arises because a single monopoly firm is associated with a number of economic performance and distribution problems such as, low quality of service, high prices and unjust enrichment of the producers at the expense of the consumers, all of which results in loss of social welfare.

An important role of the state is to mitigate the efficiency and equity problems associated with a single monopoly firm. Traditionally the state handled these problems through public ownership, however most modern forms of state intervention takes the form of a regulatory

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contract that integrates the setting of duties and rights of a private firm and the public regulator, establishing the incentives and responsibilities under which they would operate, including the risk sharing and risk allocation.\(^5\)

Legal basis of most international investment in infrastructure projects is a contract between a foreign investor and the host state. The foreign investor enjoys protection from breach of international standards by the state because of international investment protection treaty or agreement between the host state and the investors’ home state. Some of the international investment treaties and agreements also have so called “umbrella clauses”\(^6\) whereby breach of a state contract results in breach of the respective treaty or agreement. There is a strong link between the investor-state infrastructure project contracts and international investment protection treaties and agreements.

There are many pitfalls in in fulfillment of investor-state infrastructure project contracts. Firstly, performance of the parties to the contract is not simultaneous under such contracts. Investors make large, irreversible capital investments early in the project period, which are subject to state regulation over its operational life that may run over decades. Investments are based on estimates of future demand for services. Investors bear business and market risks and have legitimate expectations about the specific performance by state with respect to its regulatory framework. The value of the investment at a given point of time is dependent on its potential to generate revenues, which in the next instance is critically dependent on the performance of the state in regulating the project activity.

A second feature of investor-state contracts is the mixing of private and public rights in a single contract. Typically, the contract creates private rights for the investor, while the state retains its sovereign right to regulate. Value of the private rights for example, the future revenue from the project is critically dependent on the performance of the state with respect to exercise of its sovereign right to regulate. A change in the structure or implementation of the regulatory framework by the state can substantially affect the future revenues and thereby the economic value of the investment.

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\(^6\) “An umbrella clause is a provision in an investment protection treaty that guarantees the observance of obligations assumed by the host state vis-à-vis the investor. These clauses are referred to as “umbrella clauses” because they bring contractual and other commitments under treaty’s protective umbrella.” See Dolzer, R., Schreuer, C. (2012). “Principles of international investment law”. 166. Oxford University Press.
Thirdly, regulation of the infrastructure activities is not a trivial job. State in its capacity as a regulator, has asymmetric information about the material knowledge concerning the contracted activity—for example, in case of electricity distribution, the investor knows more about its cost of distribution of electricity than the public regulating authority. To improve economic efficiency and distribution of welfare, the regulator may use the information it observes in one period to regulate the activity in the next period. The “learning by doing” approach to regulation creates an incentive for the investor to manipulate its reporting, thereby laying the basis for potential disagreement between the investor and the State.

Investor-state infrastructure project contracts are vulnerable to opportunistic behavior for reasons beyond the characteristics of the regulatory regimes. Division of rights and responsibilities between the state and investor may be unbalanced at the time of contract formation. Capital markets for financing infrastructure projects are far from perfect. Ex-ante the foreign investor has a strong bargaining power. Ex-post investment phase, the bargaining power shifts to the side of the state. Ex-ante, foreign investors may be able to negotiate favorable terms and super profits that the state may intend to recapture ex-post through exercise of its sovereign right to regulate. Irrespective of the opportunistic behavior, the political and economic environment may change during the long-term of the contract leading to a change in costs and benefits for the investor and the state. A contract that was mutually beneficial to start with may cease to do so under the changed circumstances, to the extent that fulfillment of the contract may result in loss of societal welfare.

1.4 Contract remedies

Effective remedies for breaches of obligations between states and investors are important given the pitfalls in fulfillment of investor-state infrastructure project contracts. Remedies for breach mainly take form of liability for the injury suffered by the non-breaching party. One frequently cited cause of breach in investor-state disputes is change in state regulation that results in violation of international standards under the relevant investment treaty. In this respect, the sovereign right of the state to regulate however has its limits. In the words of the Tribunal in *ADC v. Hungary*:

“It is the Tribunal’s understanding of the basic international law principles that while a sovereign State possesses the inherent right to regulate its domestic affairs, the exercise of such right is not unlimited and must have its boundaries. As rightly pointed out by the Claimants, the rule of law, which includes treaty obligations, provides such boundaries. Therefore, when a State enters into a bilateral investment treaty like the one in this case, it becomes bound by it and the investment-protection obligations it
undertook therein must be honoured rather than be ignored by a later argument of the State’s right to regulate.”

There is a long-standing consensus in public international law that a state cannot breach an international investment standard, without providing adequate compensation to the investor. For example, irrespective of the underlying motive – public interest or otherwise; a state cannot deprive an investor of its property rights without compensation. Liability for compensation constitutes the main economic incentive to ensure compliance. The level of compliance however is dependent on the quantum of the liability for compensation. Under-compensation can promote opportunistic breach by the State. Over-compensation can result in unjust enrichment of the investor. The main objective for the state is to improve societal welfare and thus economic efficiency of the contract remedies in terms of societal welfare impacts, becomes an important criterion to assess arbitral practice with respect to compensation. Arbitral practice also has signal value to promote general preventive function of law.

1.5 Choice of the case material

Resolution of disputes involving breach of international investment standards by a state falls in the realm of International Investment Law; a hybrid dispute settlement framework that combines the instruments and principles of public international law with the procedural and enforcement mechanisms of commercial arbitration. The framework today encompasses over 3300 international bilateral/multilateral treaties and arrangements ratified by 150 different states that create individual rights for a foreign investor. Most of these disputes are resolved through international arbitration using recognized procedural rules.

A preliminary search for arbitration awards was conducted using the University of Victoria, Investor-State Law database. The cases in the available data were filtered using two main criteria; the infrastructure sector and type of agreement underlying the dispute. A preliminary sample of 28 cases was identified with disputes related to electricity, gas and steam sectors where the legal basis was an International Investment Agreement. The sample was analyzed to identify cases with a Final Award. Of the 12 cases with Final Award, in 3 cases the award was confidential whereas in 2 cases the award was in another language (Russian and Spanish.) Three comparable cases, all related to the power sector disputes were selected from this data-

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9 [https://www.italaw.com/](https://www.italaw.com/)
base. All these cases were decided under the procedural rules of the International Centre for Settlement of Investment Disputes (ICSID).\(^\text{10}\) In addition, two cases with final awards in English were identified from publicly available case data from the investment policy hub\(^\text{11}\) of UNCTAD, and the database at ICSID.\(^\text{12}\) The final purposive sample consisting of five cases is analyzed in detail in this thesis.

\(^{10}\) International Centre for Settlement of Investment Disputes ICSID is the world’s leading forum that has administered the resolution of the majority of all investor-state international investment dispute. ICSID was established in 1966 by the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (the ICSID Convention). The ICSID procedural rules are designed to take account of the special characteristics of international investment disputes and the parties involved, maintaining a careful balance between the interests of investors and host States.

\(^{11}\) [http://Investmentpolicyhub.unctad.org](http://Investmentpolicyhub.unctad.org)

\(^{12}\) [https://icsid.worldbank.org/en/Pages/cases/AdvancedSearch.aspx](https://icsid.worldbank.org/en/Pages/cases/AdvancedSearch.aspx)
2 General principles of reparation in International Investment Law.

2.1 Introduction

The doctrine of reparation can be traced to Edictum perpetuum of Hadrian; the most important Roman legal text that empowered the judge to provide in integrum restitutio whereby the judge ensured the return to the former legal state by way of annulment of an existing legal state created under duress metus. The exact scope of the relief varied in accordance with the facts of each case, e.g. whether a right of action was lost, an obligation was undertaken, or an object was transferred.\(^\text{13}\)

This chapter maps the development of the modern legal framework governing reparation in investor-state disputes involving breach of international law.

2.2 Chorzów Factory principles

Reparation claims under international investment arbitration arise when a State breaches an international legal standard that results in an injury to a foreign investor. The Permanent Court of International Justice (PCIJ) laid the foundation of the modern general principles governing the consequences of breach by a State in 1927 in the Chorzów Factory case as follows:

“It is a principle of international law that the breach of an engagement involves an obligation to make reparation in an adequate form. Reparation therefore is the indispensable complement of a failure to apply a convention and there is no necessity for this to be stated in the convention itself.”\(^\text{14}\)

The Court was interpreting “reparation” in the general sense and not restricted to return of an asset expropriated by the State, as by this stage of the case the Claimant (Germany) was no longer seeking the return of the assets expropriated by the Respondent (Poland)\(^\text{15}\). In the sub-

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\(^{14}\) Case concerning Factory at Chorzow, Publication of the Permanent Court of International Justice, Series A. - 9, July 26 1927, Collection of judgements, page 21.

sequent phase of the same case, the Court elaborated the content and purpose of the concept of reparation as follows:

“The essential principle … is that reparation must, as far as possible, wipe out all the consequences of the illegal act … and reestablish the situation which would, in all probability, have existed if that act had not been committed … Restitution in kind, or, if this is not possible, payment of a sum corresponding to the value which a restitution in kind would bear; the award, if need be, of damages for loss sustained which would not be covered by restitution in kind or payment in place of it—such are the principles which should serve to determine the amount of compensation due for an act contrary to international law”16

The main purpose of restitution is to reestablish the legal state before the breach, in other words provide *in integrum restitutio*. The call for wiping out “all the consequences” implies responsibility for full restitution. The Court further elaborated that restitution shall be “*in kind*”, and “*only if not possible, a payment*” of an equivalent value of the damages shall be made. A literal interpretation of this requirement signals restitution in kind as the preferred remedy. However “in kind” restitution may not be possible for a number of reasons. This may be due to the physical impossibility of restitution -the injury itself may be irreversible. Secondly, the Court or the Arbitration Tribunal may be reluctant to award an in-kind remedy; especially in cases where the dispute involves a conflict between the private property rights of the foreign investor and sovereign right of a State to regulate economic activity. Thirdly, the foreign investor itself may be reluctant to seek restitution in kind. A dispute with the host State involves a drastic change in the political risk facing an investment and the foreign investor may decide to discontinue its engagement under the changed conditions.

The concept of full restitution goes beyond in-kind restitution. The requirement “*Restitution in kind, or, if this is not possible, payment*” implies additional award of damages in case restitution in kind or its monetary equivalent is not sufficient to cover the loss sustained by the claimant. On the other hand, full restitution does not imply restitution in excess of the actual loss. This is in line with the doctrine of unjust enrichment under the Roman law and the maxim that "no one should be benefited at another's expense". For example, a claimant may seek relief based on a violation of more than one treaty or obligations in a treaty, or violation of both a treaty obligation and a breach of a commercial contract. In determining the award of damages, the implication of the doctrine is that the Tribunal shall ensure that the total awarded for the multiple breaches does not exceed the actual loss. Similarly, in case of an expropri-
The principle of full restitution is specific for the consequence “of the illegal act”. Firstly, the keyword “of” implies causality; in other words a requirement that there is a causal connection between the wrongful act of the state and the injury to the claimant. Tribunals have emphasized this requirement by demanding close proximity between the loss suffered and the breach of international standard by the State, alternatively that there is an adequate connection between the damage and the breach.

Secondly, by relating the principle to the illegal nature of the act, the Court by implication distinguished between a lawful and unlawful action of the State that may call for restitution. The subject matter of the dispute in the Chorzow case was illegal expropriation of the Factory by the Respondent State (Poland). By making the principle specific to illegal act, the Court by implications indicated that other standards might apply for a legal expropriation – for example in case of an expropriation to further public interest. The Court elaborated the consequences of not differentiating between lawful and unlawful expropriation as and follows:

“Such a consequence would not only be unjust, but also and above all incompatible with the aim of Article 6 – that is to say, the prohibition, in principle, of the liquidation of the property- since it would be tantamount to rendering lawful liquidation and unlawful dispossession indistinguishable in so far as their financial results are concerned”

In case of expropriation, the difference has implications for the valuation date of the expropriated asset and whether or not the claimant is awarded loss of profits beyond the date of expropriation. In case of a lawful expropriation, for example undertaken to further common good –

17 Para 127, Metalclad Corporation, v. The United Mexican States, Final Award, ICSID Case Nr. ARB(AF)/97/1, August 25th. 2000. With respect to the future status of the disputed asset, the Tribunal observed that the Claimants’ “Substantive interest in the property will come to an end when it receives payment under this award…. must, therefore, relinquish as from that moment all claim, title and interest in the site.”


public interest, legitimate environmental protection, etc. the claimant has a right to recovery of loss resulting directly from expropriation - *damnum emergens*, excluding any prospective loss.

In case of unlawful expropriation, the claimant may also be entitled to consequential loss due to expropriation; such as the loss of profits between the date of expropriation and the date of the award or loss of future profits – the *lucrum cessans*. In other words, the unlawful nature of the expropriation may result in restitution that goes well beyond the bricks and mortar value of the factory on the date of expropriation. The Court in *Chorzow Factory* case emphasized the liability beyond *damnum emergens* as follows:

“.. compensation due to the German Government is not necessarily limited to the value of the undertaking at the moment of dispossession, plus interest to the date of payment. This limitation would only be admissible if the Polish Government had had the right to expropriate, and if its wrongful act considered merely is not having paid to the two Companies the just price of what was expropriated”  

### 2.3 Codification of general principles: Article 31, ILC

The principle of Reparation is now well established and codified as Article 31 of the International Law Commissions (ILC) Draft articles on Responsibility of the States for Internationally Wrongful Acts as follows:

1. “The responsible State is under an obligation to make full reparation for the injury caused by the internationally wrongful act.
2. Injury includes any damage, whether material or moral, caused by the internationally wrongful act of the State”

The first paragraph formulates the reparation as an “obligation” of the responsible state, rather than as a right of an injured State. The obligation arises when a State commits a wrongful act. In other words, it is not contingent upon demand or protest of the injured State. The injury refers to any damage due to a single or several actions or omissions which together amount to an internationally wrongful act. The second paragraph of Article 31 encompasses damages that may go beyond the in-kind restitution or its monetary equivalent. The moral damage may

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20 Id.
22 Footnote 33, p.31. id.
include harm such as individual pain and suffering, loss of honor, dignity or prestige of the Claimant.

ILC Article 34 specifies the form of reparation for an international wrongful act as follows:

“Full reparation for the injury caused by the internationally wrongful act shall take the form of restitution, compensation and satisfaction, either singly or in combination, in accordance with the provisions of this chapter.”

Thus the general obligation shall be “Full reparation for the injury” and that it shall take the form of “restitution, compensation and satisfaction, either singly or in combination, in accordance with the provisions of this chapter”.

ILC Article 36 further specifies the extent of compensation as follows:

“1. The State responsible for an internationally wrongful act is under an obligation to compensate for the damage caused thereby, insofar as such damage is not made good by restitution.
2. The compensation shall cover any financially assessable damage including loss of profits insofar as it is established.”

Article 36.1 lays down the obligation for compensation beyond restitution, as far as it obliges the State responsible for an internationally wrongful act to compensate for the damage caused thereby, insofar as such damage is “not made good by restitution”. This is in line with the Chorzow principle. Both sources agree with respect to the need for additional compensation beyond restitution or its monetary equivalent. However, as compared to Chorzow, where restitution in-kind is the preferred remedy, the primary obligation as per Article 36.1 is for compensation. It is to be noted that Article 36.2 limits compensation to only “financially assessable damage”; in other words it excludes compensation for “moral damages” specified in Article 31.2. No such limitation is explicit in the Chorzow principle. Further Article 36.2 explicitly extends the quantum of compensation to include *lucrum cessans* “loss of profits insofar as it is established”. A literal interpretation also indicates the applicable standard of proof for the prospective loss – it should be “established” and not speculative.

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23 Article 34. P.95. Id.
24 Article 36. P. 98-99. Id.
25 Article 31.2. P. 91 and Comment 1 to Article 36. P. 98-99 Id.
The general principles governing reparation; both the *Chorzow Factory* principles and the *ILC articles* were developed in the context of illegal expropriation by a State. The tribunals resort to the Chorzow principles to calculate compensation also for violation of other standards such as fair and equitable treatment standard, despite the fact that these general principles are not explicitly developed for reparation of violation of this standard\(^{26}\). The general principles provide guidelines for calculation of compensation and leave the actual estimation of compensation for concrete assessment by the deciding court or the Tribunal.

### 2.4 Calculation of compensation: The Differential method

Merriam Webster dictionary defines damage as “loss or harm resulting from injury to person, property, or reputation”. The definition emphasizes the consequential nature of the concept. Damage is a consequence of an injury; which can be material (loss of property, profits etc.) or immaterial (honor, prestige, pain). The main point is that damage involves a transition between two states of nature; the so called “but for”\(^{27}\) hypothetical state as it would have been without the injury; and the observable state with the injury. The difference in the monetary value of the two states of nature constitutes compensation. Implementation of Chorzow and ILC principles involves a comparison of the hypothetical “but for” outcome with the actual outcome -the difference between the two being the injury to the claimant. This is the essence of the differential method of estimating compensation.

There are two principle difficulties in implementing the differential method. Firstly, there is a need to decide whose valuation shall form the basis. There are at least three alternatives to choose from – claimants valuation, respondents valuation or a third persons independent valuation. If the objective is “to wipe out all the consequences of an illegal act”, the question arises -consequences for whom? The most natural candidate here is the injured party. Thus full restitution as per the Chorzow and the ILC articles would call for compensation that draws on subjective valuation of the claimant. The burden of proof lies on the claimant. The challenge for the claimant is to prove its valuation keeping in view that it has a conflict of interest in revealing the correct value – the fact that the Tribunal is also concerned about while assessing


the compensation claim. The second difficulty for estimating compensation arises due to the hypothetical nature of the “but for” state without injury.

There are various valuation methods available for calculating the value of the investment under the hypothetical scenario\(^{28}\). In principle, one can distinguish between the methods depending on whether their basis is the past, present or future looking in character. In a backword-looking valuation, the emphasis is on the past values – the initial investment expenditures or the net book value of the investment. In the method that emphasizes the present, the focus would be on the current acquisition or replacement cost of the investment, current market value or the liquidation value of the asset. The forward-looking methods focuses on the future income-generation potential of the investment.

*Discounted Cash flow method* is the most widely forward-looking method used in estimation of compensation. The modus-operandi is to estimate the stream of future profits, and discount the same using an appropriate discount rate to arrive at an estimate of present value of the investment. This method comes closest to awarding *lucrum cessans*, however it is important to emphasize “the concept of *lucrum cessans* requires in the first place that there is a *lucrum* that comes to an end\(^{29}\)”. Evidence plays an important role in establishing compensation calculations. In practice, the Tribunals require that the disputed investment is a going concern with a history of generating profits and the breach by the State has ended the stream of profits.

### 2.5 Appropriation of arbitration costs

Arbitration under international investment law is a costly process with arbitration and litigation costs in the range of five to ten million dollars. In long-term complex infrastructure contracts, the costs may be even higher Appropriation of arbitration costs between the Claimant and the Respondent is the second most important element that determines the actual relief granted to the Claimant. Arbitration Tribunals have the jurisdiction for apportioning these costs between the Claimant and the Respondent. As per the ICSID Convention Article 61.2

“In the case of arbitration proceedings the Tribunal shall, except as the parties otherwise agree, assess the expenses incurred by the parties in connection with the proceedings, and shall decide how and by whom those expenses, the fees and expenses of the

\(^{28}\) The valuation literature is quite extensive. Various international standards recommendations and principles are in use for valuation of assets. For a detailed survey of the valuation, methods in international arbitration see Marboe, I. (2009). “Calculation of compensation and damages in international law”. Chapter 5. 185-315.

\(^{29}\) Para 313. Pseg Global Inc. and Konya Ilgin Elektrik \Üretim Ve Ticaret Limited Ş Rketi v. Republic of Turkey, Final Award, ICSID Case No. ARB/02/5, Award, January 17th. 2007.
members of the Tribunal and the charges for the use of the facilities of the Centre shall be paid. Such decision shall form part of the award”. ³⁰

“More recently tribunals have shown growing inclination to adopt the principle that costs follow the event.”³¹ In other words the party that fails to prove its case, bears its own costs in addition to a share of the costs incurred by the successful party; the share depending on the concrete facts of the case. ILC Article 39 deals with the conduct of the parties in litigation as follows:

“In the determination of reparation, account shall be taken of the contribution to the injury by willful or negligent action or omission of the injured State or any person or entity in relation to whom reparation is sought”. ³²

Applied to apportionment of the costs, the conduct of the claimant may provide a legal basis for deviation from general principle of “costs follow event”.

2.6 Interest

The notion of full restitution implies adequate compensation for loss due to any delays in payment of compensation. Interest on awarded compensation provides an incentive for reducing delay in making payments. “The interest on compensation for expropriation should follow a most objective market-related interest rate. International inter-bank interest rates such as LIBOR or the EURIBOR, would best fulfill this criterion”.³³ There has been a shift towards award of compound interest since the year 2000.³⁴ The main consideration for the Tribunal is to establish the most likely alternative use of the funds in the disputed investment.

³⁰ http://icsidfiles.worldbank.org/icsid/icsid/staticfiles/basicloc/parta-chap06.htm
³⁴ Id. 400.
3 Practice of compensation in investor-state infrastructure investment disputes

3.1 Introduction

Typically, an investor-state dispute starts with the claimant (a foreign investor) filing a request for arbitration, with a mutually agreed fora, for settlement of a dispute arising out of the breach of an international standard by the host State. The compensation issue arises once the arbitration tribunal has decided on its jurisdiction and the merits of the case. There has been a large increase in filing of international arbitration cases during recent years, however the number of final awards that are in the public domain is still limited to draw general conclusions about the trends in compensation practice.

This chapter makes use of the traditional legal method to analyze practice of the international arbitration tribunals in deciding claims of foreign investors for reparation of damages due to breaches of international investment treaties by States. In this chapter, we analyze five, primarily recent arbitration awards.

3.2 The legal basis for the claims

In most of the cases analyzed in this chapter, illegal expropriation does not seem to be the main issue. The common denominator across all the cases is the violation of fair and equitable treatment. In cases where illegal expropriation is an issue, it comes in combination with other violations. The general principles governing reparation; both the Chorzow Factory principles and the ILC articles were developed in the context of illegal expropriation by a State. However, the tribunals resort to the Chorzow principles to calculate compensation for violation of fair and equitable standard, despite the fact that these general principles are not explicitly developed for reparation of violation of this standard. Only in the Eiser case, the tribunal explicitly observed that “tribunals sometimes apply principles relevant to compensation for expropriation to other treaty violations without comment”35. The Tribunal instead based its decision on ILC Article 31 “as accurately reflecting the international law rules that are to be applied here. International law requires that the Respondent makes full reparation for the injury caused by failing to comply with its obligation to accord fair and equitable treatment under

35 Para 420, Eiser Infrastructure Limited and Energia Solar Luxembourg s.à r.i. v. Kingdom of Spain, ICSID Case No. ARB/13/36, Award, 26th. April 2017.
ECT Article 10(1), so as to remove the consequences of the wrongful act"\(^36\). In none of the other cases this issue was addressed.

In two cases, *Eiser Infrastructure Limited and Energia Solar Luxembourg s.à r.i. v. Kingdom of Spain*\(^37\) and *Teco Guatemala Holdings v. The Republic of Guatemala*,\(^38\) the Claimants pleaded violation of fair and equitable treatment. The legal basis in *Eiser* was Article 10 of Energy Charter Treaty\(^39\) whereas *Teco* based its case on CAFTA DR (Dominican Republic and Central America including Guatemala) - US Free Tarde Agreement\(^40\).

In one case, *Hrvatska Elektroprivreda D.D. v. Republic of Slovenia*, the Claimant advanced two independent legal basis\(^41\). One of these was violation of its rights as an investor under Energy Charter Treaty Articles 10(1) that “include a commitment to accord at all times to Investments of Investors of other Contracting Parties fair and equitable treatment” and Article 13 that forbids illegal expropriation. The other was a claim against Slovenia for breach of its obligation under the 2001 Agreement.\(^42\)

In the remaining two cases, *Pseg Global Inc. and Konya Ilgin Elektrik Üretim Ve Ticaret Limited § Rketi v. Republic of Turkey; AMPAL-American Israel Corp., EGI-FUND (08-10) Investors LLC, EGI-SERIES v. Arab Republic of Egypt*,\(^43\) the Claimant introduced multiple violations including violation of “fair and equitable treatment”. For example, in *Pseg Global Inc. and Konya Ilgin Elektrik Üretim Ve Ticaret Limited § Rketi v. Republic of Turkey* under its bilateral treaty with United States\(^44\). These included violation of Article II (3) that covers

\(^{36}\) Para 424, Id.

\(^{37}\) Para 349, Id.


\(^{39}\) Energy Charter Treaty (ECT), header1-3

\(^{40}\) Para 264, page 58-59


\(^{43}\) AMPAL-American Israel Corp., EGI-Fund (08-10) Investors LLC, EGI-Series Investments LLC, and BSS-EMG Investors LLC. v. Arab Republic of Egypt, ICSID Case No. ARB/12/1, Decision on liability and heads of loss, 21st February, 2017.

\(^{44}\) Treaty between the United States of America and the Government of the Republic of Turkey Concerning the Reciprocal Encouragement and Protection of Investments (the “Treaty” or the “BIT”), which was signed on December 3, 1985, and entered into force on May 18, 1990.
violations of “fair and equitable treatment standard”\[^{45}\]
, “obligation to provide full protection and security”\[^{46}\]
, “protection against arbitrary and discriminatory measures that impair the management, operation, maintenance, use, enjoyment, acquisition, expansion or disposal of the investment”\[^{47}\]
, and “any obligation it may have entered into with regard to investments”\[^{48}\].

The Claimant did not argue the existence of direct expropriation, however it requested a finding of liability on account of the breach of Article III (1) that concerns “measures adopted ....resulted in indirect expropriation”\[^{49}\].

### 3.3 Consistency in practice

#### 3.3.1 Financially assessable damages

Chorzow principle identifies restitution in-kind as the preferred remedy and prescribes full compensation. As per ILC Article 31.1, the primary obligation for a wrongful act of the state is compensation. Although ILC Article 31.2 recognizes the possibility of both “material and moral “damages, ILC Article 36.2 limits compensation only for “financially assessable” damage. In all the five cases, compensation was limited to “financially assessable” damage. In none of the cases, tribunals considered restitution or relief for moral damages\[^{50}\] as a suitable remedy.

In *Eiser Infrastructure Limited and Energia Solar Luxembourg versus Kingdom of Spain* the Claimant pleaded the violation of fair and equitable treatment and sought restitution of the legal and regulatory regime under which they made their investments. The arbitration tribunal did not regard restitution as an appropriate remedy. The tribunal noted that it did not question the “Respondent sovereign right to take appropriate regulatory measures to meet public needs.”\[^{51}\] The Tribunal however qualified its statement and observed that the State must exer-

\[^{45}\] Para 222, *Pseg Global Inc. and Konya Ilgin Elektrik Üretim Ve Ticaret Limited Ş Rketi v. Republic of Turkey*, Final Award, ICSID Case No. ARB/02/5, Award, January 17th. 2007.

\[^{46}\] Para 257, Id.

\[^{47}\] Para 260, Id.

\[^{48}\] Para 263, Id.

\[^{49}\] Para 27, Id.

\[^{50}\] In *Teco Guatemala Holdings versus The Republic of Guatemala*, the Claimant alleged harassment of its senior executives by the State apparatus, such that the executives had to leave the country. However, the Claimant did not seek relief for the non-pecuniary damages resulting from such harassment. Thus although the claimant may have alleged moral damages, in the absence of a concrete claim the Tribunal would not consider such damages. Further proving and valuing non-pecuniary damages is not a trivial matter and may explain their absence in case law.

cise its sovereign right “within the international legal framework it accepted when it adhered to the ECT, including the obligation to provide compensation for any breach of its commitments under the Treaty”. Thus, the Tribunal recognized the right of the State to change the regulatory framework; however, it questioned the gravity of the consequences of the change.

3.3.2 No over-compensation

In *Hrvatska Elektroprivreda D.D. v. Republic of Slovenia*, the claimant based its plea on two treaties; a Treaty between Croatia and Slovenia related to the subject matter of the dispute signed in 2001 and the Energy Charter Treaty ECT, to support a single claim for compensation against Slovenia. The Tribunal awarded compensation under the bilateral treaty signed in 2001, and dismissed all the claims under ECT. In a subsequent submission made by the Claimant to the Tribunal to reconsider and reverse its ruling on dismissal of claims under ECT the Tribunal observed that it “had understood from the very beginning that “the Claimant was offering alternative treaty bases of liability for identical monetary relief “. The “Claimant has achieved now the “single claim for compensation” it sought from Respondent and that the “Claimant has been deprived of nothing by the dismissal of its alternative ECT Claim. No purpose would be served by its continuation”. The decision is in line with an earlier award in *SD Myers Inc. v. Government of Canada* where the Tribunal noted that “damages for breach of any one NAFTA provision can take into account any damages already awarded under a breach of another NAFTA provision; there must be no “double recovery”.

3.3.3 Approach and method

The general principles expressed in Chorzow Factory case and the ILC articles at best provide the direction, however these do not lay down how compensation is to be calculated. Cases analyzed in this thesis indicate consensus with respect to use of differential approach, and in particular, use of Discounted Cash Flow method for computing compensation over a period. The core of the differential approach is to compute the difference in revenues between two scenarios, the “actual scenario” with the State in violation and a “but-for” scenario assuming that the state did not commit the violation to arrive at the “fair market value” of the investment under the two scenarios.

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52 Id.
54 Para 580, Id.
There is a “remarkable consensus”\textsuperscript{56} as regards the definition of fair market value in the valuation community and international arbitration field. For example, the tribunal in \textit{CMS Gas Transmission Company v. Argentine Republic} defined fair market value as follows:

“The price, expressed in terms of cash equivalents, at which a property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms (sic) length in an open and unrestricted market, when neither is under compulsion to buy or sell, and when both have reasonable knowledge of the relevant facts”\textsuperscript{57}

In \textit{Teco Guatemala Holdings versus The Republic of Guatemala}, both the Claimant and the Respondent were in agreement with use of the differential approach and the DCF method for computing the loss\textsuperscript{58}, although there were some disagreements with respect to certain parameter values in the calculations. The Claimant estimated the \textit{fair market value} of the company with tariffs set according to the values established by the regulatory authority (“actual value”) and a “but-for” scenario that estimated the value of the company assuming the tariffs had been fixed according to the process agreed at the time of investment (“but-for value”). The Claimants experts calculated the actual and the but-for value using three different methods; namely the \textit{discounted cash flow} ("DCF") method, the \textit{comparable publicly-traded companies method} (PTC), and the \textit{comparable transactions method} (CT). The estimates were used to compute a weighted average “actual” and the “but-for value”. In computing the weighted average, DCF method estimate had the highest weight (60%), PTC method (30%) and (CT) method being the least reliable with (10%). The Claimant presented the difference between the two weighted average values as the \textit{loss in the fair market value} of the company.\textsuperscript{59} In the final award, the Tribunal accepted the use of DCF method. The Tribunal ruled on the disagreements with respect to the inputs to the DCF method. The final decision relied on the evidence presented by the technical expert witness.

In \textit{Eiser Infrastructure Limited and Energia Solar Luxembourg versus Kingdom of Spain}. The Claimant defended the use of the DCF method urging that the “[T]he DCF method is the appropriate method to assess the fair market value in the circumstances because CSP projects


\textsuperscript{58} Para 719-720, \textit{Teco Guatemala Holdings v. The Republic of Guatemala}, ICSID Case No. ARB/10/17), Award, December 19th. 2013

\textsuperscript{59} See Para 338-340, Id., The computations were subject to some technical adjustments for company debt.
have a relatively simple business model ‘producing electricity, whose demand and long-run value can be analyzed and modeled in detail based on readily available data. In its analysis, the Tribunal agreed with the Claimants’ approach for determining its damages. The Tribunal observed that “assessing the reduction of the fair market value of its investment by calculating the present value of cash flows said to have been lost on account of the disputed measures – offers an appropriate means to determine the amount of reparation due in the circumstances of this case.

3.3.4 Date and duration of breach

Case examined reflects consensus with respect to award of compensation for historical losses; i.e. the losses from the date of the breach to the date of the award. The Chorzow principle calls for reestablishment of the situation that in “all probability have existed” however it leaves to the tribunals to establish the standard of proof regarding the balance of probabilities. Historical losses are observable and the quantum of losses is certain once the underlying parameters of the calculations have been determined on merits. Award of such losses is not probabilistic in character.

3.4 Inconsistency in practice

A frequent criticism of arbitration tribunals is that they “frequently ‘cherry-pick’ the rules which will be applied to the dispute” resulting in lack of consistency in final decisions. An often quoted example are the Lauder v. Czech Republic arbitrations where, despite identical parties, norms and facts of the case, two investment tribunals came to completely opposite conclusions. None of the cases analyzed were identical, however one observes inconsistency in application of measures and methods.

3.4.1 Application of fair market value

In Hrvatska Elektroprivreda D.D. v. Republic of Slovenia, the Tribunal faced a choice between two competing compensation measures. The Claimant presented a so-called “replace-
ment cost” measure, while the respondent adopted a so-called “market value” measure\textsuperscript{64}. The replacement cost measure reflected the actual costs that the Claimant incurred to replace electricity when the Respondent was in breach of its obligation to supply, as agreed under the Bilateral Agreement of 2001 between Croatia and Slovenia. The “market value” measure, introduced by the respondent, reflected the costs of replacements assuming that the Claimant had acquired the shortage in supplies through optimal use of market transactions- in other words, a fair market valuation of the replacements. The Tribunal observed that:

“The central proposition established in the Chorzów Factory is that restitutionary damages must make the claimant whole by restitutioning the value to it of the right of which it has been deprived, and not just the fair market value which might, for example, be required as compensation in the event of lawful expropriation. (This principle has figured prominently in the jurisprudence of the Iran-U.S. Claims Tribunal; see, e.g. Phillips Petroleum Co. Iran v. Iran, 21 Iran-U.S. Claims Tribunal Report 79 (1989 I)).” \textsuperscript{65}

As per the Tribunal, the fair market value is relevant only under lawful expropriation. The Tribunal accepted the replacement cost measure for calculating historical losses from the date of the breach to the date of the award. The decision deviates from the outcomes in Teco and Eiser cases, fair market value is the accepted measure. Furthermore rejecting the use of fair market valuation for reparation under an unlawful breach of an international standard lacks persuasion. An implication of the Tribunals decision is that if Slove

\textsuperscript{3.4.2 Claims involving future losses}

Tribunal practice with respect to compensation claims involving future losses is varied and largely restrictive.

In \textit{Pseg Global Inc. and Konya İlgın Elektrik Üretim ve Ticaret Limited Şirketi v. Republic of Turkey}, the Tribunal quoted earlier practice, - the award in \textit{Autopista Concesionada de Venezuela, C.A. v. Bolivarian Republic of Venezuela} in which it was observed that, ICSID tribunals are “reluctant to award lost profits for a beginning industry and unperformed work. This reluctance of ICSID tribunals is confirmed by the practice of the Iran-U.S. Claims Tribu-

\textsuperscript{64} Para 360, \textit{Hrvatska Elektroprivreda D.D. v. Republic of Slovenia}, ICSID Case No. ARB/05/24, Award, June 12th, 2009.,

\textsuperscript{65} Para 365, Id.
nal”66. The Tribunal further observed, “this measure is normally reserved for the compensation of investments that have been substantially made and have a record of profits, and refused when such profits offer no certainty.”67 The Claimants argued that there is a need to distinguish the situation where there have been contractual arrangements that establish the expectation of profit at a certain level and over a given number of years. The Tribunal response was that it: “would have no difficulty with this proposition, because in fact a self-contained and fully detailed contract can well determine a basis for the calculation of future profits. However, the Tribunal must also note that in many long-term contracts it is most difficult if not impossible to calculate such future profits with certainty, particularly if the contract is subject to adjustment mechanisms and other possible variations with time” 68

In Teco Holding v. The Republic of Guatemala, the Claimant sold its share of equity in the project, due to a dispute with the regulatory authority of the Respondent regarding adjustment in parameters underlying tariffs. The Claimants’ argument was that the tariffs set by the regulatory authority for the current tariff period were lower as the process for setting tariffs was not conducted as agreed between the investor and the electricity regulatory authority of the Respondent. The Claimant sought compensation for the resulting reduction in fair market value of the firm at which it sold its share of the investment. The Tribunal observed that it had “no reasons to doubt that … the decision to divest was taken primarily as a consequence of the breach by the CNEE (the Respondent regulatory authority) of the regulatory framework”69. The Tribunal however agreed with the Respondent that the claim was “speculative” as “it is actually impossible to know what will happen with the tariffs in the future”70 thus rejecting the claim based on future valuations. In other words, the probability of being able to “establish” the loss was considered to be close to zero.

The decision in Eiser Infrastructure Limited and Energia Solar Luxembourg s.à r.i. v. Kingdom of Spain is a clear deviation from both Teco and Pseg Global cases. In Eiser case, in response to a fundamental change in the tariff regime by the electricity regulator, the Claimant sought relief for loss of future revenues assuming a plant operational life of 40 years – or 38 years from the valuation date. The loss was defined as the difference between the present values of two sets of discounted cash flows; the first assuming no change in the tariff regime

67 Para 310, Pseg Global Inc. and Konya Ilgin Elektrik Üretim Ve Ticaret Limited Şirketi v. Republic of Turkey, Final Award, ICSID Case No. ARB/02/5, Award, January 17th, 2007.
68 Para 312, Id.
70 Para 757, Id.
while the other set represented the cash flows under the changed regime. The Respondent raised objection with respect to both the Discounted Cash Flow methodology and the length of the period, urging that the claims were “totally and completely speculative”\(^71\) - a claim that was quite similar to the views expressed in the *Teco* case.

The Tribunal rejected the objections raised by the Respondent both on general and contextual grounds. It observed that the “DCF techniques have been universally adopted including by numerous arbitral tribunals, as an appropriate method for valuing business assets”\(^72\). Thus with respect to the choice of method for calculating compensation it was consistent with earlier practice. It also accepted contextual argumentation introduced by the Claimant’s experts that “Power stations have a relatively simple business, producing electricity, whose demand and long-run value can be analyzed and modeled in detail based on readily available data”\(^73\) and that its “costs and performance are easy to predict.”\(^74\) While awarding the compensation, the Tribunal also commented on the “reasonableness” of the compensation and observed, “By way of context, there is no serious dispute that Claimants invested on the order of 126 million Euro. The Tribunals assessment of the amount of compensation due – 128 million Euro – is consistent with the amount Claimants invested. This provides a “reality check” on the reasonableness of the Tribunal’s conclusion regarding compensation”\(^75\) The Claimant was awarded loss of future cash flows, however the actual amount was lower than the claim as the Tribunal accepted the Respondent’s objection that the plant was designed for an operation life of 25 years and not 40 years.

A question that arises is: Do the different outcomes in *Teco* and *Eiser* cases concerning award of compensation for future loss of profits due to change in regulation, reflect lack of consistency in arbitral rule making? The answer depends on the jurisprudential perspective one uses to answer the question.

From a legal perspective, in the *Eiser* case, the Tribunal focused on the general principle of proportionality as a criterion of fairness and justice in interpretation of the fair and equitable treatment standard in international investment law. The *Teco* case on the other hand focused mainly on the balance of probabilities in establishing the future loss of profits; without elaborating the standard of proof required to establish injury.


\(^72\) Para 465, Id.

\(^73\) Id.

\(^74\) Id.

\(^75\) Para 474, Id.
In the *Eiser* case, the dispute concerned an investment in a solar power production facility. The investment was made in response to the Respondents’ regulatory and economic regime that established a permanent economic subsidy for production of renewable electricity. Claimants and their co-investors leveraged their investments and loans with substantial non-recourse borrowings\(^76\) and built high-grade facilities capable of high production, including provisions for future storage to allow increased production. They did so because the regulatory regime based incentives on production. Banks were prepared to provide the non-recourse funding required because, like Claimants, they had confidence in the stability of Respondent’s regulatory regime. The subsidy under the regulatory regime was not subject to periodic revision for example as in the *Teco* case. The new regime reduced projected revenues of Claimants’ up to 66% compared to those projected under the prior regime. Since, the plants were highly leveraged – as Respondent’s regulatory authorities previously anticipated that such plants would be – this revenue cut had grave consequences for the investor.

The Claimant based its argumentation on the unlawful nature of the action and the gravity of the consequences of the regulatory change. The Council of the Claimant quoted\(^77\) the award in *ADC v. Hungary*; an important case that established a clear departure from pre 2006 jurisprudence in the context of expropriation\(^78\) as follows:

> “….while a sovereign State possesses the inherent right to regulate its domestic affairs, the exercise of such right is not unlimited and must have its boundaries. … when a State enters into a bilateral investment treaty…. it becomes bound by it and the investment-protection obligations it undertook therein must be honoured rather than be ignored by a later argument of the State’s right to regulate.”\(^79\)

> “…It is one thing to say that an investor shall conduct its business in compliance with the host State’s domestic laws and regulations. It is quite another to imply that the investor must also be ready to accept whatever the host State decides to do to it.”\(^80\)

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\(^{76}\) Non-recourse finance is a loan where the lender is only entitled to repayment from the profits of the project the loan is funding, not from other assets of the borrower. High capital expenditures, long loan periods and uncertain revenue streams characterize these types of projects. [http://www.investopedia.com/terms/n/non-recoursefinance.asp](http://www.investopedia.com/terms/n/non-recoursefinance.asp)


\(^{80}\) Para 424, Id.
In its analysis, the Tribunal noted the precedence set by ADC v. Hungary and in addition quoted from Charanne v. Spain, which although different in factual terms, offered relevant insight regarding the dramatic nature of the change to the regulatory regime and the proportionality standard, as follows.

“[A]n investor has the legitimate expectation that, when modifying the regulation based on which the investment was made, the State will not act unreasonably, disproportionately or contrary to the public interest.”  

As per the Tribunal, whether viewed as basis for reasonable expectations, or as a statement of a State’s obligations under ECT, the principle is the same. It drew on the Charanne v. Spain award in which it was observed that: “As for proportionality, the Arbitral Tribunal considers that this criterion is satisfied as long as the changes are not capricious or unnecessary and do not amount to suddenly and unpredictably eliminate the essential characteristics of the existing regulatory framework.”

The Eiser Tribunal interpreted the Claimants legal basis -The Energy Charter Treaty ECT using the general rule of interpretation under the Vienna convention. It interpreted the ECT in the light of its object and purpose, as stated in the ECT and the 1991 European Energy Charter - a political document that was the precursor to the ECT. The 1991 Charter explicitly pointed that in order to promote the international flow of investments, the signatories will “provide for a stable, transparent legal framework for foreign investments, in conformity with the relevant international laws and rules on investment and trade.”

The tribunal concluded “Taking account of the context and of the ECT’s object and purpose, the … Article 10(1)’s obligation to accord fair and equitable treatment necessarily embraces an obligation to provide fundamental stability in the essential characteristics of the legal regime relied upon by investors in making long-term investments. This does not mean that regulatory regimes cannot evolve. … However, the Article 10(1) obligation to accord fair and equitable treatment means that regulatory regimes cannot be radically altered as applied to existing investments in ways that deprive investors who invested in reliance on those regimes of their investment’s value.”

82 Para 517, id.
84 Para 382, Eiser Infrastructure Limited and Energia Solar Luxembourg s.à r.l. v. Kingdom of Spain, ICSID Case No. ARB/13/36, Award, 26th. April 2017.
The dispute in *Teco* case concerned a concession for distribution of electricity, where tariffs are subject to revision on periodic basis. The core of the dispute was the conduct of the process used by the regulating authority to determine the value of the basic parameters for setting of tariffs and thereby the revenues of the investor. This was not a dispute about the stability of the regulatory framework, but rather a dispute about the calculations under a single tariff revision period. Claimants’ argument was that the tariff revision process was conducted in a manner that resulted in lower tariff levels and reduction in fair market value of the investment at which the Claimant had to sell its share of the investment. The claim put forward by the Claimant was the difference between the actual fair market value and the “but for” fair market value of the investment that assumed higher level of tariffs had the tariff revision process been unbiased. While calculating the actual fair market value the Claimant extrapolated low tariffs for the operational life of the investment based on a dispute in one tariff period.

The Tribunal accepted the Claimants’ argument that its decision to sell its share of the investment was a consequence of the breach by the Respondent. The Tribunal agreed that a self-contained and fully detailed contract can well determine a basis for the calculation of future profits. In other words, the probability of being able to calculate future profits is not zero or impossible. It also accepted that “the existing tariff were considered as a relevant factor in determining the price of the transaction” when the Claimant sold its share of the investment. However, it ruled that it “cannot conclude with sufficient certainty that an increase in revenues until 2013 would have been reflected in the purchase price and to what extent.” The tribunal rejected relief for future loss to the Claimant on grounds that “in many long-term contracts it is most difficult if not impossible to calculate such future profits with certainty, particularly if the contract is subject to adjustment mechanisms and other possible variations with time.” The Tribunal did not elaborate on the applicable standard of proof that it applied with respect to the level of certainty required to prove the breach. Neither did it consider the issue of gravity of the consequence for the investor. The Tribunal it seems adapted a standard of proof to the result that it desired.

The argumentation of the Tribunal, is not persuasive as it conflicts with the factual reality of the subject matter of, and the motivation behind the contract. Calculation of current and future costs and profits of the monopoly supplier is an essential component in implementation of the adjustment mechanisms in the regulatory framework governing such contracts. The essence of

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86 Para 754, Id.

87 Para 312, Id.
the monopoly regulation,\footnote{For a comprehensive overview of the theoretical and empirical literature on the regulation of natural monoplies, Joskow, P. L. (2007). "Regulation of Natural Monopoly." In Polinski, A.M. Shavell, S. (Eds.) Handbook of Law and Economics 2. 1227-1348. Elsevier BV.} as in Teco case is that on basis of competitive bidding, a government through its appropriate agency allocates sole rights to the bidder who offers to operate the natural monopoly activity at the lowest price. The idea is that the power of competitive markets can be harnessed ex-ante contract execution stage even though ex-post there is only a single firm supplying the service. After allocation of the contract, ex-post regulation effectively involves determination of prices according to the terms and conditions of the contract that were determined by competitive bidding ex-ante. In the ex-post price determination process, the supplier has an interest in getting as high a price as possible, whereas the objective of the government is to keep prices at an efficient level that maximizes social welfare - in other words keep the price at a level that covers suppliers’ costs including a fair rate of return on suppliers investment. The opposing interest of the parties’ ex-post leads to the need for an institutional mechanism to adjudicate contractual disputes. This could be a court or the regulatory agency created by the government to monitor contractual performance. In practice, the government agency in consultation with the supplier determines prices based on detail calculation of current and future costs, investment needs and profit margins. Both the parties have an estimate of future profits, though they may disagree on its level. Calculation of future profits is not impossible as stated by the Tribunal.

### 3.5 Concluding remarks

The five cases analyzed in this chapter indicate that awards are consistent on many issues. One observes consistent practice with respect to limiting of compensation to financially assessable damages, no overcompensation, acceptance of definition of fair-market value, acceptance of discounted cash flow method to value future loss, and award of historical loss – loss from the date of breach to the date of award.

The main area of inconsistent decisions is with respect to the award of expression interest involving loss of future profits from the date of the award and period ahead. The inconsistency occurs both with respect to size of the award (from total rejection to full compensation) and reason giving - while in one case the tribunal emphasizes the impossibility of calculation in future profits, in the other case calculation of future loss is accepted assuming an operational life of 25 years for the project. It seems that the tribunals adopt a pragmatic approach that involves selective rule picking and adaptation of standard of proof to the desired result.
4 Arbitral practice and economic welfare

4.1 Introduction

As per Article 59 of the Statute of the International Court of Justice (ICJ), "The decision of the Court has no binding force except between the parties and in respect of that particular case." Accordingly, arbitral decisions in investment disputes are only directly applicable to the parties to the dispute. However, in reality “the pronouncements that these tribunals make as to the existence or non-existence of an alleged rule of international foreign investment law or the meaning and scope of a rule have wider ramifications and implications for other states as well as for international law as a whole”

The objective of this chapter is to assess arbitral practice analyzed in chapter 3 using a law and economics perspective. The use of economic welfare criterion to understand arbitral decision making governing investor-state infrastructure investment projects is particularly relevant, as the basic motivation governing infrastructure investments and their regulation is concerned with the legislators and the policy makers objective to increase social welfare through these investments.

4.2 Efficient breach

_Pacta sunt servanda_ is the basic principle of contract law. When performance of the parties to the contract is simultaneous, and costs and benefits accruing to the contracting parties are certain, fulfillment of a contract increases societal welfare. However, in long-term investor-state infrastructure project contracts there are significant lags between the performances of the parties. Investment made at one point of time is recovered over many years. A contract that was mutually beneficial at the time of entry, due to unexpected contingences, may cease to be so later in the contract period. The cost of fulfilling the contract for one party may exceed the value of fulfillment for the counterparty. Under such circumstances, breach of the contract can be justified from societal economic welfare point of view, in terms of what in economic theory is known as the Kaldor/Hicks criteria. The Kaldor-Hicks criterion provides a measure to assess the desirability of reallocation of resources between parties in terms of how it affects the aggregate value of the resources for the society. The criterion is mainly used to assess the social economic desirability of a given change in allocation of resources.


A system is efficient in economic terms if it uses minimum resources to achieve a given output. In economics, there are various types of efficiency criteria to assess allocation of resources. A system is Pareto efficient if no reallocation is possible that will result in higher welfare for one party without making some other party worse off. A reallocation is Kaldor-Hicks efficient, if resources are allocated to parties with highest valuation for the resources - after theoretically allowing for compensation the gaining parties would have to make to the parties from whom the resources are transferred. Such a reallocation will increase the value of the resources for the society. In other words, from a societal economic welfare point of view, an outcome is an improvement if those who gain from a reallocation could compensate those who lose. For example if the gain from breach of the contract is greater than the loss to the non-breaching party, and the gainer prefers breach even if it has to compensate the non-breaching party for its loss, then breach of the contract would increase societal economic welfare. This is the essence of the so-called efficient breach theory91.

The basic principle of contract law emphasizes promissory obligations, principles of corrective justice, autonomy, or other non-welfarist principles. The relevant criterion underlying the idea of efficient breach theory is economic efficiency expressed in terms of a social benefit of fulfillment of a contract. The theory is not free for criticism. “[The efficient breach theory’s] focus on the pecuniary aspects of breach fails to take account of notions of the sanctity of contract and the resulting moral obligation to honor one’s promises. The analysis of breach of contract in purely economic terms assumes an ability to measure value with a certainty that is not often possible in the judicial process. The analysis also ignores the “transaction costs” inherent in the bargaining process and in the resolution of disputes, a defect that is especially significant where the amount in controversy is small.”92

It is important to emphasize that a departure from the basic principle of contract law is vulnerable to opportunistic behavior. Costs and benefits of fulfillment are private information of
the parties to the contract. A party may gain by breach even though the cost of fulfillment may be less than the loss to the non-breaching party.

To ensure efficient breach, as per Richard Posner “contract remedies should give the party to a contract an incentive to fulfill his promise unless the result would be an inefficient use of resources.” The relevant incentive as per the efficient breach theory is to make the breaching party liable for damages suffered by the non-breaching party. 93 The simplest version of the theory recommends expectation damages. 94 “Neither restitution nor liability for reliance interest is a sufficient incentive to assure efficient breach.

4.3 Award of expression interest

The primary requirement to assure fulfillment of contracts that are desirable from a social welfare point of view is to make the breaching party liable for the damage borne by the non-breaching part. In the simplest case where breach is of a finite duration, the implication of the requirement is compensation for the actual loss during the duration of the breach.

In Hrvatska Elektroprivreda D.D. v. Republic of Slovenia, the Claimant sought compensation for costs it had to bear to replace electricity supplies from alternate sources due to the failure by the Respondent to meet its supply obligations for a finite duration (1 July 2002 to 18 April 2003), subsequent to which the Respondent resumed supplies. The Tribunal was confronted with multiple estimates of the loss suffered by the claimant based on different approaches to calculation of the cost of replacements. The main difference between the approaches pertained “to the replacement source of electricity, and the reasons justifying the decision to use those replacement sources.” 95 In other words, the estimates differed depending on whether it was based on what the Claimant actually did to source replacements, contra estimates based on assumptions regarding what the Claimant should or could have done to source replacements. The Tribunal awarded costs based on what the Claimant reported it actually did to source replacements. All the calculations in this case were conducted ex-post the period of breach. Ex-ante as per the date of breach this approach would imply compensation for future loss – loss of expression interest as estimated by the Claimant.

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95 Para 367, Hrvatska Elektroprivreda D.D. v. Republic of Slovenia, ICSID Case No. ARB/05/24, Award, June 12th, 2009.
4.3.1 Reconciling inconsistency: An economic view point

The starting position of the Tribunal in *Eiser Infrastructure Limited and Energia Solar Luxembourg versus Kingdom of Spain* was a recognition of the Claimant right to protection of its expression interest – the future loss of fair market value of the concern. The Tribunal agreed “that the Claimants’ approach for determining its damages – assessing the reduction of the fair market value of its investment by calculating the present value of cash flows said to have been lost on account of the disputed measures – offers an appropriate means to determine the amount of reparation due in the circumstances of this case.”\(^{96}\) After examining the merits of the main threshold issues (length of the operational life, tax issues and claims for partwise encroachment on the rights of the Claimants in the past), the Tribunal awarded compensation for future loss of the value of the firm assuming an operational life of 25 years of the Claimants solar power generation plant.

The Tribunal also provided an alternate justification of its decision. It pointed to the fact that the quantum of compensation for future loss of fair market value of the firm amounting to Euro 128 million was quite close to the Claimants initial investment of Euro 126 million. In other words, the quantum of compensation for future loss – the expression interest of the claimant, was quite close to the reliance interest, the amount Claimant invested relying on the Respondents performance of the contract. From an economic point of view, the approximate equivalence between reliance interest and the expression interest is not surprising. A rational profit maximizing investor will take into account the expected revenues from the project and it will invest when the required investment is equal or less than the discounted present value of the future revenues.

In *Teco Guatemala Holdings versus The Republic of Guatemala* the Tribunal accepted that it had “no reasons to doubt that … the decision to divest was taken primarily as a consequence of the breach by the CNEE (the Respondent regulatory authority) of the regulatory framework”\(^{97}\). However, it rejected relief for future loss to the Claimant on grounds that “in many long-term contracts it is most difficult if not impossible to calculate such future profits with certainty, particularly if the contract is subject to adjustment mechanisms and other possible variations with time.”\(^{98}\) If one takes a strict rule-oriented interpretation of the contractual relationship between the investor and state, the decision in *Teco* dispute is not persuasive and it

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\(^{98}\) Para 312, Id.
is inconsistent with *Eiser* decision where the Tribunal awarded compensation for future loss of the value of the firm assuming an operational life of 25 years.

However, from an economic efficiency point of view, a persuasive argumentation can be made to support the decisions of the Tribunals in both the cases. While a detailed discussion of economic literature is beyond the scope of this thesis, the main economic argument in favor of compensation is, that liability to compensate disciplines the government to make efficient decisions that maximize social welfare. 99 The point is that compensation internalizes the cost of regulation, thus forcing the government to regulate efficiently.

In the *Eiser* case, the dispute concerns the level of subsidy for renewable energy. This is an economic measure to deal with, what economists refer to as externalities (environmental costs) associated with production of electricity from fossil fuels. The rationale behind state regulation is as follows: Price of electricity is same, irrespective of whether it is produced from fossil fuel (coal, gas, oil) or “green” sources (wind, solar, hydro) power. However, the cost of production with fossil fuels is lower than the production from “green” sources. Those who invest in green sources will have to bear higher production costs, whereas the society will get the benefit in terms of less damage to the environment. If the society desires green electricity, one alternative is that it provides a subsidy to the green producers to cover their higher cost of production, for the benefit the society gets from low level of emissions. This is what economists refer to as “pollutee pays” principle100. In other words, society (through the government) pays for the additional cost that a producer bears by producing from green sources. To assure that the government makes efficient decisions about subsidies - it is important that the government bears the liability for the subsidy payments as agreed with the investor. Award of compensation, in *Eiser case* is justified from an economic point of view.

Further, in *Eiser* case, the Tribunals rejected the Claimants alternate estimate of damages that was based on an assumption of the present value of the amount the Claimants would receive had they earned “the reasonable return that was implicit”101 in the original regulatory regime offered by the Respondent. In economic regulation of infrastructure projects, the government regulator will take into consideration a normal rate of return while determining the parameters of the regulation. In principle, from an economic point of view, the claim may be justified.


100 The other alternative is the “polluter pays” principle, where the society can chose to impose a tax on the fossil fuel producer, thus removing the difference in cost of production of electricity from fossil fuel and green sources.

101 Para 433. *Eiser Infrastructure Limited and Energia Solar Luxembourg s.à r. i. v. Kingdom of Spain,*
However, keeping in view that the legal basis of the case was violation of the fair and equitable treatment standard, where the purpose is to provide a minimum level of protection; the Tribunals’ award is justifiable. The Tribunal rightfully observed that it “finds the legal theory underlying it unpersuasive. ECT Article 10(1) does not entitle Claimants to a “reasonable return” at any given level, but to fair and equitable treatment.” The decision reflects balancing of economic and legal issues, where in this case the legal constraints overruled the economic considerations.

In case of Teco, the dispute concerns regulation of rates charged by a monopoly distributor of electricity. This is an economic regulation to deal with problems associated with market power of a single supplier of natural monopoly activity. In the absence of economic regulation, the society will have to bear the costs associated with the monopoly, such as low quality of service, high prices and unjust enrichment of the producers at the expense of the consumers. The society avoids the costs by regulating the monopoly. Compensating for economic effects of regulation can defeat the purpose of economic regulation and reduce social welfare.

However, it may be argued that it is still important that monopoly regulation is efficient. For example, inefficient price regulation where prices fail to cover the cost of production can bankrupt the monopoly supplier thus leading to supply disturbances and loss of social welfare. Similarly, if price is higher than the costs of production, it will result in loss of social welfare including unjust enrichment of the producer at the cost of the consumer. In principle, in case of monopoly regulation one can also argue that the regulator needs to maintain discipline and should be liable for its mistakes. However, as per a second strand of economic literature, the argument for cost internalization by government regulator is weakened as the government regulating agency itself does not have any incentive to undertake inefficient regulation; the point being it does not have anything to gain from distorting its regulatory actions. A restrictive practice of awarding compensation in case of monopoly regulation is justifiable from an economic point of view. Considered in light of this second strand of literature, decision in case of Teco can be justified from a law and economic point of view.

An additional issue in award of future loss in Teco case is that it would imply a decision with respect to the structure and implementation of the monopoly regulation in the future; the economic impact of which in terms of social welfare is unknown and difficult to compute ex-ante. The change in economic welfare is particularly relevant in this case given that the legal basis of the dispute -CAFTA DR (Dominican Republic and Central America including Guan-

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102 Para 434. Id.
temala)-US Free Tarde Agreement, explicitly confirms the importance of the economic impact of the government action.\textsuperscript{104} Neither the Parties nor the Tribunal explicitly raised the issue of social economic impact of the assumptions underlying the calculation of future loss, and there is no explicit discussion of the issue in the award.

It is to be noted that the Claimant sought relief under two headings. (a) The historical loss - cash flow lost by Claimant from August 2008 until October 2010 (such date being the date of EEGSA’s sale to EPM) amounting to US$21,100,552; (b) A compensation for the future loss – the depressed value at which it sold its shares in October 2010 (loss of value) amounting to US$222,484. It seems that the Tribunal adapted a restrictive practice while awarding compensation for monopoly regulatory action, although the argumentation provided was not persuasive in its own right.

4.3.2 Reservation on quantum and costs

In AMPAL-American Israel Corp., EGI-FUND (08-10) Investors LLC, EGI-SERIES v. Arab Republic of Egypt the Claimants sought relief for multiple violations by the Respondent. The Tribunal unanimously held the Respondent liable for multiple violations, but reserved its decision with respect to quantum of compensation and apportionment of costs between the parties.

The question that arises is – can a decision on liability accompanied by a reservation of the decision about quantum and costs assure efficient breach of contract. The answer lies in the argumentation provided by Ronald Coase who proposed that if legal entitlements can be cheaply traded, then who gets them in the first instance does not affect their ultimate alloca-

\textsuperscript{104} For example, para 4 of annex 10-C of the CAFTA DR (Dominican Republic and Central America including Guatemala) - US Free Tarde Agreement confirms the Parties' shared understanding with respect to indirect expropriation as follows:

“The determination of whether an action or series of actions by a Party, in a specific fact situation, constitutes an indirect expropriation, requires a case-by-case, fact based inquiry that considers, among other factors:

(i) The economic impact of government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred

(ii) The extent to which the government action interferes with distinct reasonable investment-backed expectations; and

(iii) The character of the government action” \textsuperscript{104}

The same Treaty also includes an exception for regulatory action to protect legitimate public welfare objectives.
tion, which will always be efficient”.105 The main point is that a decision on liability clarifies legal rights of the contracting parties. Reservation on quantum and costs opens up for post contractual negotiations between the parties to the contract. In case the cost of fulfillment is higher than the value of fulfillment, the parties can exchange their legal rights, for example, the breaching party, in return for compensation, “buys” a right to breach from the counterpart to the contract. Vice versa, in case the cost of fulfillment is less than the value of fulfilment, the parties will not be able to arrive at a negotiated breach and the liable party will stand to gain by fulfilling the contract.

4.3.3 Expectation interest and past performance

In Pseg Global Inc. and Konya Ilgin Elektrik Üretim Ve Ticaret Limited Ş Rketi v. Republic of Turkey, the Tribunal rightfully accepted the notion of expression interest and observed “in fact a self-contained and fully detailed contract can well determine a basis for the calculation of future profits.”106 However, the Tribunal rejected the award of future profits on grounds that such a measure “is normally reserved for the compensation of investments that have been substantially made and have a record of profits, and refused when such profits offer no certainty.”107 The Tribunals argumentation would result in a weak signal for efficient allocation of resources. Infrastructure development and operation contracts concern forward-looking large-scale investments that take into account future demand and profits from the concerned service. Typically, during the early years the project would be working under capacity and have low or even negative profits. Profits increase as capacity utilization increases due to increase in demand over time. The requirement that the project must have a “record of profits” is a backward-looking condition. A literal interpretation implies partial liability for breach, only during the latter part of the contract period. During the early part of the contract period when capacity utilization and profits are low, a backward-looking condition will not trigger compensation for loss of future profits.

4.4 Concluding remarks

Perceived negative economic implications of the arbitral decisions for the host states public policy making and the welfare of its citizens is one of the factors driving the current unprece-


106 Para 752. Pseg Global Inc. and Konya Ilgin Elektrik Üretim Ve Ticaret Limited Ş Rketi v. Republic of Turkey, Final Award, ICSID Case No. ARB/02/5, Award, January 17th. 2007.

107 Para 310.
dented level of public scrutiny and criticism of the arbitral practice in international investment law. Understanding arbitral practice from an economic point of view, particularly for infrastructure projects, where disputes are essentially economic in content and highly political in consequence, has a potential to enrich the current debate.

In this chapter, five cases are analyzed using an economic efficiency-focused approach to understand the economic rationale underlying the argumentatively produced findings presented in the previous chapter. The simplest version of the economic theory of efficient breach recommends that the breaching party should be liable for expression interest of the non-breaching party, because the liability for expression interest disciplines the parties to fulfill contracts that increase aggregate social welfare. The awards analyzed were largely consistent with respect to the award of expression interest, where it was relevant.

The main area of inconsistent decisions, identified in the previous chapter involved practice with respect to the award of expression interest involving loss of future profits from the date of the award and period ahead. From an economic efficiency point of view, the inconsistency seems to be justifiable once the regulatory context and the economic incentives facing the disputing parties are taken into account. However, the practice with respect to reserving award of loss of future profits only for cases where the non-breaching party can document record of past profits is not justifiable for infrastructure projects. Most of awards analyzed display balancing of economic-welfare interests, although such justification is seldom explicit in the reasoning justifying the awards.
Conclusion

From a traditional legal dogmatic perspective, the cases examined in this thesis indicate a tendency towards use of a pragmatic approach with respect to award of expression interest involving future loss of profits starting the date of award and period ahead. It seems, that with respect to award of future profits, the tribunals tend to “cherry pick” rules and adapt standard of proof to the desired result. However, when the same case material is subjected to an efficiency focused economic analysis the rationale underlying the decisions seem justifiable. Largely, the decisions tend to make economic sense from a societal welfare point of view.

It is true, that the purpose of international investment law framework is to provide a minimum standard of protection and not a social welfare maximizing balance in protection of foreign investments. On the other hand, there is no denying that the perceived economic implications of the decisions for the host states public policy making and the welfare of its citizens needs to be addressed.

“The law of foreign investment is in a state of flux...”108 “A trend in investment rulemaking over the last decade relates to the revision of wording of various substantive International Investment Agreement IIA obligations.”109 In particular, the economic impacts are specifically emerging as a relevant criterion for judging government action. With respect to indirect expropriation, “the new generation IIA clarify that an adverse effect on economic value of an investment, as such, does not establish that an indirect expropriation has occurred”110. For example, para 4. of annex 10-C of the CAFTA DR (Dominican Republic and Central America including Guatemala) - US Free Tarde Agreement illustrates this trend.111 There is also a long-standing consensus in international law that a State is not liable to compensate for reasonably necessary regulation passed for the protection of “public health, safety, morals, or welfare”112.

110 Id. P.17
111 Annex 10-C, Para 4(a), 4(b), CAFTA DR (Dominican Republic and Central America including Guatemala) - US Free Tarde Agreement.
The core of international investment disputes involves balancing of complex technical, economic environment, public health and safety interests. Balancing of multiple interests will be even more important in the future, as states resort to detail in drafting of investment agreements and treaties. Such treaties will provide the formal basis for well-reasoned independent decisions. Although formally the decisions will have no binding force except between the parties and in respect of that particular case, in practice they will continue to have wider ramifications and influence future arbitrations. Arbitrators have a responsibility to reach well-reasoned independent decisions; for the parties who appoint them, and not the least to strengthen public confidence in the international investment law dispute resolution framework.
6 Table of references

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6.4  International treaties and agreements


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