ISDS Reforms on Assessment of Compensation: Addressing Climate Change Concerns

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Introduction

Recent discussions surrounding the reform of Investor-State-Dispute-Settlement **["ISDS"]** mechanisms are centred on the treatment of claims arising out of climate change mitigation measures implemented by host states.[1] The necessity for such reforms stems from an expanding number of cases where investors assert that environmental regulations enacted by states adversely impact their profits. The fossil fuel industry in particular is responsible for bringing in 20% of the total known ISDS cases.[2] In contrast, the mining industry which brings in the second greatest number of claims, is responsible for only around 11% of the total cases on record. The fact that the fossil fuel industry is a dominant player in ISDS arbitration should be a cause for concern, especially when the Paris Agreement places an obligation on the international community to phase out fossil fuels expediently. In a report by a UN Special Rapporteur addressing *"[T]he catastrophic consequences of investor-State dispute settlement for climate and environment action and human rights,"* ISDS is described as *"a secretive international arbitration process,"* that impedes efforts to address climate and environmental issues, and as a result, affects the human rights of disadvantaged and marginalised communities.[3] While there are multiple facets to ISDS and environmental regulation, this essay will focus on the calculation of compensation by tribunals in cases involving a climate change angle.

Indirect Expropriation

"Expropriation" in international investment law is generally used to define the acquisition of property by the state. Expropriation is not a legally wrongful act per se, as it hinges on the state's territorial sovereignty. Therefore, a tribunal cannot ask the state to repeal the policy or regulation but what it can do is make the state pay compensation or damages to the foreign investor adversely affected by state action. It is important to note that the current principles guiding compensation, which evolved from the notion that only direct expropriation is a possibility, are now also being applied to other types of expropriation as well. Best known examples are the ***Tethyan Copper v. Pakistan***[4] and ***Union Fenosa Gas v. Egypt***[5] awards. The former involved expropriation through the failure of the host state to grant approval for a project that never actually manifested, and the latter involved expropriation through inadequate

[1] Barber, *Zeph Investments v Australia: The Latest in Investor-State Climate Change-Related Claims*, KLUWER ARBITRATION BLOG (Aug. 24, 2023), https://arbitrationblog.kluwerarbitration.com/2023/08/24/zeph-investments-v-australia-the-latest-in-investor-state-climate-change-related-claims/ (last visited Oct 10, 2023).
[2] LEA DI SALVATORE, *Investor–State Disputes in the Fossil Fuel Industry*, (2021).
[3] UNHRC, *A/78/168: Paying Polluters: The Catastrophic Consequences of Investor-State Dispute Settlement for Climate and Environment Action and Human Rights*, (2023), https://www.ohchr.org/en/documents/thematic-reports/a78168-paying-polluters-catastrophic-consequences-investor-state-dispute (last visited Oct 10, 2023).
[4] Tethyan Copper Company Pty Limited v. Islamic Republic of Pakistan, ICSID Case No. ARB/12/1.
[5] Unión Fenosa Gas, S.A. v. Arab Republic of Egypt, ICSID Case No. ARB/14/4.

supply of natural gas that the state argued was needed for domestic consumption instead. In both these cases, the state did not directly acquire the property, but rather rendered the investment useless through indirect expropriation.

Climate Change and Indirect Expropriation

Two categories of claims have been identified when it comes to climate change regulation and ISDS. The first category pertains to the introduction of policies aimed at phasing out fossil fuels in order to strengthen new energy transition, such as the claim brought against Canada by the US company Westmoreland, asking for USD 479 million in damages arising from Canada's decision to phaseout thermal coal mining.[6] The second category of claims involve a more direct engagement by states with fossil fuel companies involving the denial or revocation of project approvals and licenses for climate-change related reasons. An example for this kind of an *"indirect expropriation"* is the recent case of ***Rockhopper v. Italy,***[7] wherein Italian government had to pay approximately EUR 190 million to the UK oil and gas giant Rockhopper, as the tribunal found that legislating to deny Rockhopper a license to exploit an offshore oilfield despite the company meeting all legal requirements, amounted to indirect expropriation.

Principles Governing Compensation

While literature and jurisprudence on other aspects of investment arbitration law has been evolving quite radically, the same extent of focus on principles governing compensation under investment treaties has not been seen. This has been attributed to the seemingly *"technical"* nature of compensation, and the belief that it can be decided by the arbitrators themselves. However, it is crucial at this juncture to re-evaluate these beliefs, in light of massive payouts given to fossil fuel companies by host states that only sought to regulate for environmental considerations. The amount of compensation claimed and subsequently awarded in claims brought forth by fossil fuel companies have generally been higher than those of non-fossil fuel companies.[8] Eight out of the ten highest awards ever granted in investment arbitration were given to fossil fuel companies.[9]

The issue of increasing amounts of compensation being awarded by ISDS tribunals is only now starting to get some attention and scrutiny, leading to the UNCITRAL Working Group III which deals with ISDS reforms taking up issues surrounding damages and compensation as one of its agendas.[10] Within the wider ramifications stemming from calculating quantum of compensation, there are two major implications that increasing amounts of compensation can

[6] Westmoreland v. Canada (I) | Investment Dispute Settlement Navigator | UNCTAD Investment Policy Hub, https://investmentpolicy.unctad.org/investment-dispute-settlement/cases/936/westmoreland-v-canada (last visited Oct 10, 2023).

[7] Rockhopper Exploration Plc, Rockhopper Italia S.p.A. and Rockhopper Mediterranean Ltd v. Italian Republic (ICSID Case No. ARB/17/14).

[8] DI SALVATORE, *supra* note 2.

[9] JONATHAN BONNITCHA & SARAH BREWIN, *Compensation Under Investment Treaties: What Are the Problems and What Can Be Done?*, (2020), https://www.iisd.org/publications/compensation-under-investment-treaties (last visited Oct 10, 2023).

[10] A/CN.9/WG.III/WP.220 - Possible reform of investor-State dispute settlement (ISDS): Assessment of damages and compensation.

have on the climate – *firstly,* it creates a regulatory chill, wherein countries fail to effectively regulate for the environment fearing the threat of investment arbitration.[11] *Secondly,* the high amounts of compensation awarded on projected future value of fossil fuels in cases involving expropriation by the host state even before the project has been completed only leads to the fossil fuel company using the money to go extract elsewhere.

Both of these implications can be observed in ***Rockhopper v. Italy.*** Interestingly enough, although the Italian government did end up regulating anyway, the award reveals that the Italian authorities had initially wanted to carve out certain exemptions to the offshore drilling ban fearing ISDS litigation. This proves that ISDS as it stands currently impedes effective environmental regulation by influencing how governments frame policies, creating a regulatory chill. After the award became public, the Chief Executive of Rockhopper went on to say that the compensation will be invested into the company's oil extraction project at the Falkland Islands, which means that the Italian government regulated to protect the environment, only to ultimately assist Rockhopper in its extraction projects elsewhere.[12]

The Method of Valuation

Multiple approaches exist for determining the quantum of compensation to be awarded to parties, and investment treaties are largely silent on which approach is to be used in a dispute. The treaty provisions concerning expropriation only mention the criteria that states must adhere to in order for an expropriation to be considered lawful, and provide that compensation for the same must be *"prompt, adequate, and effective."*[13] Some treaties will go on to mention that the compensation must be equivalent to the *"fair market value"* of the expropriated assets, but refrain from mentioning the appropriate method to be used to arrive at the value. In the absence of guiding soft laws on the manner to choose a methodology, coupled with the availability of a wide range of valuation methods, unfettered discretionary powers are granted to tribunals.

One major consequence of this is the usage of the *"Discounted Cash Flows"* **["DCF"]** methodology, which locates an assets value through its anticipated future profitability as opposed to relying solely on its historical costs. It involves the aggregation of projected cash flows, while factoring in a discount rate to account for associated risks. The prevalent usage of this method of valuation by tribunals has been leading to largely inflated awards and is criticised for the same by commentators. To give some perspective, in the ***Tethyan Copper*** award, the DCF method was used and the analysis incorporated the projected market prices for minerals over the entire anticipated lifespan of the mine *(which never materialised).* The damages in this case amounted to USD 4 billion, which was a long way from the investor's

[11] Kyla Tienhaara, *Regulatory Chill and the Threat of Arbitration: A View from Political Science*, *in* EVOLUTION IN INVESTMENT TREATY LAW AND ARBITRATION 606 (Chester Brown & Kate Miles eds., 2011), https://www.cambridge.org/core/books/evolution-in-investment-treaty-law-and-arbitration/regulatory-chill-and-the-threat-of-arbitration-a-view-from-political-science/9426A8659CDD8BFB69FF552058CE7AD0 (last visited Oct 10, 2023).

[12] Doruntina Basha, *Outrage as Italy Ordered to Pay out Millions to Oil Investor over Energy Charter Treaty Claim*, CAN EUROPE (Aug. 24, 2022), https://caneurope.org/outrage-as-italy-ordered-to-pay-out-millions-to-oil-investor-over-energy-charter-treaty-claim/ (last visited Mar 11, 2023).

[13] JONATHAN BONNITCHA & SARAH BREWIN, *Compensation Under Investment Treaties*, (2021).

actual initial expenditure, which was USD 200 million. In contrast, in ***Bear Creek Mining Corporation v. Republic of Peru,***[14] its facts mirroring Tethyan Copper inasmuch as both cases involved mines did not materialise and indirect expropriation took place, the tribunal only relied on the actual expenditure incurred by the investor and not DCF, with the Republic of Peru having to only pay USD 18 million. This exemplifies the massive differences that can arise out of the method of valuation used, and the inconsistencies in application of valuation methods.

Valuation of fossil fuel assets

Commentators have pointed out the broad issues associated with the usage of the DCF methodology by ISDS tribunals in arriving at the quantum of compensation. One such issue of particular relevance to International Environmental Law jurisprudence is the valuation of fossil fuel assets in an era of rapid renewable energy transition. ISDS awards that require states to pay huge amounts of compensation to fossil fuel companies are at odds with the Paris Agreement's Article 2.1(c) which calls on governments to make *"financial flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development."*

Moreover, as states gear up the process of a renewable energy transition, the question of whether a tribunal can even use the DCF methodology to forecast whether the price of fossil fuel assets would remain consistent in the future arises. Climate-related risks to corporate profits is now a pressing issue and is discussed by financial regulators and bodies.[15] It can be argued that these risks encompass both the physical risks to assets arising from natural disasters and also transition risks, which would include legal changes, harm to reputation, and shifts in market preferences for technological advances. Within the context of ISDS too, then, it is imperative that we deliberate upon the implications for fossil fuel investments resulting from the commitments and actions taken by governments to align with the *"carbon budget."* To ensure that valuation methods do not presuppose the reliability of future income generated by stranded fossil fuel assets, thus resulting in unjust enrichment of investors at the expense of states, the extent of state responsibility under international law on climate change and how it would impact investors must be delineated expediently.

Proposals and Ways Forward

In order to ensure that awards such as that of ***Rockhopper v. Italy*** are not repeated, urgent reforms are required both at the procedural and substantive level.[16] The issue of calculation of compensation to be paid may prima facie appear substantive. However, there can also be procedural reforms undertaken to address the same. The UNCITRAL WG III is already looking into reforms to address the competence of the tribunal to calculate damages in accordance with international principles, and acknowledging the importance of a tribunal appointed expert to

[14] Bear Creek Mining Corporation v. Republic of Peru (ICSID Case No. ARB/14/21).

[15] Kyla Tienhaara, Michael Burger & Lise Johnson, *Valuing Fossil Fuel Assets in an Era of Climate Disruption*, INVESTMENT TREATY NEWS (Jun. 20, 2020), https://www.iisd.org/itn/en/2020/06/20/valuing-fossil-fuel-assets-in-an-era-of-climate-disruption/ (last visited Apr 27, 2023).

[16] Jonathan Bonnitcha et al., *Damages and ISDS Reform: Between Procedure and Substance*, J. INT. DISPUTE SETTL. idab034 (2021).

deal with the same. As mentioned earlier, since investment treaties are largely silent on how to choose the appropriate method of valuation, the creation of soft laws that would guide the tribunals on the different circumstances under which a particular method of valuation can be used may also prove to be helpful. Some commentators go on to propose much radical measures such as termination of investment treaties that contain provisions that do not take into consideration issues of sustainable development. The termination of older treaties that hinder a state's commitments under the Paris Agreement has also been proposed as a legitimate policy solution by the UNCTAD'S reform package for the International Investment Regime.[17] However, terminating investment treaties can prove to be a herculean task, as exemplified by the issues surrounding the Energy Charter Treaty, due to considerations of diplomacy, unanimous consent, and the existence of sunset clauses.[18] Yet another possibility, which would not involve the complete doing away with of the DCF methodology in investment disputes, is the consideration of risks related to climate change – both physical and transitional – being included in the valuation of the expropriated assets, leading to inflated discount rates and deflated valuations.[19]

Conclusion

The manner in which tribunals handle questions of compensation carries significant consequences for states and for democracy at large. If the investment treaty system is functioning in a manner inconsistence with global commitments to reduce fossil fuel emissions, then states must prioritise compensation as a key area for reform. The perceived *"intricate"* nature of the current body of jurisprudence surrounding compensation should not bar states from actively participating in UNCITRAL reform processes by advancing the work on compensation, especially when it comes to compensation arising out of environmental regulation claims.

[17] UNCTAD'S REFORM PACKAGE FOR THE INTERNATIONAL INVESTMENT REGIME, (2018), https://investmentpolicy.unctad.org/uploaded-files/document/UNCTAD_Reform_Package_2018.pdf (last visited Oct 10, 2023).

[18] Tushar Behl & Dikshi Arora, *Modernization of Energy Charter Treaty: Addressing the Elephant in the Room over Investment Protection v/s Sustainable Development*, (May 7, 2021), https://ijpiel.com/index.php/2021/05/07/modernisation-of-energy-charter-treaty-addressing-the-elephant-in-the-room-over-investment-protection-v-s-sustainable-development/ (last visited Mar 13, 2023).

[19] Toni Marzal, *Polluter Doesn't Pay: The Rockhopper v Italy Award*, EJIL: TALK! (Jan. 19, 2023), https://www.ejiltalk.org/polluter-doesnt-pay-the-rockhopper-v-italy-award/ (last visited Mar 11, 2023).