

ASSESSMENT OF DAMAGES AND COMPENSATION IN THE CONTEXT OF INVESTOR-STATE DISPUTE SETTLEMENT REFORM PROPOSALS

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Abstract

This article discusses the possible reforms in the assessment of damages and compensation in international investment arbitration. The article highlights the challenges of the valuation leading to the need for reforms, such as the inflation of awards issued in investment arbitration cases, the major gap between the damages claimed and damages awarded, and the difficulties posed by the large damages awards for the developing states. Other reasons for reforms include arbitral tribunals' inconsistency in the valuation, the incorrectness of awards and potential conflicts of interests between arbitrators and damages experts. The author further discusses whether the issues of damages and compensation in investor-state disputes fall within the mandate of the UNCITRAL Working Group III, which is argued to be limited to solely procedural issues. The author concludes that the reforms could and should be developed by the Working Group III. The assessment of damages and compensation in investor-state disputes requires a comprehensive reform process based on procedural solutions as well as substantive suggestions, which the Working Group III can devise. Based on the law and economics theories, the author analyzes the appropriate approach of tackling the quantum issues, concluding that the reforms should be implemented through soft law instruments. The article dwells on viable procedural reforms on the quantification of damages and compensation in investment arbitration. The analysis focuses on the reforms prospecting to address the damages experts' possible conflict of interest, the divergence in the parties' experts damages amounts and the anchoring effect of the claimants' requested amounts on arbitrators, as well as on the option of conducting early damages conferences, drawing on the insights from behavioral economics. Lastly, the article discusses substantive reforms options for the valuation that help promote the consistency and correctness of awards. The author considers the options of clarifying the use of the discounted cash flow method and setting standards that require damages to reflect a balance between the competing interests, providing guidance on the investor's contributory fault, capping compensation to the actually invested amount and the assessment of contextual factors relevant for the calculation of damages.

Key words

damages, compensation, investor-state dispute settlement, reforms

Introduction

The ultimate objective of the claimant in investor-state arbitration is to obtain compensation for the harm it believes it has suffered due to the host state's actions. Concurrently, the respondent state aims to defeat the claim altogether or at least reduce the financial and political impact of a significant arbitral award against it. The assessment of compensation and damages¹ is therefore a central concern for both sides of an investment dispute.

There is no dispute about the basic principles governing damages and compensation in investor-state dispute settlement (hereinafter — ISDS). Most investment treaties provide that compensation for expropriation is to be valued based on the fair market value of an investment. To value the damages due for other breaches of investment treaties, arbitrators generally use the customary “full reparation” standard.² However, there is no consistency in the application of these vague standards in practice. Among valuation methods used by investment tribunals, the discounted cash flow analysis has become the most popular. However, the use of this method requires a certain degree of speculation in determining the discount rate and cash flows for future periods. This raises doubts about the appropriateness of using this method. Other

¹ Within the context of investor-state arbitration, the term “compensation” means the amount of money to be paid by a state to an investor as a requirement for the legality of expropriation, while “damages” means the amount of money due as a remedy for the breach of an investment treaty (both expropriatory and non-expropriatory).

² PCIJ. *Factory at Chorzów (Germany v. Poland)*. Judgment of 13 September 1928 // P.C.I.J. Series A, № 17. 1928. P. 47. E.g., the tribunal in *BG Group v. Argentina* held that the “full reparation” standard articulated in *Chorzów* was crystallised into a rule of customary international law and, thus, was applicable even in the event of a breach of the fair and equitable treatment provision (UNCITRAL. *BG Group Plc. v. The Republic of Argentina*. Final Award of 24 December 2007, §421–429).

questions have been raised, such as on arbitrators' competence to correctly value damages and the inflation of arbitral awards. Due to the mentioned concerns, the quantum question was referred to the United Nations Commission on International Trade Law (hereinafter — UNCITRAL).

The present article seeks to examine if the valuation in investment arbitration requires reforming, and which reform proposals put forth within the UNCITRAL reform process can effectively help overcome the constraints of the ISDS regime in the quantum assessment.³ The article includes two sections. The first section sets out the core reasons for the need for reforms on damages and compensation in ISDS. The second section is dedicated to reforms in the valuation of damages and compensation in ISDS and their possible effectiveness. Its first subsection answers the question whether such reforms can be developed by the UNCITRAL Working Group III, whose mandate is argued to be limited to solely procedural aspects. The second subsection discusses the approaches to tackling the issues of damages and compensation on the reform agenda. The last subsection analyses the appropriateness and effectiveness of procedural and substantive reform options.

The author relies on economic thinking in her analysis. In particular, the author uses the traditional law and economics approach and the behavioural law and economics approach to public international law. The latter applies psychological (behavioural) insights in the context of international law⁴. Although traditional law and economics scholars are sometimes sceptical about the behavioural approach, the author believes that both theories can be fruitfully applied for the analysis of ISDS reform proposals related to damages and compensation as the use of behavioural insights complements the tools of traditional economic analysis, allowing to build more accurate assumptions about human behaviour and more accurate predictions and prescriptions about law.⁵

1. Reasons for reforms in the assessment of damages and compensation in ISDS

In 2017, UNCITRAL mandated its Working Group III (hereinafter — WG III; Working Group) to identify concerns regarding ISDS and develop potential reform solutions. The topic of damages and compensation was added to the agenda of the UNCITRAL reform process implemented by WG III. This happened in view of several challenges that created momentum for reforms in the valuation of damages and compensation in ISDS cases.

The *first* issue that prompted the need for reforms is the heavy inflation of arbitral awards rendered in investment disputes. Bonnitcha and Brewin identify 50 awards issued after 2000 with the granted amounts higher than USD 100 million.⁶ Some awards even reached multi-billion figures, such as those issued in *Tethyan Copper v. Pakistan* (USD 5.84 billion),⁷ *ConocoPhillips v. Venezuela* (USD 8.7 billion).⁸ The largest awarded amount is more than USD 50 billion granted in *Yukos* cases.⁹ The nominal median of damages awards increased by 97 % and the nominal mean increased by 790% between the 2000–2009 and 2010–2019 periods, amounting to a 267 % increase on the average (excluding the *Yukos* cases).¹⁰

³ This article proceeds from the assumption that it is desirable to improve the accuracy of quantum analysis in investment arbitration cases via the ISDS reforms, even though the implementation of reforms might be a costly endeavor. While the steps to develop and implement the reforms might require substantial costs, the author believes that ISDS reforms will lead to a decrease in costs and duration of ISDS in the long run as certainty and predictability of the quantum process in ISDS are increased. Similar idea is expressed, for example, by the delegation of the European Union: "...we think increasing and dealing with the issue of predictability and consistency will help address the issue of costs" (See Roberts A., Bouraoui Z. *UNCITRAL and ISDS Reforms: Concerns about Costs, Transparency, Third Party Funding and Counterclaims* // EJIL:Talk! 6 June 2018. URL: <https://www.ejiltalk.org/uncitral-and-isds-reforms-concerns-about-costs-transparency-third-party-funding-and-counterclaims/> (accessed: 17.09.2023). What is more, the predictability and consistency of quantum assessment resulting from the reforms will help increase the legitimacy of the damages awards, the challenge of which leads to the crisis of the ISDS system.

⁴ Aaken A. *Behavioral International Law and Economics* // Harvard International Law Journal. 2014. Vol. 55. № 2. P. 421–422.

⁵ Jolls C., Sunstein C., Thaler R. *A Behavioral Approach to Law and Economics* // Stanford Law Review. 1998. Vol. 50. P. 1474.

⁶ Bonnitcha J., Brewin S. *Compensation Under Investment Treaties* // ISDS Best Practices Series. 2020.

⁷ ICSID. *Tethyan Copper Company Pty Limited v. Islamic Republic of Pakistan*. Case No. ARB/12/1. Award of 12 July 2019. §1858.

⁸ ICSID. *ConocoPhillips Petrozuata B.V., ConocoPhillips Hamaca B.V. and ConocoPhillips Gulf of Paria B.V. v. Bolivarian Republic of Venezuela*. Case No. ARB/07/30. Award of 8 March 2019. §1010.

⁹ PCA. *Hulley Enterprises Limited (Cyprus) v. The Russian Federation*, Case No. 2005-03/AA226. Final Award of 18 July 2014. §1888; PCA. *Veteran Petroleum Limited (Cyprus) v. The Russian Federation*. Case No. 2005-05/AA228. Award of 18 July 2014. §1888; PCA. *Yukos Universal Limited (Isle of Man) v. The Russian Federation*. Case No 2005-04/AA227. Award of 18 July 2014. §1888.

¹⁰ Bonnitcha J., Langford M., Alvarez-Zarate J. M., Behn D. *Damages and ISDS Reform: Between Procedure and Substance* // Journal of International Dispute Settlement. 2023. Vol. 14. № 2. P. 219.

Tribunals' tendency to grant large amounts to investors is related to the expansion of the application of the income-based discounted cash flow (hereinafter — DCF) valuation method when calculating damages and compensation. The wide reliance on DCF began with the concurring opinion of Justice Bower to the award issued in *Amoco v. Iran*. While the majority of arbitrators in this case questioned the validity of DCF,¹¹ Justice Bower stated that “[where], however, damages are certain to have occurred, as concededly is the case here, and it is only their proper amount that remains uncertain, such a tribunal must make an award in accordance with the best available evidence, even though this process be inherently speculative”.¹²

Nowadays, based on the principle of full compensation, fair market value (hereinafter — FMV) is considered the commonly accepted standard of value in investment disputes.¹³ In the tribunals' opinion, this standard justifies the use of DCF in cases where the investment is a “going concern” projected to continue operations after the state's breach.¹⁴ DCF is used even in cases where the investment is not a “going concern” but is “likely to yield economic benefits”.¹⁵ It became the most widely used method. For instance, between 2011 and 2015, it was used in 69 % of cases where compensation was assessed, compared to only 17 % before 2000.¹⁶

However, assessing damages based on the DCF method places a significant burden on the host state's finances. As noted by the International Law Commission, DCF should only be used in a narrow range of circumstances, such as when an investor is entitled to a defined income stream under the contract.¹⁷ The wide application of income-based valuation methods leads to heavily inflated awards, especially when the tribunal relies solely on DCF.

Another concern is that large awards of compensation are made in cases where a state's environmental policies affected the investment. For example, in *Santa Elena v. Costa Rica*, the environmental purpose of the expropriation of the investment was considered immaterial, and the tribunal granted USD 16 million to the claimant.¹⁸ Large compensations were granted to investors specialising in fossil fuel production.¹⁹ In such situations, income-based compensation can have a chilling effect on the adoption of environmental-friendly measures by states and increase the costs of energy transition.²⁰

The *second* problematic issue is a major gap between damages claimed and damages awarded. The mean amount of damages claimed stands at USD 1.5 billion, while the mean amount awarded is USD 438 million, and the median figures were USD 143 million and USD 21 million.²¹ The UNCITRAL Secretariat notes that investors claim on average three – five times the amount they are actually awarded.²²

This gap resulted from investors' tendency to claim higher amounts, which are then significantly reduced by the tribunals. Investors do so in order to catch the attention of the respondent state and of the tribunal or

¹¹ IUSCT. *Amoco International Finance Corporation v. The Government of the Islamic Republic of Iran, National Iranian Oil Company, National Petrochemical Company and Kharg Chemical Company Limited*. Case No. 56. Partial Award (Award No. 310-56-3) of 14 July 1987. §227–232.

¹² IUSCT. *Amoco International Finance Corporation v. The Government of the Islamic Republic of Iran, National Iranian Oil Company, National Petrochemical Company and Kharg Chemical Company Limited*. Case No. 56. Partial Award (Award No. 310-56-3) of 14 July 1987. Concurring Opinion of Judge Brower. §26.

¹³ ICSID. *AIG Capital Partners, Inc. and CJSC Tema Real Estate Company Ltd. v. The Republic of Kazakhstan*. Case No. ARB/01/6. Award of 7 October 2003. P. 85.

¹⁴ ICSID. *Quiborax S.A., Non Metallic Minerals S.A. and Allan Fosk Kaplún v. Plurinational State of Bolivia*. Case No ARB/06/2. Award of 16 September 2015. §344.

¹⁵ PCA. *CC/Devas (Mauritius) Ltd., Devas Employees Mauritius Private Limited and Telecom Devas Mauritius Limited v. India*. Case No. 2013-09. Award on Quantum of 13 October 2020. §540.

¹⁶ *Possible reform of investor-State dispute settlement (ISDS): Assessment of damages and compensation*, UNCITRAL, Note by the Secretariat, 5 July 2022 (A/CN.9/WG.III/WP.220). §32.

¹⁷ *Report of the International Law Commission on the work of its fifty-third session (23 April–1 June and 2 July–10 August 2001)*, 2001 (A/56/10). P. 104. URL: https://legal.un.org/ilc/publications/yearbooks/english/ilc_2001_v2_p2.pdf (accessed: 05.04.2023).

¹⁸ ICSID. *Compañía del Desarrollo de Santa Elena S.A. v. Republic of Costa Rica*. Case No. ARB/96/1. Award of 17 February 2000. §71, 111.

¹⁹ *Hulley Enterprises v Russia; ConocoPhillips v Venezuela*; ICSID. *Unión Fenosa Gas, S.A. v. Arab Republic of Egypt*. Case No. ARB/14/4. Award of 31 August 2018; ICSID. *Occidental Petroleum Corporation and Occidental Exploration and Production Company v. The Republic of Ecuador*. Case No. ARB/06/11. Award of 5 October 2012.

²⁰ Tienhaara K., Cotula L. *Raising the cost of climate action? Investor-state dispute settlement and compensation for stranded fossil fuel assets* // International Institute For Environment And Development, 2020. P. 6.

²¹ Hodgson M., Kryvoi Y., Hrcka D. *2021 Empirical Study: Costs, Damages and Duration in Investor-State Arbitration* // British Institute of International and Comparative Law. 2021. P. 5. URL: https://www.biicl.org/documents/136_isds-costs-damages-duration_june_2021.pdf (accessed: 11.02.2023).

²² *Possible Reform of Investor-State Dispute Settlement (ISDS): Assessment of Damages and Compensation*, UNCITRAL, Note by the Secretariat, 5 July 2022 (A/CN.9/WG.III/WP.220). §77.

to create stronger pressure on the state.²³ Another reason for such a gap is the wide divergence of damages amounts presented by the parties' experts in investment disputes.²⁴ PWC Study 2015 revealed that the amount quantified by respondents' experts was on average 13 % of the amount quantified by claimants' experts.²⁵ This divergence exists since experts are instructed by parties and value damages based on different factual or legal assumptions and questions.

Thirdly, there are concerns that excessive damages awarded in ISDS cases create substantial difficulties for countries with limited financial resources.²⁶ For example, in *Tethyan Copper v. Pakistan* the tribunal awarded 4 billion USD against Pakistan,²⁷ while in *P&ID v. Nigeria* the 6.6 billion USD award was rendered against Nigeria.²⁸ Claims and awards toward developing countries are financially more significant, and the largest damages awards were rendered in disputes against developing countries.

The core of the problem is historical. During decolonization after World War II and the 1980s, there was a debate about the extent and even existence of the obligation to compensate foreign investors for expropriation. After the expropriation of foreign investments by communist and so-called "Third World" states, capital-exporting countries argued that expropriation is only lawful when investors are provided with "prompt, adequate and effective" compensation, amounting to the full FMV of the expropriated assets (the Hull formula). But capital-importing states challenged foreign investors' right to receive compensation for expropriation on various grounds, such as economic inequalities borne out of "colonial sin" and excessive profits of the investors granted compensation.²⁹ Instead of the Hull formula, the developing countries suggested the Calvo doctrine, under which foreign investors should be afforded no more than the same treatment as nationals and must limit themselves to filing claims in the domestic judicial system.³⁰

The arbitral and treaty practice evolved, and full compensation for expropriation and the principle of full reparation for treaty breaches have been generally recognised. It is beyond question that compensation or damages must be quantified based on FMV. Investment treaties state as a standard prompt, effective and adequate compensation of the expropriated investment (the Hull formula) equivalent to its FMV.³¹

However, the debate between the developing and developed states about compensation took another turn. The developing states complain that the amounts of compensation and damages are disproportionately high and particularly affect them, which can be resolved within the WG III reform process.³² The delegations of WG III representing African states advocated greater intervention to limit the amounts of damages. At the same time, the Western delegations express sceptical views as to the practicability of introducing caps or a prescribed methodology for valuation and suggest that damages are outside the mandate of WG III since they are a substantive, rather than a procedural issue.³³ Such unwillingness to focus on damages and compensation can be explained by the fact that a large number of investors from capital-exporting countries invest billions of money in projects in the developing states, and capital-exporting countries aim to ensure that their nationals are entitled to claim large compensations.

Therefore, the developed and developing states have different views on the quantum question. The former do not wish to limit the existing possibility of granting huge amounts to their investors by investment

²³ Kudrna J. *Tax Gross-up in Investment Treaty Arbitration: Legitimate Concern or a Method to Inflate Damages?* // *The American Review of International Arbitration*. 2019. Vol. 30. № 3. P. 329.

²⁴ *Ibid.*, §74.

²⁵ *International Arbitration Damages Research, Closing the Gap between Claimants and Respondents* // PriceWaterhouseCoopers LLP (PwC), 2015. URL: <https://www.pwc.com/sg/en/publications/assets/international-arbitration-damages-research-2015.pdf> (accessed: 05.05.2023). P. 2.

²⁶ Hodgson M., Kryvoi Y., Hrcka D. *Op.cit.* P. 3.

²⁷ *Tethyan Copper v Pakistan*, §278.

²⁸ *Process and Industrial Developments Ltd. v. The Ministry of Petroleum Resources of the Federal Republic of Nigeria, Ad Hoc Arbitration*, Final Award of 31 January 2017. §110.

²⁹ *Compensation for Expropriation* // International Institute for Sustainable Development. 2013. URL: https://www.iisd.org/system/files/publications/best_practice_compensation_expropriation_en.pdf (accessed: 06.05.2023).

³⁰ Miles K. *The Origins of International Investment Law: Empire, Environment, and the Safeguarding of Capita*. Cambridge : Cambridge University Press, 2013. P. 1000.

³¹ See, e.g., Art. 10.7 of the United States-Dominican Republic-Central America Free Trade Agreement (2004); Art. 5.2 of the Italy-Morocco BIT (1990); Art. 3.1 of the Estonia - United States BIT (1995).

³² Roberts A., St John T. *UNCITRAL and ISDS Reform: What to Expect When You're Expecting* // *EJIL: Talk!*, 5 October 2022. URL: <https://www.ejiltalk.org/uncitral-and-isds-reform-what-to-expect-when-youre-expecting/> (accessed: 05.04.2023).

³³ Kryvoi Y. *UNCITRAL Investor-State Dispute Settlement Reform Group Makes Progress Despite Disagreements* // *British Institute of International and Comparative Law*. 2022. URL: <https://www.biicl.org/blog/44/uncitral-investor-state-dispute-settlement-reform-group-makes-progress-despite-disagreements> (accessed: 21.04.2023).

tribunals, while the latter identify the issue of damages as an important one and especially needs reforms. Given the large sums awarded by tribunals in cases against the developing countries, it can be said that the ISDS system places significant burdens on the developing states,³⁴ which leads to the need for ISDS reforms.

The *fourth* reason for the reforms is the inconsistency of tribunals in valuation. Among others, there is a lack of consistency in the choice of valuation method by arbitral tribunals,³⁵ the choice of the valuation date used to calculate damages,³⁶ the determination of interest rate,³⁷ the treatment of specialised damages provisions in investment contracts,³⁸ and the application of standards of proof regarding quantification issues.³⁹

Inconsistency in valuation by tribunals leads to uncertainty and unpredictability in this crucial area since the application of different approaches to value damages and compensation can lead to different outcomes on the same facts. Meanwhile, there can be enormous amounts at stake in tribunals' choice of one approach over another. Thus, inconsistency in valuation is among the most salient problems in ISDS and is one of the key issues addressed by the UNCITRAL reform process.

The *fifth* reason for reforms is the problem of correctness. Arbitral tribunals have been criticised for engaging in the so-called practice of "splitting the baby" at the stage of quantification.⁴⁰ Under such practice the monetary awards will involve a compromise for which arbitrators will seek a middle ground between the parties' positions, where a proportionate reduction is made based on the investor's initial damages claim (for example, the sum of the investor's calculation and the state's calculation is divided by two times). Baby-splitting leads to potential arbitrariness in calculating damages, while parties expect well-founded and accurate valuations. Such compromise awards that are not supported by articulated reasons can undermine the legitimacy of valuations.

Another problematic aspect of correctness is the quality of arbitrators' reasoning on damages and compensation. For instance, in *Perenco v. Ecuador*, the Annulment Committee annulled the part of the award with the determination of the claimant's loss of an opportunity of the extension of the contract since no explanation was given on the concept of a nominal value or the reason to award a nominal value of USD 25 million as opposed to any other value.⁴¹

The *sixth* issue that necessitates the reforms in quantum assessment is the experts' conflict of interest. It is crucial that a valuation expert should be impartial and independent of the arbitrators considering the case, and the tribunal can consider any links between the experts and the parties when assessing the probative value of the expert testimony. However, there are no detailed rules for the impartiality and independence of experts in investment arbitration, their relationship with parties and/or arbitrators.

The problem of conflict of interest between arbitrators and experts in ISDS can be illustrated by the case of *Eiser v. Spain*,⁴² in which an ICSID Annulment Committee annulled the award since the arbitrator appointed by the investors, Stanimir Alexandrov, failed to disclose a prior relationship with valuation expert

³⁴ Wegmann V., Hall D. *The Unsustainable Political Economy of Investor-State Dispute Settlement Mechanisms* // International Review of Administrative Sciences. 2021. Vol. 87. № 3.

³⁵ To illustrate, the tribunals came to different conclusions on the application of DCF in *Bear Creek v. Peru* and *Tethyan Copper v. Pakistan*, which both involved mining projects that were never realised. In both cases, the tribunals found that the state's refusal to issue leases or approvals necessary for the projects was an indirect expropriation of the investor's investment and that damages should be valued based on the investment's FMV. In *Tethyan Copper v. Pakistan*, the tribunal applied the DCF analysis and awarded USD 4.1 billion in damages plus interest in favour of the investor. Conversely, the tribunal in *Bear Creek v. Peru* found the proposed mine too speculative for the application of DCF and awarded damages in the amount of USD 18.2 million plus interest based on the amount actually invested by the investor. ICSID. *Bear Creek Mining Corporation v. Republic of Peru*. Case No. ARB/14/21. Award of 30 November 2017.

³⁶ Bekker P., Bello F. *Reimagining the Damages Valuation Framework Underlying Fair and Equitable Treatment Standard Violations through a Three-Stage Contextualized Approach* // ICSID Review – Foreign Investment Law Journal. 2021. Vol. 36. № 2. P. 340.

³⁷ Bonnitca J., Langford M. et al. *Op. cit.* P. 228.

³⁸ Arato J. *The Private Law Critique of International Investment Law* // American Journal of International Law. 2019. Vol. 113. № 1. P. 22–24.

³⁹ Beharry C. L., Bräutigam E. M. *Damages and Valuation in International Investment Arbitration* in Chaisse J., Choukroune L., Jusoh S. *Handbook of International Investment Law and Policy*. Singapore : Springer, 2020. P. 7.

⁴⁰ Langford M., Behn D. *Managing Backlash: The Evolving Investment Arbitrator* // European Journal of International Law. 2018. Vol. 29. № 2. P. 568–569.

⁴¹ ICSID. *Perenco Ecuador Ltd. v. Republic of Ecuador and Empresa Estatal Petróleos del Ecuador (Petroecuador)*. Case No. ARB/08/6. Decision on Annulment of 28 May 2021. §466.

⁴² ICSID. *Eiser Infrastructure Limited and Energía Solar Luxembourg S.à r.l. v. Kingdom of Spain*. Case No. ARB/13/36. Decision on the Kingdom of Spain's Application for Annulment of 11 June 2020.

Carlos Lapuerta of the Brattle Group, also appointed by the investors. While the arbitration in *Eiser v. Spain* was pending, Brattle was retained in three other cases for the clients, for which Dr. Alexandrov acted as counsel, and the two cases involved expert Lapuerta. In the Committee's view, this gave rise to an intense working relationship on behalf of a shared client, creating "a manifest appearance of bias on the part of Dr. Alexandrov".⁴³ Such drastic measures as the annulment of the award were applied due to a relationship between an arbitrator and an expert, even in the lack of express rules governing this situation.

Nevertheless, multiple interactions of arbitrators with experts do not always lead to the presumption of their conflict of interest. For instance, in *Misen v. Ukraine*, the ICSID Chair refused to disqualify Dr. Alexandrov, which did not disclose details about his professional relationship with the expert retained in two arbitrations where Dr. Alexandrov acted as co-counsel. The Chair noted that due to the scarcity of valuation experts for investment arbitration cases the same expert can appear before the same arbitrator on multiple occasions.⁴⁴ Since Dr. Alexandrov had not directly worked with the expert to assist him in preparing testimony and deciding on the key valuation matters in the previous arbitrations, the Chair found that the professional relationship between the expert and Dr. Alexandrov does not evidence a manifest lack of independence or impartiality on Dr. Alexandrov's part, for which the closer connection between an arbitrator and an expert is needed.⁴⁵ Thus, while in *Eiser v. Spain* several direct interactions between Dr. Alexandrov and expert Lapuerta in the previous arbitrations were sufficient to conclude on the possible conflict of interest, in *Misen v. Ukraine* the numerous interactions between him and another expert did not lead to the appearance of lack of independence or impartiality.

The party's arguments to disqualify arbitrators might be motivated by the lack of clear procedural principles on the permissible interaction between damages experts and arbitrators and its limits. An arbitrator's professional relationships with experts and failure to disclose those relationships may have a drastic effect on proceedings, resulting even in the annulment of the award. Therefore, the damages experts' conflict of interest is also a problematic issue that requires the development of procedural standards.

Given the above, the present state of investment tribunals' practice in quantum matters is characterised by the inflation of the awards and big gaps between the claimed and awarded damages amounts, not least due to the widespread application of the DCF method. The developing states raise special concerns about exorbitant damages awards rendered against them without taking their interests into account. Due to the abstract regulation on valuation aspects in ISDS, the tribunals have been inconsistent in various quantum matters. The correctness of arbitrators' awards and the lack of sufficient reasoning for valuation have also become the subject of criticism. Another matter of concern is damages experts' possible conflict of interest. All these issues make it necessary to conduct ISDS reforms on damages and compensation.

2. Reforms on damages and compensation in ISDS and their possible effectiveness

2.1. Whether the reforms of the quantum assessment fall under the mandate of UNCITRAL Working Group III: procedural or substantive issue

During the 38th session of October 2019, it was suggested that WG III could be tasked with conducting research on damages, methodologies for their calculation and underlying legal principles, but the question arose as to whether such matters could fall under the mandate of WG III.⁴⁶ This was restricted to procedural reforms,⁴⁷ which was explained by the mandate's focus on ISDS and not treaties and pragmatism, given that there are over 3500 investment treaties. Some delegations expressed concerns that the issues of damages and compensation were substantive in nature and fell outside the mandate of WG III.⁴⁸

Originally, damages were considered as a part of substantive treaty law since compensation levels were calculated based on the wording of investment treaties and not by the design and procedure of arbitration. Investment treaties provide protection to foreign investors through substantive guarantees and standards,

⁴³ *Ibid.*, §229.

⁴⁴ ICSID. *Misen Energy AB (publ) and Misen Enterprises AB v. Ukraine*. Case No. ARB/21/15. Decision on the Respondent's Proposal to Disqualify Dr. Stanimir A. Alexandrov of 15 April 2022. §141.

⁴⁵ *Ibid.* §142, 145.

⁴⁶ *Report of Working Group III (Investor-State Dispute Settlement Reform) on the Work of its Thirty-eighth Session* (Vienna, 14–18 October 2019). UNCITRAL, 23 October 2019 (A/CN.9/1004). §102.

⁴⁷ *Report of Working Group III (Investor-State Dispute Settlement Reform) on the Work of its Thirty-fifth Session* (New York, 23–27 April 2018), UNCITRAL, 14 May 2018 (A/CN.9/935). §18.

⁴⁸ *Report of Working Group III (Investor-State Dispute Settlement Reform) on the work of its forty-third session* (Vienna, 5–16 September 2022). UNCITRAL, 7 October 2022 (A/CN.9/1124). §93.

such as protection from expropriation, fair and equitable treatment, full protection and security, and allow investors to claim compensation for breaches of those obligations in ISDS proceedings. A number of valuation issues are questions of substance, such as the kind of damage recoverable, the valuation date.

Nevertheless, the interpretation of the WG III mandate as limited to solely procedural matters has been heavily contested. There is no agreement on the exclusion of substantive treaty reform from the mandate. The major reason behind such criticism is that the core concerns created by the ISDS system cannot be corrected without substantive rule reform. To illustrate, South Africa made a comment within WG III that “the Working Group would not be fully discharging its mandate if discussions on the substantive concerns were excluded”.⁴⁹ Prominent groups like the Columbia Center for Sustainable Investment (hereinafter — CCSI) argued that the limited ISDS reforms have the effect of locking in a “broken system”.⁵⁰

Furthermore, it has been acknowledged that the strict differentiation between procedural and substantive matters can be illusory. For instance, during the April 2019 session, WG III discussed several topics crossing the procedural-substantive division, including damages. Indonesia stated that a substance — procedure dichotomy in the proposed ISDS reform discussion “may actually defeat the purpose of having a meaningful ISDS mechanism as it is difficult to separate between substance and procedure”⁵¹ since “procedural law is inherently substantive and vice versa”.⁵² The result of this session was a statement that although “the focus of its work should be on the procedural aspects of ISDS, [WG III should take] due note of the interaction with underlying substantive standards”.⁵³

Indeed, concerns about the valuation in ISDS have various procedural dimensions, which represent the primary focus of the UNCITRAL reform process. Valuation issues also have some substantive components (e.g. the choice of valuation date). It is not always easy to determine whether the issues are solely procedural or substantive. However, the development of solutions to the issues substantive in nature should not be excluded because a reform process that only focuses on procedural matters would not adequately address the problem and would have critical gaps. Procedural and substantive concerns are intrinsically linked, and effective reform is unlikely if they are arbitrarily disassociated.⁵⁴

The WG III delegations seem to have come to an agreement that damages and compensation in ISDS should be addressed comprehensively. In the WG III session held in October 2019, delegations demonstrated their willingness to consider damages as crucial follow-up questions under other topics, such as third party funding in ISDS.⁵⁵ During the September 2022 session of WG III, it was recognised that caution should be exercised in order not to embark on work on underlying substantive standards and not to undermine the investor’s right to remedy for a breach of treaty provision, but rather focus on how damages were assessed as well as unjustifiable inconsistency and lack of correctness of decisions regarding quantification.⁵⁶

Therefore, it follows from the WG III discussions that the problem of damages and compensation can be addressed within the mandate of WG III through procedural reforms with the addition of some substantive solutions. Nevertheless, caution should be taken as not to override the substantive guarantees for investors, on which states are to decide bilaterally or plurilaterally.

2.2. The approach of tackling the issues on the Working Group reform agenda

After the delegations agreed to address the issues of damages and compensation within the WG III reform process, the Working Group pointed out the possible areas of work in respect of valuation, including, inter

⁴⁹ *Possible Reform of Investor-State Dispute Settlement (ISDS) Submission from the Government of South Africa*. UNCITRAL, 17 July 2019 (A/CN.9/WG.III/WP.176). §20.

⁵⁰ *The UNCITRAL Working Group III Work Plan: Locking in a Broken System? // Columbia Center on Sustainable Investment*, 4 May 2021. URL: <https://ccsi.columbia.edu/news/uncitral-working-group-iii-work-plan-locking-broken-system> (accessed: 15.05.2023).

⁵¹ *Possible reform of Investor-State dispute settlement (ISDS) Comments by the Government of Indonesia*. UNCITRAL, 9 November 2019 (A/CN.9/WG.III/WP.156). §1.

⁵² *Ibid.*, §2.

⁵³ *Report of Working Group III (Investor-State Dispute Settlement Reform) on the Work of its Thirty-seventh Session (New York, 1–5 April 2019)*. UNCITRAL, 9 April 2019 (A/CN.9/970). §27.

⁵⁴ *Investor-State Arbitration: an Opportunity for Real Reform? // International Institute for Environment and Development*, 7 December 2018. URL: <https://www.iied.org/investor-state-arbitration-opportunity-for-real-reform> (accessed: 16.09.2023).

⁵⁵ *Report of Working Group III (Investor-State Dispute Settlement Reform) on the Work of its Thirty-eighth Session (Vienna, 14–18 October 2019)*. UNCITRAL, 23 October 2019 (A/CN.9/1004). §80.

⁵⁶ *Report of Working Group III (Investor-State Dispute Settlement Reform) on the Work of its Forty-third Session (Vienna, 5–16 September 2022)*. UNCITRAL, 7 October 2022 (A/CN.9/1124). §94.

alia, the compensation standard, the valuation method and date, the claimant's conduct, the role of experts in assessing damages including means of appointment and their ethical regime.⁵⁷

The question arose as to what approach should be taken to address these issues. During the September 2022 session, some delegations supported a narrow approach to tackling the issues in WG III by limiting the focus on problems such as the role of valuation experts and the burden of proof in estimating damages.⁵⁸ They argued that issues of damages were policy issues best left to individual states to negotiate and address on a treaty-by-treaty level.⁵⁹

The narrow approach implies that WG III could explore how only procedural tools might be used to address some of the concerns around damages, which might include options such as facilitating the engagement of tribunal-appointed experts and clarifying rules on the proof required for successful damage claims. This approach will probably not raise debates as to the Working Group's mandate. However, such a narrower approach may not be enough in order to tackle the gaps in the current practice of valuing damages and compensation. The core of the reform process is to address the issues that have arisen from the protection of substantive investors' rights through arbitration. That is why focusing only on some procedural issues such as the role of experts and the burden of proof in estimating damages would drastically diminish the opportunity to address core substantive issues. The overriding need is not for some procedural reforms, but a substantial overhaul of the valuation of damages and compensation in ISDS.

Therefore, the valuation of damages and compensation in ISDS requires a comprehensive reform process based on both procedural solutions and substantive suggestions. In this connection, most states expressed support for a broader approach addressing a range of issues.⁶⁰ Broad discretion was proffered by WG III about solutions it would devise, after considering the view of all states.

The topic of damages and compensation is closely linked with other ISDS issues that require reform, such as early dismissal of speculative, unsubstantiated, and inflated claims; third-party funding; appellate and multilateral standing mechanisms to address procedural and substantive correctness of decisions and to rectify errors in decisions by ISDS tribunals; means to address regulatory chill; and means to address multiple proceedings including on shareholder claims and reflective loss.⁶¹ In particular, claims for shareholder reflective loss create the risks of multiple proceedings⁶² and double recovery,⁶³ leading to excessive damages. Third-party funding increases the number of investor-state arbitration cases, the frivolous claims and the amount of claimed damages. It has been proposed that the review for errors of fact and law through a new appellate mechanism should be extended to damages valuation.⁶⁴ While the analysis of reform options in other areas falls outside the scope of this article, they must also be taken into account when discussing reforms in the quantum assessment in order to address inconsistencies in a more structured and comprehensive way.

Finally, the crucial question of tackling the issues on the ISDS reform agenda is the format of implementing the reforms. The commonly discussed means of implementation include providing particularised rules in the form of draft treaty provisions and/or guidelines. Another format of implementation is the development of model clauses. These are the soft law instruments, i.e. non-binding rules or instruments that interpret or inform the understanding of binding legal rules or represent promises that in turn create expectations about future conduct.⁶⁵

The CCSI, the International Institute for Sustainable Development (hereinafter — IISD) and the International Institute for Environment and Development (hereinafter — IIED) stated that a legally binding

⁵⁷ *Possible Reform of Investor-State dispute Settlement (ISDS): Assessment of damages and compensation*, UNCITRAL, Note by the Secretariat, 5 July 2022 (A/CN.9/WG.III/WP.220). §65.

⁵⁸ Ostřanský J., Bernasconi-Osterwalder N. *Working Group III and the Assessment of Compensation and Damages: Thinning scope for impactful reform or an opportunity to make a difference?* // International Institute for Sustainable Development. 7 October 2022.

⁵⁹ Johnson L. *UNCITRAL Working Group III: An Update on Certain Key Issues in ISDS Reform* // Curtis, Client Alert, 27 September 2022. URL: <https://www.curtis.com/our-firm/news/uncitral-working-group-iii-an-update-on-certain-key-issues-in-isds-reform> (accessed: 03.05.2023).

⁶⁰ Ostřanský J., Bernasconi-Osterwalder N. *Op. cit.*

⁶¹ *Possible Reform of Investor-State Dispute Settlement (ISDS): Assessment of Damages and Compensation*, UNCITRAL, Note by the Secretariat, 5 July 2022 (A/CN.9/WG.III/WP.220). §78.

⁶² ICSID. *Orascom TMT Investments S.à r.l. v. People's Democratic Republic of Algeria*. Case No. ARB/12/35. Award of 31 May 2017. § 388.

⁶³ ICSID. *Impregilo S.p.A. v. Argentine Republic*. Case No. ARB/07/17. Award of 21 June 2011. §139–140.

⁶⁴ *Report of Working Group III (Investor-State Dispute Settlement Reform) on the Work of Its Resumed Thirty-Eighth Session*, UNCITRAL, 28 January 2020 (A/CN.9/1004/Add.1). §28.

⁶⁵ Guzman A., Meyer T. *International Soft Law* // The Journal of Legal Analysis. 2010. Vol. 2. № 1. P. 174.

multilateral treaty that clarifies, integrates, or amends the provisions of existing bilateral and regional treaties would be the most effective means to address problems linked to compensation.⁶⁶ While the adoption of a treaty is generally considered a preferable form of establishing relationships and obligations between states, now the prospect of the conclusion of a multilateral treaty clarifying or amending the provisions of existing treaties related to damages and compensation is not in sight. First, any treaty will only take legal effect for those states that have expressed their consent to be bound, and states that are not willing to take binding obligations may not grant such consent. Second, the conclusion of treaties typically faces obstacles stemming from domestic (constitutional) law, such as the need to consult with advisory bodies and ratification. Decision-making in a modern state is thoroughly regulated by internal law, and the conclusion of a treaty typically becomes a lengthy procedure that must comply with all the requirements of the state's internal law.

What is more, states treat bilateral investment treaties and other instruments of "hard" international law with much more caution than they used to. Few decades ago, the developing countries largely adopted bilateral investment treaties as they were presented by developed countries as a risk-free instrument to attract foreign investment.⁶⁷ Nowadays, there is a growing understanding that the traditional model for bilateral investment treaties requires reconsideration. It is argued that such treaties create an unequal distribution of obligations and rights between developing countries, which are the source of most foreign direct investment, and developing countries, which are mainly recipients.⁶⁸ Investment treaties also entail the increased risk of litigation, resulting in the negative impact on the net benefit of investment to recipient countries.⁶⁹ The UN Human Rights Office of the High Commissioner recognises that "investment agreements <...> have undermined development, [having resulted] in the restriction of the type of policies that developing countries can adopt to grow their domestic economies and local industries".⁷⁰

Under the law and economics "loss avoidance" theory, the choice of soft law rather than hard law can be value maximising for states due to the consequences that states face when they violate a legal commitment. The costs imposed by hard law come in the form of lost reputation, retaliation, or reciprocal non-compliance. Reputational losses are costly since they make it more difficult for a state to enter into value-increasing agreements in the future, while the violated-against state does not enjoy an offsetting gain. Retaliation involves a punishment imposed by one state on the other, and it is costly for both. Indeed, hard law will generate greater compliance pull, but in the case of a violation, hard law imposes greater costs on the violating state than soft law. In this connection, the joint loss in the event of a violation will cause states to choose soft law instead of hard law.⁷¹

States will also choose soft law under the delegation theory as a strategy to deal with uncertainty, for example when it is advantageous to allow a specific state or several states to adjust expectations in the case of changed circumstances.⁷² The delegation theory provides that under certain circumstances, soft law will be an effective way for states to control their uncertainty over the future desirability of legal rules adopted today as soft law increases the feasibility of the process for amending legal rules that can be more efficient than explicitly renegotiating international rules. Nonbinding agreements lower the penalty associated with deviating from existing legal rules, encouraging states interested in the content of legal rules to unilaterally innovate. This approach can help avoid the hold-up problem involved in renegotiating contracts in which

⁶⁶ *Possible Reform of Investor-State Dispute Settlement (ISDS): The assessment of damages and compensation*, Submission to UNCITRAL Working Group III on ISDS Reform, contributed by the Columbia Center on Sustainable Investment (CCSI), the International Institute for Environment and Development (IIED), and the International Institute for Sustainable Development (IISD), 12 November 2021. URL: https://ccsi.columbia.edu/sites/default/files/content/docs/CCSI_IISD_IIED%20Submission%20to%20UNCITRAL%20WG%20III%20on%20damages%5B20102%5D.pdf (accessed: 01.05.2023).

⁶⁷ Poulsen L. *Bounded Rationality and the Diffusion of Modern Investment Treaties* // *International Studies Quarterly*. 2014. Vol. 58. № 1. P. 12.

⁶⁸ *Why Developing Countries are Dumping Investment Treaties* // *The Conversation*, 23 March 2016. URL: <https://theconversation.com/why-developing-countries-are-dumping-investment-treaties-56448#:~:text=The%20treaties%20create%20an%20unequal,countries%2C%20which%20are%20mainly%20recipients> (accessed: 12.05.2023).

⁶⁹ *Ibid.*

⁷⁰ *Reforming International Investment Agreements*, UN Human Rights Office of the High Commissioner. URL: <https://www.ohchr.org/sites/default/files/documents/issues/development/resources/2022-08-04/Reforming-International-Investment-Agreements.pdf> (accessed: 12.05.2023).

⁷¹ Guzman A., Meyer T. *Op.cit.* P. 177.

⁷² *Ibid.*

every state effectively exercises a veto over potential amendments and lead to welfare-enhancing amendments to legal rules.⁷³

Given the debates on the legitimacy of the ISDS system, and states' intense discussions on virtually all issues pertaining to damages and compensation, ISDS reforms and their future effect are an uncertain landscape. The implementation of reforms through soft law instruments will allow states to adapt to changes faster and more easily than unanimity allows and therefore seems more feasible.

Therefore, ISDS reform options must be flexible and adaptable, for which soft law provisions as a form of reform implementation will be the most suitable. In this connection, the specific reform options are discussed below based on the assumption that UNCITRAL WG III can elaborate soft law instruments (draft treaty provisions, guidelines, or model clauses) for their implementation.

2.3. Reform options and their possible effectiveness

The issues of damages and compensation in ISDS that need reforms are wide-ranging. Given that damages and compensation have both procedural and substantive dimensions, reform options can be roughly divided into procedural, which focus on procedural solutions and changes to arbitral proceedings rather than specific valuation standards, and substantive, which concentrate on setting valuation standards and clarifying circumstances in which it is appropriate to use specific valuation methods or reduce compensation.

2.3.1. Procedural reform options

There is a range of procedural reforms that can address concerns about the quantification of damages and compensation in investor-state disputes.

The notable achievement in the light of the problem of damages experts' conflict of interest is that WG III has prepared the draft Code of Conduct for Arbitrators by July 2023.⁷⁴ Some provisions of this draft Code deal with the issue of the conflict of interest for experts in ISDS, which can also be applicable to damages experts. Under the draft Code of Conduct, arbitrators would be barred for a certain period from acting concurrently as legal representatives or expert witnesses in other cases involving the same measures (Article 4(2), the same or related parties (Article 4(3), and the same rules of the same treaty (Article 4(4)), unless the parties agree otherwise.

The double-hatting issues, including the role of experts, caused hot debates in WG III: some delegations were in favour of the full prohibition of double-hatting (e.g. Lebanon), some delegations wanted no limitations on double-hatting.⁷⁵ After the discussions and finalisation of the draft Code of Conduct, there appears to be an agreement on the text of Article 4, and it is highly likely that double-hatting will be limited under this provision. The Code will increase confidence in not only ISDS arbitrators' but also ISDS experts' impartiality.

Nevertheless, there is still room for improvement in addressing damages experts' possible conflict of interest with arbitrators and parties. The general situation in ISDS is when an expert appears before an arbitrator multiple times, which is insufficient to conclude on the manifest lack of independence and impartiality on their side. Rather, it can be created by a specific connection between an arbitrator and an expert, based on its proximity, dependence, intensity and/or materiality.⁷⁶ The Working Group could develop more detailed clarifications on this matter. Another concern is that quantum experts specialised in investment arbitration cases are few in number,⁷⁷ and the same experts often appear in cases involving completely different industries, such as oil and gas, aviation, tobacco, electricity, etc. Valuation experts may not always have in-depth industry knowledge in numerous fields of business. In this connection, it may be advisable to engage industry specialists who can provide insight into industry knowledge specific to a particular market so that such specialists could assist the valuation experts in investment cases.

⁷³ *Ibid.* P. 197.

⁷⁴ *Draft Code of Conduct for Arbitrators in International Investment Dispute Resolution and Commentary*, UNCITRAL, 3–21 July 2023 (A/CN.9/1148).

⁷⁵ Ünüvar G. "Nothing is Agreed until Everything is Agreed": *The Code of Conduct and Reflections on the 44th Session of the UNCITRAL Working Group III // International Institute for Sustainable Development*. 2023. URL: <https://www.iisd.org/itn/en/2023/04/02/nothing-is-agreed-until-everything-is-agreed-the-code-of-conduct-and-reflections-on-the-44th-session-of-the-uncitral-working-group-iii/> (assessed 03.03.2023).

⁷⁶ ICSID. *Misen Energy AB (publ) and Misen Enterprises AB v. Ukraine*. Case No. ARB/21/15. Decision on the Respondent's Proposal to Disqualify Dr. Stanimir A. Alexandrov of 15 April 2022. §142.

⁷⁷ *Ibid.*, §141.

The solution to the issue of the wide divergence of damages amounts presented by the parties' experts in ISDS is to enhance the role of tribunal-appointed experts, for instance, by granting tribunals a stronger power to appoint their own experts and not be limited by the parties' consent.⁷⁸ Where there were great differences between the scenarios contemplated by the experts, comparison of their reports is an exercise of limited utility.⁷⁹ Insights from behavioural economics strongly argue for the appointment of tribunal-appointed experts since their inclusion may enrich deliberation by providing further perspectives on the given problem.⁸⁰

In this connection, WG III may consider preparing draft treaty provisions or guidelines on the appointment of experts to assist the tribunals in calculating damages, which might strengthen the impartiality and independence of damages experts. The feasible option is to reformulate the wording of Article 29 of the UNCITRAL Arbitration Rules and Article 39 of the ICSID Arbitration Rules to show the parties' propensity for the inclusion of tribunal-appointed experts, for example by adding the provisions that the parties encourage the tribunal to appoint one or more independent experts.

A more institutional approach is to create a standing commission for damages calculation,⁸¹ for instance within a charter for a multilateral investment court, which could increase consistency and allow you to receive a more impartial and thorough assessment. Such a reform option may help enhance the legitimacy of the award on damages by institutionalising the experts' competence and providing a fully neutral environment for some damages experts. However, the idea of a multilateral investment court may not be realistic or achievable, given the UNCITRAL delegations' different views on the aspects of the reform and the difficulty in agreeing on specific solutions.⁸²

The alternative solution for the problem of divergence in the parties' experts' damages amounts is developing guidelines for party-appointed damages experts which would require alternative calculations in case of disagreement on facts and legal approaches, a joint statement by the experts explaining the differences, the teaming up of party-appointed experts to issue a joint report and the right of tribunals to direct experts.⁸³ Such guidelines will help to properly manage party-appointed experts to ensure their value to the proceedings. For example, the effective soft law instrument in international commercial arbitration is the 2007 Chartered Institute of Arbitrators Protocol for the Use of Party Appointed Expert Witnesses in International Arbitration,⁸⁴ which provides details about the contents of expert reports, independence of party-appointed experts and privilege. The specialised guidance for party-appointed damages experts in ISDS will bring clarity to the process of valuation by such experts and will yield more weight to the calculations of party-appointed experts.

Another procedural reform option is related to the so-called "anchoring" effect in damage calculations. The anchoring effect was discussed in WG III as a reason for the inflation of awards because investors tend to make exaggerated claims as a legal tactic, counting on a possible cognitive bias of tribunals where exaggerated claims are used as a basis for the valuation of compensation.⁸⁵

The anchoring effect refers to cognitive bias in which human beings rely too much on the first piece of information encountered in their consciousness when they make decisions. Its power in affecting human decision-making is well recognised in the literature of psychology.⁸⁶ Anchoring — requesting an inflated damages award — is effective in investment arbitration,⁸⁷ particularly when arbitrators lack objective means to determine compensation and for this reason use the investor's big initial claim as a baseline.

⁷⁸ Bonnitca J., Langford M., Alvarez-Zarate J. M., Behn D. *Op. cit.* P. 236.

⁷⁹ ICSID. *HOCHTIEF Aktiengesellschaft v. Argentine Republic*. Case No. ARB/07/31. Decision on Liability of 29 December 2014. §314.

⁸⁰ Elm J.-P. *Behavioral Insights into International Arbitration: An Analysis of How to De-Bias Arbitrators*. Working Paper No. 2017-01. University of St. Gallen Law School Law and Economics Research Paper Series. 2017. P. 75.

⁸¹ Bonnitca J., Langford M., Alvarez-Zarate J. M., Behn D. *Op. cit.* P. 236.

⁸² Naish V., Ambrose H. *Progress towards a Multilateral Investment Court? EU Momentum-Building and Divisions in UNCITRAL Working Group III*, Herbert Smith Freehills LLP, 14 May 2018. URL: <https://hsfnotes.com/arbitration/2018/05/15/progress-towards-a-multilateral-investment-court-eu-momentum-building-and-divisions-in-uncitral-working-group-iii/> (accessed: 09.09.2023).

⁸³ *Possible Reform of Investor-State Dispute Settlement (ISDS): Assessment of Damages and Compensation*, UNCITRAL, Note by the Secretariat, 5 July 2022 (A/CN.9/WG.III/WP.220). §77.

⁸⁴ *Chartered Institute of Arbitrators (CI Arb) Protocol for the Use of Party-Appointed Expert Witnesses in International Arbitration 2007*. URL: <https://www.ciarb.org/media/6824/partyappointedexpertsinternationalarbitration.pdf> (accessed: 12.05.2023).

⁸⁵ *Possible reform of investor-State dispute settlement (ISDS): Assessment of damages and compensation*, UNCITRAL, Note by the Secretariat, 5 July 2022 (A/CN.9/WG.III/WP.220). §72.

⁸⁶ Kahneman D., Tversky A. *Judgment under Uncertainty: Heuristics and Biases // Science*. 1974. Vol. 185. № 4157. P. 1128–1129.

⁸⁷ Swinehart M. *Reliability of Expert Evidence in International Disputes // Michigan Journal of International Law*. 2017. Vol. 38. № 2. P. 310.

It is suggested that WG III may wish to consider whether manifest over-statements of the damages amounts could be addressed through the allocation of costs. However, such a reform option aimed at threatening investors to bear more costs will not be sufficient to help overcome the anchoring effect. For greater effectiveness, the means to cure the anchoring effect should include the implementation of tactics to de-bias persons making the decision. Therefore, to escape bias, arbitrators should be invited to do their own thorough research and drop their anchors.

The awareness of the person of the effect that strategic anchors can have on his or her judgement will already reduce the anchoring effect to some extent. For this purpose, explicit provisions that refer to the need for an arbitrator to be careful in order not to take the claimed amounts as an “anchor” might be added to the applicable arbitration rules. For example, it is suggested to include the following provision aimed at reducing anchoring when determining damages amounts in Article 27 of the UNCITRAL Arbitration Rules: “Ensuring accuracy in inferences of damages amounts, the parties wish the arbitral tribunal to explicitly process information more by alternatives than by presented attributes so that initial views will be weighed against contrasting instances”.⁸⁸ This is a plausible solution that can be considered by WG III and developed within the UNCITRAL reform process.

The anchoring bias is unconscious, and thus even the most diligent arbitrators will still be susceptible to their own biases. To mitigate the effect of unconscious bias, it is necessary to incorporate an increase in diversity among arbitrators, as a result of which one person’s bias is neutralised by another. As Gary Born puts it: “Tribunals often arrive at better, more careful and nuanced decisions precisely because different arbitrators have different perspectives and different (initial) views of the evidence and the law”.⁸⁹

However, the ICSID Caseload — Statistics based on cases registered or administered by ICSID as of December 31, 2022 reveal that in terms of distribution of appointments by geographical region 46 % of arbitrators come from Western Europe, 20 % are from North America, while only 3 % of arbitrators come from Eastern Europe and Central Asia and 2 % come from Sub-Saharan Africa.⁹⁰ Appointments by gender are 14 % women and 86 % are men. These statistics divulge the arbitrators diversity concern in investment arbitration, which leads to the related issue of ISDS arbitrators bias.

Thus, to reduce arbitrators’ bias in general and anchoring bias specifically, there is a need to promote diversity among arbitrators on the basis of sex, gender, race, nationality, religion, age, education, class, neurodiversity, legal background and a number of other factors. For this purpose, depending on the number of arbitrators that contracting parties deem to be appropriate from a behavioural perspective, they may also opt for more than three arbitrators. The suggestions to include the possibility for parties to choose more than three arbitrators have long been made with regard to the UNCITRAL Arbitration Rules.⁹¹ The same may be proposed for the ICSID Arbitration Rules. Such a reform option appears to be reasonable, given the high complexity of ISDS disputes and biases emerging in the proceedings. However, it will greatly affect costs, which are also a reform process concern.

Ensuring deliberative features in arbitral proceedings is crucial. Dealing with damages can be more effective and predictable if the damages issues are addressed early in the administration of the case by the investment tribunal. An early discussion on the issues of compensation and damages will allow the arbitrators to understand various aspects of the damages problems of the case, such as the strength of the evidence that the claimant will present on liability, the extent to which the liability evidence is organically linked with evidence of damages, and the theories presented by the parties as the bases for their positions on damages.⁹²

To ensure deliberative features early, conducting initial procedural conferences on damages should be encouraged. In this connection, it would be helpful to include in the arbitration rules that as soon as practicable after its constitution, the arbitral tribunal shall convene a case management conference to consult the parties on the quantum issues or provide guidance on this matter. Such early conferences should not be intended to stifle the parties’ ability to take different positions on damages at later stages,⁹³ but should be

⁸⁸ Elm J.-P. *Op. cit.* P. 61.

⁸⁹ Born G. *International Commercial Arbitration*. 2nd. ed. Kluwer Law International, 2014. P. 2303.

⁹⁰ *The ICSID Caseload — Statistics (Issue 2023–1)*. ICSID. URL: https://icsid.worldbank.org/sites/default/files/Caseload%20Statistics%20Charts/The_ICSID_Caseload_Statistics.1_Edition_ENG.pdf (accessed: 15.05.2023). P. 17.

⁹¹ Binder P. *Analytical Commentary of the UNCITRAL Arbitration Rules*. London : Sweet & Maxwell, 2013. P. 100–101.

⁹² *Protocol on Determination of Damages in Arbitration*. CPR International Committee on Arbitration. URL: <https://drs.cpradr.org/rules/protocols-guidelines/protocol-on-determination-of-damages-in-arbitration> (accessed: 16.05.2023).

⁹³ *Ibid.*

aimed at fostering the arbitrators' comprehension of the damages aspects. However, if a party subsequently presents a position on damages misleading an opponent or increasing its costs, the tribunal should not let it slip quietly.

But then again, arbitrators should be aware of the loss-aversion bias. This can occur where a tribunal may discuss their findings after the hearing and come to one decision, but when drafting the award and setting down all the evidence and arguments realise that a different decision should be reached. In view of the effort, time and energy put into reaching the initial decision, arbitrators can become biased and emotionally attached to their original conclusions.

The above procedural solutions supported by behavioural economics insights can help in prevention of the valuation experts' conflict of interest, enhancing the role of the tribunal-appointed experts, clearing arbitrators from bias and fostering the appointment of early conferences on damages. These procedural reforms can assist in addressing criticisms of the system by tackling the issues of heavy inflation of the damages awards, the gap between the damages claimed and awarded and the divergence in parties' valuation experts' results and the potential experts' conflict of interest. Given the Working Group's mandate for procedural aspects, there are good chances that procedural reforms can be effectively developed and implemented within the WG III reform process.

2.3.2. Substantive reform options

Substantive reform options mainly focus on developing standards for limiting the damages and compensation in ISDS by setting boundaries around the full reparation principle when quantifying the claimant's losses. The Working Group decided to consider developing draft treaty provisions or guidelines to be followed by ISDS tribunals in the three substantive directions:

- The use of valuation methods;
- The capping of compensation, for instance to the amount actually invested by the investor; and
- Contextual factors, such as the host States' ability to pay for the amounts awarded, the potential "crippling effect" of an award on the respondent state, and the benefits of the investment to the state's sustainable development goals.⁹⁴

As for the first direction, it is generally suggested that the Working Group should develop technical clarifications on valuation, for example when it is appropriate to rely upon specific valuation methods. The most discussed valuation method is the DCF analysis.

DCF consists of two parts: the estimation of a company's expected future free cash flows and discounting these cash flows to the valuation using an appropriate discount rate. Cash flows comprise revenues, operating expenses, capital expenses, taxes and changes in working capital. The most commonly applied discount rate is the weighted-average cost of capital⁹⁵ (hereinafter — WACC), which is construed by looking at the time value of money⁹⁶ and other risks related to the investment,⁹⁷ such as sectorial and country risks. Applying DCF, investment tribunals must assess different variables for the entire duration that the investment was anticipated to create a future cash flow, including all future revenues and expenses, capital and operating expenditures, additional capital requirements, and other elements. The accurate determination of these values is very difficult and creates the risk of speculation.

Notwithstanding its drawbacks, DCF-valuation is regarded as the preferred method for valuation of income-earning assets.⁹⁸ The tribunals assume that investors are always entitled to compensation for the loss of the expectation of future profits if there is evidence that the investment could have generated profit, acting as if the right to future profits necessarily exists and not justifying that it does.⁹⁹ In turn, this leads to the misuse of the DCF analysis and a massive inflation of awards.

⁹⁴ *Possible Reform of Investor-State Dispute Settlement (ISDS): Assessment of Damages and Compensation*, UNCITRAL, Note by the Secretariat, 5 July 2022 (A/CN.9/WG.III/WP.220). §69.

⁹⁵ *International Valuation Standards*, International Valuation Standards Council, 2020. §50.31.

⁹⁶ Brealey R., Myers S., Allen F. *Principles of Corporate Finance*. 10th ed. The McGraw-Hill/Irwin Series, 2017. P. 39.

⁹⁷ Ripinsky S., Williams K. *Damages in international investment law*. British Institute of International and Comparative Law, 2008. P. 197.

⁹⁸ *SCC. Novenergia II - Energy & Environment (SCA) (Grand Duchy of Luxembourg), SICAR v. The Kingdom of Spain*. Case No. 2015/063. Award of 15 February 2018. §818.

⁹⁹ Marzal T. *Against DCF Valuation in ISDS: on the Inflation of Awards and the Need to Rethink the Calculation of Compensation for the loss of future profits* // EJIL: Talk!, 26 January 2021. URL: <https://www.ejiltalk.org/against-dcf-valuation-in-ids-on-the-inflation-of-awards-and-the-need-to-rethink-the-calculation-of-compensation-for-the-loss-of-future-profits/> (accessed: 09.04.2023).

To tackle DCF, there are suggestions to provide a ban on the use of DCF, at least in cases of early-stage investments without a history of business operations.¹⁰⁰ Given that DCF is considered as the best practice of economics and business and is based on fundamental principles of economics and finance,¹⁰¹ it does not seem reasonable to fully ban the application of DCF by ISDS tribunals. Nevertheless, the DCF analysis should not be applied in every ISDS case, which can be drastically different from factual and economic point of view. In this connection, it would be helpful to set guidelines on the number of factors for its application. For instance, in *Rusoro v. Venezuela*, the tribunal held that DCF cannot be applied to all types of circumstances and would be appropriate if certain criteria are met, such as the enterprise's established historical record of financial performance, the availability of reliable projections of its future cash flow, the possibility to determine the price at which the enterprise will be able to sell its products or services with reasonable certainty, the possibility to calculate a meaningful weighted average cost of capital, including a reasonable country risk premium, etc.¹⁰² These factors can be taken as the basis for the application of the DCF analysis in the guidelines. It is recommended that the arbitrators be careful and thorough in explaining the extent to which they accept or reject DCF.

Thus, the Working Group may consider setting guidelines clarifying the circumstances of the proper application of DCF. Another suggestion is to provide clarifications on the form and strength of evidence required to support projected future cash flows, on determining discount rates and on whether post-award interest on damages should be calculated at a commercial rate or a risk-free rate.¹⁰³ Provision of greater precision has the potential benefit of minimising confusion, setting expectations, and offering guidance to arbitrators about how they must or may exercise their authority.

Instead of DCF-valuation, it is proposed to set standards that require damages to reflect a balance between a range of competing factors,¹⁰⁴ including the public interest and investors' interests. Following this approach, the model bilateral investment treaty of the South African Development Community provides with regard to compensation for expropriation: "The assessment of fair and adequate compensation shall be based on an equitable balance between the public interest and interest of those affected, having regard for all relevant circumstances and taking into account the current and past use of the property, the history of its acquisition, the fair market value of the property, the purpose of the expropriation, the extent of previous profit made by the foreign investor through the investment, and the duration of the investment".¹⁰⁵ The revised Common Market for Eastern and Southern Africa Investment Agreement sets forth that compensation for expropriation shall be based on FMV but further notes that "where appropriate, the assessment of fair and adequate compensation shall be based on an equitable balance between the public interest and interest of those affected".¹⁰⁶

If this option is adopted, there would be a need for further clarification on the application of this approach in cases of breaches of investment treaties' other provisions, aside from the expropriation provision, as well as for other factors that should be considered in the balancing exercise. Developing model clauses or guidance requiring that compensation reflect a balance between a range of competing factors would allow tribunals to take into account a range of contextual factors for estimating the amount of compensation, but under this approach arbitral tribunals will have wide discretion in finding the relevant circumstances in each dispute and in striking an "equitable balance" between them.¹⁰⁷ What is more complicated is the appearance of FMV in the provisions aimed at setting the balancing rules. It can be argued that FMV is usually calculated according to the DCF method as FMV takes into account the future cash flows of the investment, and DCF becomes applicable again.

One of the issues identified by WG III is the claimant's conduct, which would limit the amount of compensation. This can also be relevant to setting substantive standards for valuation. In this regard, the investor's contributory fault is recognised as a ground limiting the amount of damages and compensation.

¹⁰⁰ *Possible Reform of Investor-State Dispute Settlement (ISDS): The Assessment of Damages and Compensation*, Submission to UNCITRAL Working Group III on ISDS Reform, contributed by the CCSI, the IIED and the IISD, 12 November 2021. URL: https://ccsi.columbia.edu/sites/default/files/content/docs/CCSI_IISD_IIED%20Submission%20to%20UNCITRAL%20WG%20III%20n%20damages%5B2010%5D.pdf (accessed: 01.05.2023).

¹⁰¹ *Novenergia II v Spain*. §818.

¹⁰² ICSID. *Rusoro Mining Ltd. v. Bolivarian Republic of Venezuela*. Case No. ARB(AF)/12/5. Award of 22 August 2016. \$759.

¹⁰³ Bonnitca J., Langford M., Alvarez-Zarate J. M., Behn D. *Op. cit.* P. 238.

¹⁰⁴ Brewin S. *Op. cit.* P. 32.

¹⁰⁵ *South African Development Community Model Bilateral Investment Treaty*, 2012, art. 6.2.

¹⁰⁶ *Revised Investment Agreement for the COMESA Common Investment Area (CCIA)*, 2017, art. 20.3.

¹⁰⁷ Bonnitca J., Brewin S. *Op. cit.* P. 33.

The tribunals generally reduce the amount of damages awarded to investors by a percentage to reflect investors' role in the events leading to a loss. However, the grounds for such a percentage are generally not explained. For example, in *Occidental v. Ecuador*, the tribunal decided that the investors contributed to the extent of 25 % to the loss which they suffered from the state's regulatory measures affecting the investment.¹⁰⁸ The reasons for the split (as against any other number) were not explained. Similarly, in *UAB v. Latvia* the tribunal reduced the final damages by 50 % in view of the investor's contributory fault.¹⁰⁹ The state complained of the arbitrariness of the decision, and the ICSID Annulment Committee recognised that "more detailed reasoning could have been provided by the tribunal with respect to its decision that there had been contributory fault".¹¹⁰ Determining contributory fault in *Yukos v. Russia*, the tribunal calculated the percentage to be allocated in the amount of 25 %, which it found "fair and reasonable" in the circumstances of the case,¹¹¹ but it was not supported by objective empirical valuation and scientific basis.

Given the lack of detailed rules for the application of the contributory fault rule to investor-state arbitration, WG III may consider clarification of the circumstances in which a tribunal should reduce damages in view of the investor's contributory negligence. As follows from the analysis of cases, the tribunals often do not explain grounds for the percentage of the reduction of damages, while the current 50/50 or 25/75 analysis that is not supported by the specific reasons seems inappropriate in multi-billion-dollar disputes. In this connection, consistency among tribunals may be increased by developing guidance that the tribunal should explain in detail how the investor contributed to the loss and provide reasons for the specific reduction percentage.

The second reform direction suggested for discussion of WG III is the capping of compensation, for instance to the amount actually invested by the investor (the sunk-costs-based approach). In this context, Jonathan Bonnitcha and Sarah Brewin suggest excluding how much income the investor expects the investment to generate over its lifetime.¹¹² The benefits of this approach are its relative simplicity and easiness to obtain the evidence necessary to determine the amount of money actually invested by an investor as compared to the evidence required to estimate damages using DCF.¹¹³ Using such an approach, the tribunal in *Bear Creek v. Peru* held that the early-stage investment in question was too speculative, and damages should be calculated by reference to the amounts actually invested by Bear Creek, the so-called sunk costs.¹¹⁴

The Working Group might consider reflecting this sunk-costs-based approach in guidance and clarification of the circumstances of its application. However, adopting a purely sunk-costs-based approach may not sufficiently compensate claimants for the significant risks they are taking at the time of the respondent state's breaching conduct, which would have the chilling effect of discouraging investors from investing, especially in emerging economies where FDI is most needed.¹¹⁵ The sunk-costs-based approach may be appropriate in some settings, such as in cases where investment projects have not started since the date of the award, but it is unlikely that this approach would replace DCF. Furthermore, the sunk-costs-based approach would require departure from the FMV standard because sunk costs do not correspond to FMV of the investment, while it is FMV that is provided for by both treaties and customary international law. In this connection, the total ban on DCF seems unreasonable. If sufficient data is available, future profitability from projects can be reliably measured and DCF can be applied.

Another reform option in this context aims at requiring a tribunal to consider whether the host state has obtained any benefit from allowing the investment to proceed and then breaching its obligations under the investment treaty. If yes, compensation would be capped at whichever amount is lower between the host state's gain and the investor's expenditure in making the investment; otherwise, no compensation would be owed.¹¹⁶ Integrating gain-based considerations into the estimation of compensation might help to constrain

¹⁰⁸ *Occidental v Ecuador*. §687.

¹⁰⁹ ICSID. *UAB E energija (Lithuania) v. Republic of Latvia*. Case No. ARB/12/33. Award of 22 December 2017. §1144.

¹¹⁰ ICSID. *UAB E energija (Lithuania) v. Republic of Latvia*. Case No. ARB/12/33. Decision on Annulment of 8 April 2020. §195.

¹¹¹ *Yukos v. Russia*. §1637.

¹¹² Bonnitcha J., Brewin S. *Op. cit.* P. 33.

¹¹³ *Ibid.* P. 35.

¹¹⁴ *Bear Creek v Peru*. §604.

¹¹⁵ Burnett H., Miles C. *Mining Disputes in Latin America // Global Arbitration Review*, 2022. URL: <https://globalarbitrationreview.com/guide/the-guide-arbitration-in-latin-america/first-edition/article/mining-disputes-in-latin-america> (accessed: 17.05.2023).

¹¹⁶ Aisbett E., Bonnitcha J. *A Pareto-Improving Compensation Rule for Investment Treaties // Journal of International Economic Law*. 2021. Vol. 24. № 1. P. 195.

opportunistic conduct by the host state, allowing the state to respond to changing circumstances. However, this approach is a very complex one since it requires two valuation calculations that both rely on historical data. Investment practitioners are not experienced in valuing the amount that a host state has gained from allowing an investment to proceed,¹¹⁷ and, currently, the perspectives of implementing this reform option are too vague. The limitations on the use of DCF are unlikely to succeed due to its extensive use in valuation practice, including outside ISDS. In this connection, the suggestions to provide guidelines on the application of the use of DCF (concerning discount rates, cash flows predictions, etc.) appear much more viable.

The Working Group also identified contextual factors relevant for the estimation of damages and compensation, including the host states' ability to pay for the amounts awarded and the potential "crippling effect" of an award on the respondent state. Large damages awards rendered without taking into account these two factors, contributing to the crisis of the developing state, as represented by the cases of *Tethyan Copper v. Pakistan* and *ConocoPhillips v. Venezuela*. In these two cases, the developing states were obliged to pay the highest damages awards, compromising their capacities to meet their people's basic needs.

The developing states complain of the enormous amounts of damages awarded against them and in this connection challenge the legitimacy of the ISDS system. Indeed, large damages awards could be crippling for the respondent developing states in relation to their economic capacities. The relevance of catastrophic consequences of large damages awards for states was emphasised by ICSID annulment committees¹¹⁸ and WG III.¹¹⁹ Although there can be an argument in favour of excessive compensation as a tool for incentivizing states to avoid breaching investors' rights, this article proceeds from the assumption that the goal of arbitrators in investment disputes is to provide the accurate and equitable amount of damages to the investor, which is also fair to the host state.¹²⁰ In this connection, the ultimate financial burden imposed on a respondent state should not be so excessive, and tribunals should consider the state's economic condition and its capacity to pay.¹²¹ Setting requirements that damages should be adjusted in light of a state's ability to pay and the crippling effect of an award on the state might help achieve a balance between the interests of the developing and developed states.

WG III also suggests considering a causation between the breach and the loss when calculating damages.¹²² Investors bear the burden of proving not only the existence and amount of the losses allegedly suffered, but also that there is a direct causal link between the state's breach of investment obligations and the claimed losses.¹²³ However, investors' damages may be attributed to the existence of an economic or political crisis in the host country, which does not entail any liability for the host state.¹²⁴ A host state may only be financially liable for the consequences of the measures taken by the state in reaction to this crisis that directly and adversely interfere with the investor's rights.¹²⁵ It may be helpful to provide guidelines that any decrease in the value of investment resulting from factors other than those related to the breach of investment treaty guarantees should not be compensated for.

The open question is whether such other factors may include international economic sanctions imposed on a host state. In one investment arbitration, the tribunal considered the dispute between investors from the sanctioned state (Iran) and Bahrein and found that international economic sanctions imposed on the investors constituted a factor militating against an income-based valuation since the investment's record of profitability derived from Iranian exposure was too speculative to project into the future.¹²⁶ However, it is

¹¹⁷ Bonnitca J., Brewin S. *Op. cit.* P. 35.

¹¹⁸ ICSID. *Burlington Resources Inc. v. Republic of Ecuador*. Case No. ARB/08/5. Decision on Stay of Enforcement of the Award of 31 August 2017. §83.

¹¹⁹ *Report of Working Group III (Investor-State Dispute Settlement Reform) on the Work of its Forty-third Session (Vienna, 5–16 September 2022)*. UNCITRAL, 7 October 2022 (A/CN.9/1124). §94.

¹²⁰ Simmons J. *Valuation in Investor-State Arbitration: Toward A More Exact Science* // *The Berkeley Journal of International Law*. 2012. Vol. 30. № 1. P. 198.

¹²¹ Paparinskis M. *Crippling Compensation in the International Law Commission and Investor-State Arbitration* // *ICSID Review*. 2022. Vol. 37. № 1–2. P. 302.

¹²² *Possible reform of investor-State dispute settlement (ISDS): Assessment of damages and compensation*, UNCITRAL, Note by the Secretariat, 5 July 2022 (A/CN.9/WG.III/WP.220). §65.

¹²³ ICSID. *United Parcel Service of America Inc. v. Government of Canada*. Case No. UNCT/02/1. Award on the Merits of 24 May 2007. §38.

¹²⁴ IUSCT. *American International Group, Inc. and American Life Insurance Company v. Islamic Republic of Iran and Central Insurance of Iran (Bimeh Markazi Iran)*. Case No. 2. Award of 7 December 1983. §61; ICC. *Cengiz İnşaat Sanayi ve Ticaret A.S v. Libya*. Case No. 21537/ZF/AYZ. Award of 7 November 2018. §613–614.

¹²⁵ *Enron Creditors Recovery Corporation (formerly Enron Corporation) and Ponderosa Assets, L.P. v. Argentine Republic*, ICSID Case No. ARB/01/3, Award of 22 May 2007, §143–144.

¹²⁶ PCA. *Bank Melli Iran and Bank Saderat Iran v. Bahrain*. Case No. 2017–25. Award of 9 November 2021. §763–770.

unclear whether arbitral tribunals would apply the same logic when sanctions against the respondent state affect the investment's value. The considerations of fairness allow us to suggest that the decrease in investment's value can be attributed to unilateral economic sanctions for which the host state cannot be responsible, which entails the need to decrease the amount of compensation.

Finally, WG III suggests developing draft treaty provisions or guidelines on the benefits of the investment to the state's sustainable development goal as a contextual factor relevant to the assessment of compensation. This is especially relevant in light of the measures taken by the international community to decarbonise the global energy system. The Paris Agreement¹²⁷ set the goal to limit global warming to 1.5°C above pre-industrial levels, which requires states to shift away from fossil fuels. Given the states' climate change commitments, the Energy Charter Treaty¹²⁸ (hereinafter — ECT) as the treaty aimed at the protection of cross-border investments in the energy sector, including fossil fuels, is practically “dead”: several EU states have terminated or announced their withdrawal from this treaty.¹²⁹ On 7 July 2023, the European Commission issued its proposal for a Council decision on the withdrawal of the European Union from the ECT,¹³⁰ which is to be submitted to the Council of the EU for adoption by a qualified majority.

However, under international and domestic legal regulation fossil fuel companies are still entitled to receive large amounts of compensation from states. At the same time, carbon majors are generally successful in ISDS. To illustrate, seven of the top ten largest ISDS awards (exceeding USD 1 billion) have been granted in cases involving fossil fuel investments.¹³¹ Thus, substantial amounts of public funds have been flowing to large fossil fuel companies through ISDS. Furthermore, requiring states to pay large compensations to investors increases the costs of the energy transition¹³² and leads to regulatory chill.¹³³

In this regard, some commentators have argued that certain types of projects, such as development of new fossil fuel reserves or infrastructure, should be excluded from ISDS,¹³⁴ for example by providing a climate-measure carve-out in international investment agreements, which would prevent investors from using ISDS to stop, slow, change, or shift the cost of climate-related policies.¹³⁵ Given the frequency and impact of claims involving fossil fuel assets, as well as the urgency of the climate crisis, climate change and just transition raise the need for fundamental reconceptualisation of damages and compensation in ISDS. The purpose of such reconceptualisation is to exclude exorbitant compensation for investors affected by states' measures in disputes involving fossil fuel companies and climate measures.

A discussion of possible principles or criteria on damages and compensation in the light of a just energy transition in ISDS may be included in the work of UNCITRAL WG III. Being the forum for the states' dialogue, the Working Group can become the place where debate on these complex topics can be conducted and practical approaches that integrate climate change considerations into investment arbitration can be developed. Indeed, some state delegates have highlighted the need to ensure reforms are pursued in a manner that “promote[s] investment policies in line with the three pillars of sustainable development”,¹³⁶ which depends on just transition.

To address climate implications, the number of suggestions can be considered for discussion in WG III. According to Martin Dietrich Brauch, Senior Legal and Economics Researcher at the CCSI, equity considerations and frameworks for compensation for climate and energy transition should be based on the

¹²⁷ *Paris Agreement to the United Nations Framework Convention on Climate Change*, 12 December 2015, T.I.A.S. No. 16–1104.

¹²⁸ *The Energy Charter Treaty and the Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects*, 1994, 2080 U.N.T.S. 100.

¹²⁹ *Will Coordinated European Withdrawal be the Death Knell of the Energy Charter Treaty?* // CMS Law-Now. 16 February 2023. URL: <https://cms-lawnow.com/en/eaalerts/2023/02/will-coordinated-european-withdrawal-be-the-death-knell-of-the-energy-charter-treaty> (accessed: 19.05.2023).

¹³⁰ *Proposal for a Council Decision on the Withdrawal of the Union from the Energy Charter Treaty*, European Commission, 7 July 2023. URL: https://energy.ec.europa.eu/system/files/2023-07/COM_2023_447_1_EN_ACT_part1_v1.pdf (accessed: 09.09.2023).

¹³¹ *Unión Fenosa Gas v Egypt; Occidental v Ecuador; ConocoPhillips v Venezuela; Hulley Enterprises v Russia; Yukos v Russia; Veteran Petroleum v. Russia; ICSID. Venezuela Holdings, B.V., et al (case formerly known as Mobil Corporation, Venezuela Holdings, B.V., et al.) v. Bolivarian Republic of Venezuela*. Case No. ARB/07/27, Award of 9 October 2014.

¹³² Tienhaara K., Cotula L. *Op. cit.*

¹³³ Tienhaara K. *Regulatory Chill in a Warming World: The Threat to Climate Policy Posed by Investor-State Dispute Settlement* // *Transnational Environmental Law*. 2018. Vol. 7. № 2. P. 229–250.

¹³⁴ Johnson L., Sachs L., Lobel N. *Aligning International Investment Agreements with the Sustainable Development Goals* // *Columbia Journal of Transnational Law*. 2019. Vol. 58. P. 71–79.

¹³⁵ van Harten G. *An ISDS carve-out to Support Action on Climate Change*. Research Paper No. 38. Osgoode Legal Studies Research Paper Series, 2015.

¹³⁶ *Draft Report of Working Group III (Investor-State Dispute Settlement Reform) on the Work of Its Thirty-Sixth Session*. UNCITRAL, 6 November 2018 (A/CN.9/964). §16.

principle that any compensation that fossil fuel companies might receive should at a minimum be conditioned upon specific just transition obligations imposed on the company for the benefit of its employees.¹³⁷ Another principle that he proposes to consider is the prohibition for investors of reinvesting any compensation received in fossil fuel projects and related infrastructure.¹³⁸ Some commentators propose that the awards should take into account that investors are increasingly expected to pay for the costs inflicted on society by climate change (such as the social cost of carbon), which should be subtracted from the damages awarded.¹³⁹ Specifically for fossil fuel companies, the valuation techniques capping compensation discussed above may be introduced, such as the balancing of interests, the sunk-costs-based approach or taking into account whether the state benefited from the breach of the investment treaty. The reforms to compensation rules for fossil fuel companies are likely to facilitate climate change and a just transition by mitigating threats of regulatory chill and overcompensation that hamper states' climate actions.

Given the above, there are suggestions to limit compensation for investors specialising in fossil fuel. States have already started taking steps to abide by climate transition policies, such as massive withdrawal from the ECT leading to its "death". In this connection, the UNCITRAL ISDS reform process can specifically focus on damages for fossil fuel-related investments in order to contribute to distributive and procedural justice in climate and energy transition. In disputes involving climate measures, damages in ISDS should be fundamentally reconceptualised to exclude exorbitant compensation for investors affected by states' measures. States might raise the questions of climate change considerations and the contested value of fossil fuel resources in ISDS, and arbitrators have wide discretion to integrate solutions to these issues in their assessments of damages and compensation.

The implementation of both procedural and substantive reforms can make a difference and lead to more balanced and reasonable outcomes of ISDS. UNCITRAL WG III can effectively contribute to the issues of damages and compensation by elaborating procedural and substantive reform options.

Conclusion

As the range of cases and economic stakes in investment arbitration has grown, so too has the significance of compensation and damages issues. The issues of valuation have been generally within the discretion of tribunals in the absence of clear guidance from investment treaties. While there is a high level of agreement across decisions concerning the basic principles governing damages in ISDS, there are no detailed rules on how to apply those principles in individual cases.

However, modern arbitral practice is characterised by the inflation of awards (not least due to the application of DCF) and a major gap between damages claimed and damages awarded. The developing states have been increasingly pointing to the issue of compensation in ISDS and its potential to negatively impact their policy space and public spending. This leads to the need for a balance between the interests of developing and developed states in valuation in ISDS. Another big problem is tribunals' inconsistency in valuation. Concerns have also been raised about the incorrectness of awards and potential conflicts of interest between arbitrators and damages experts.

In view of this, the issues of damages and compensation were included on the agenda of the reform process undertaken by UNCITRAL WG III. Although some delegations expressed doubt that issues of damages and compensation are outside the procedural mandate of WG III, the majority of states are calling for reforms on valuation in ISDS to be developed and implemented by WG III. Since there is no clear division between procedure and substance in investment treaty disputes, the issues of damages and compensation can fall under the mandate of WG III. Reforming solely procedural aspects would not allow us to solve problems in a comprehensive way.

The implementation of ISDS reforms through soft law instruments (draft treaty provisions, guidelines, model clauses) appears to be more efficient, which is supported by the "loss avoidance" and delegation

¹³⁷ *Event Highlights: Compensation for a Just Energy Transition in International Investment Law and Domestic Law* // Columbia Center on Sustainable Investment, 19 May 2022. URL: <https://ccsi.columbia.edu/sites/default/files/content/docs/publications/CCSI-compensation-just-energy-transition-international-investment-domestic-law.pdf> (accessed: 18.05.2023).

¹³⁸ *Ibid.*

¹³⁹ Burger M., Johnson L., Tienhaara K. *Valuing Fossil Fuel Assets in an Era of Climate Disruption* // International Institute for Sustainable Development, 20 June 2020. URL: <https://www.iisd.org/itn/en/2020/06/20/valuing-fossil-fuel-assets-in-an-era-of-climate-disruption/> (accessed: 13.05.2023).

theories inferred from law and economics. The valuation of damages and compensation should be reformed by both formulating procedural rules and elaborating substantive reform options for greater efficiency.

There is a number of feasible procedural reform options on the assessment of damages and compensation in ISDS that the UNCITRAL WG III can consider for the discussion and elaboration:

- 1) In addressing the issue of damages experts' potential conflict of interest, the last big achievement was the preparation of the Draft Code of Conduct for Arbitrators that contains some clarifications on how double-hatting can be limited. This issue and the issue of the wide divergence in the parties' experts damages amounts require other efficient procedural solutions, such as developing detailed guidance on these matters, engaging the industry specialists for assisting quantum experts, strengthening the role of the tribunal-appointed expert, creating a standing commission for damages calculation in ISDS.
- 2) Arbitrators can fall victim of the anchoring effect, i.e. when evaluating information relevant for decision-making, arbitrators are influenced by the large amount of damages claimed by investors. It can be tackled by raising awareness of arbitrators of this effect, for example, by including explicit provisions in the arbitration rules as to de-bias arbitrators, as well as by promoting arbitrators' diversity.
- 3) An important procedural step that can make addressing damages issues in ISDS more effective is to encourage the appointment of early conferences on damages, for instance, by providing guidance or inserting provisions to this effect in arbitration rules.

In respect of substantive reform options aiming at clarification of valuation methods and limiting damages and compensation in ISDS, the following conclusions were made:

- 1) The valuation methods should be clarified. Guidance may be developed that arbitrators should apply DCF when estimating damages on a fair and reasoned basis, taking into account such criteria as the record of the enterprise's financial performance, the reliable projections of the future cash flow, etc. The alternative solution is to set standards that require damages to reflect a balance between competing interests, but this requires more detailed clarifications and is unlikely to replace DCF.
- 2) The application of the rule on the investor's contributory fault requires some clarification. Encouraging the more detailed reasoning by arbitrators and providing guidance on the investor's contributory fault can contribute to the consistency of arbitral practice.
- 3) WG III can consider capping compensation to the actually invested amount (the sunk-costs-based approach) and requiring a tribunal to consider whether the state has obtained any benefit from the investment and its breach of investment treaty obligations. However, caution should be exercised in elaborating these reform options since the sunk-costs-based approach may not sufficiently compensate investors, while integrating gain-based considerations into the estimation of compensation can be quite complex. The total replacement of DCF with other approaches appears to be not realistic due to the widespread use of DCF in valuation in ISDS and outside it.
- 4) Providing guidance on the assessment of contextual factors, such as the respondent state's ability to pay and the potential "crippling effect" of an award on the state might help find a balance between the interests of the developing and developed states.
- 5) Some raise fundamental concerns about the chilling effect of large compensation awards on adopting climate mitigation measures and increasing the cost of the energy transition. Climate implications can be mitigated by introducing valuation techniques capping compensation specifically for fossil fuel companies, such as the balancing of interests, the sunk-costs-based approach or considering whether the state benefited from the breach of the investment treaty.

The issue of valuation of damages and compensation is central to the debate about the legitimacy of the ISDS system. UNCITRAL as one of the key actors capable of influencing the ISDS system should seriously consider suggestions on both procedural and substantive reform options in its current reform process. The delegations participating in the UNCITRAL can seize this opportunity to address these issues at a multilateral level and elaborate a solid framework on damages quantification in investment arbitration for both legal and financial practitioners. Whether the WG III delegations will be able to come together on the issue of compensation and agree on reforms that matter will be seen in the coming months and years. It will depend on the coordinated action of those delegations who wish to advance this issue within WG III.

ОЦЕНКА УБЫТКОВ И КОМПЕНСАЦИИ В КОНТЕКСТЕ ПРЕДЛОЖЕНИЙ ПО РЕФОРМИРОВАНИЮ СИСТЕМЫ УРЕГУЛИРОВАНИЯ СПОРОВ МЕЖДУ ИНВЕСТОРАМИ И ГОСУДАРСТВАМИ

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Аннотация

В статье рассматриваются реформы в области оценки убытков и компенсации в международном инвестиционном арбитраже. Статья определяет проблемы оценки убытков и компенсации, которые привели к необходимости проведения реформ, такие как инфляция арбитражных решений, принимаемых в инвестиционных арбитражных разбирательствах, большой разрыв между запрашиваемыми суммами убытков и присуждаемыми суммами, а также трудности, создаваемые большими суммами убытков для развивающихся стран. Другие основания для реформ включают непоследовательность арбитражных трибуналов в оценке убытков и компенсации, неточность решений и возможный конфликт интересов между арбитрами и экспертами по оценке. Спорным является вопрос о том, могут ли проблемы убытков и компенсации в спорах между инвесторами и государствами быть решены в рамках мандата Рабочей группы III ЮНСИТРАЛ, в отношении которого утверждается, что мандат ограничен исключительно процессуальными вопросами. Автор приходит к выводу о том, что реформы в области оценки убытков и компенсации могут и должны быть разработаны Рабочей группой III. Оценка убытков и компенсации в инвестиционном арбитраже требует комплексной реформы, включающей как процессуальные решения, так и субстантивные предложения, которые может разработать Рабочая группа III. Опираясь на теории права и экономики, автор приходит к выводу, что реформы должны осуществляться с помощью инструментов мягкого права. Далее в статье представлены целесообразные процессуальные реформы оценки убытков и компенсации в инвестиционном арбитраже. Основное внимание уделяется реформам, направленным на устранение возможного конфликта интересов экспертов по оценке, расхождений в суммах убытков экспертами сторон и эффекта якоря от запрашиваемых истцами сумм для арбитров, а также опции проведения ранних конференций по убыткам. При этом статья обращается к идеям поведенческой экономики. Наконец, в статье обсуждаются субстантивные реформы оценки убытков и компенсации, которые могут улучшить последовательность и корректность арбитражных решений. Автор рассматривает варианты дачи разъяснений по использованию метода дисконтированных денежных потоков, установления стандартов, согласно которым присуждаемые суммы будут отражать баланс между конкурирующими интересами, дачи разъяснений относительно наличия вины инвестора в убытках, ограничения компенсации суммой, фактически вложенной инвестором, а также оценки контекстуальных факторов, имеющих значение для расчета убытков.

Ключевые слова

убытки, компенсация, урегулирование споров между инвесторами и государством, реформы

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