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ECT Modernisation Perspectives: Quantum Indetermination in the Current ECT Framework – A Need to Revamp Damages Provisions in the Pursuit of Full Reparation

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In the absence of a uniform standard of compensation under the Energy Charter Treaty ("ECT"), tribunals have been tasked with filling the gap and have done so by exercising an important margin of appreciation for the assessment of damages. Such wide discretion has resulted in divergent approaches in assessing damages. Since the first ECT decision, tribunals have provided little guidance as to the basis upon which damages will be awarded. The lack of sufficient reasoning coupled with divergent outcomes has led quantum to remain the main concern of parties, while garnering significant criticisms due to its onerous and seemingly arbitrary nature. The discrepancies regarding quantum determination have undermined the capacity for the ECT to ensure reparation for internationally wrongful acts in a harmonized and consistent fashion.

This post first examines the scope of application of Article 13 of the ECT, to highlight the ambiguity surrounding the current formulation of the ECT's only express compensation standard. It then highlights the methodologies applied to valuation in ECT disputes to propose some concrete recommendations. The recommendations aim at streamlining the application of the ECT compensation standard for treaty breaches to ensure consistency and predictability in future ECT cases.

Article 13 of the ECT: A Limited Scope of Application

Like other analogous treaty-based reparation standards, the ECT solely provides a standard for compensation in case of lawful expropriation. Article 13 of the ECT enshrines an obligation to pay "prompt, adequate, and effective compensation" for lawful expropriations. Article 13 also sets out general principles concerning the valuation of such damages, focusing on "the fair market value of the investment expropriated". Article 13 then provides that the market value is estimated "at the time immediately before the expropriation" or at the valuation date. While the inclusion of a particular valuation methodology was perceived as a welcome development at the time of the ECT's adoption, its narrow scope of application leaves various issues unaddressed.

Notably, Article 13 fails to provide sufficient guidance on what compensation will be due for unlawful (including indirect) expropriations. In addition, none of the ECT provisions directly tackle the standard of compensation for other ECT breaches (including the fair and equitable

treatment provision), or the availability or quantum of pre- or post-award interest. In the absence of guidance on how to assess damages in these situations, tribunals have frequently endorsed customary international law principles of compensation to devise an appropriate valuation methodology. For instance, in the *Nykomb* arbitration, the tribunal stated that the principles of compensation within Article 13 (1) of the ECT would not apply to an assessment of damages under Article 10 of the ECT (the fair and equitable treatment provision). It found on this basis that "the question of remedies to compensate for losses or damages caused by the Respondent's violation of its obligations under Article 10 of the Treaty must primarily find its solution in accordance with established principles of customary international law". This has meant that most ECT tribunals have referred to the principle of full reparation under customary international law in order to assess compensation for unlawful expropriation and other breaches of the ECT.

Reforms for ECT Remedies Provisions?

The current text of the ECT treaty does not contain any reference to the principle of full reparation, and also fails to incorporate existing industry practice concerning the valuation of damages for non-lawful expropriations and other treaty breaches. In the absence of clear direction, tribunals may engage in an overzealous approach to valuing quantum in ECT cases, which may risk unduly favoring one of the parties. In addition, difficulties arise in discerning fair market value ("FMV") and full restitution when measuring loss. In particular, emerging jurisprudence shows that many tribunals do not draw a clear distinction between FMV and full restitution, thereby making it hard to discern on what assessment such amounts are awarded.

The ECT modernization process could therefore usefully produce some articulation of applicable compensation standards that should apply in ECT investor-State arbitration cases, in addition to those applicable to lawful expropriations. It could moreover usefully supply tribunals with more guidance as to the methodology that should apply to calculate quantum in ECT investor-State cases.

To this end, the ECT contracting parties have proposed to reform damages in the context of the ECT modernization process. For instance, Turkey has suggested an additional protocol to cover this topic, aiming at explicitly including FMV and excluding lost profits. The EU recently proposed a Revised Draft Proposal on April 2020. The EU draft article is still unclear on the question of quantum calculations, stating *inter alia* that: "[v]aluation criteria shall be based on internationally recognised principles and norms" (i.e. full reparation), and adding that "[t]he EU reserves the right to propose more detailed rules on valuation at a later stage pending the outcome of discussions in other international fora". In view of the EU's increasing role in ISDS reform, a concrete proposal on damages is to be expected in the future.

A Need for Guidance as to Applicable Valuation Methodologies

Embracing new techniques and including alternative methodologies in the new draft of the ECT will be in line with the objective of ensuring that the ECT can encourage and create stable, equitable, favorable and transparent conditions for investors. This could encompass a range of reforms regarding damages.

First, the ECT parties should expressly indicate what principles should guide damages assessments including, for example, to designate the role of full reparation standards in damages analyses. The Turkish proposal endorses the use of a FMV methodology, and exclusion of lost profits in quantum assessments. It is in our view, however, important that tribunals have the capacity to account for post-expropriation events, including lost profits, as these directly affect net recovery. This also aligns with the full reparation principle, recognizing consequential and other losses. While States have yet to put forward more detailed proposals, these considerations indicate that the ECT modernization process could usefully encompass revisions to the text to more expressly endorse (or detail) a methodological analysis. In our view, there continues to be a role for methodologies like discounted cash flow ("DCF") analysis. This is a method that accounts for the importance of the nature of the asset and the specific facts of the case. DCF techniques[1)] appear to be more consistent than FMV methodologies with the overall objective of the full reparation principle, because it accounts for future income streams. DCF treats an investment as an asset or enterprise capable of generating profit in the future after expropriation. By contrast, the FMV standard contained in Article 13, which assesses quantum as at the date of expropriation, has two drawbacks. First, it negates the nature of the investment as an asset or enterprise capable of operating in the future. It also fails to take into account post-expropriation events. There may be circumstances in which a state may legally take a profitable investment that would have continued to operate with an enhanced profit. However, by applying a FMV standard, tribunals may end up compensating with a lower value which goes against the basic tenet of the full reparation principle.

Second, ECT parties could use the modernization process to adopt a clear and coherent choice of valuation methodology, including to stipulate guidance as to its use for specific violations. In this respect, we are of the view that the application of different methodologies should not be based on whether or not expropriation has been lawful or not. Rather, importance should be placed on the nature of the underlying investments that have been subject to either lawful or unlawful expropriation. Such criteria were already suggested in the 1992 World Bank Guidelines on the Treatment of Foreign Investment, whereby the compensation would "account [for] the nature of the investment, the circumstances in which it would operate in the future and its specific characteristics". This approach has a significant advantage because it attempts to measure the value created by a business directly and precisely. Such an approach would also remain sensitive to assumptions related to perpetual growth of underlying dispute.

Finally, the ECT modernization process could usefully define which methodologies will apply in different circumstances (based on specific industry standards) to prevent the overzealous interpretation of provisions by tribunals and narrow the scope of applications. Defining methodologies and applying them based on specific industry standards is important because it underlies that each asset may have a different stream of revenue based on the specifications of that industry. For instance, evaluation for oil and gas extraction requires accounting projected future net revenues, or if the investment is a start up with no track record, history of operation or other solid basis on which to make projections of profits, then other methodologies may be more suitable.

Final Remarks

Revising the ECT to provide a comprehensive compensation standard and methodology for assessing damages for both expropriation and other breaches of the ECT would give tribunals the confidence to thoroughly explicate their quantum decisions. Moreover, it would provide comfort to

States parties which are also respondents over the outcome of disputes, while at the same time, giving investors greater certainty regarding the possible outcome of any recourse to the treaty for dispute resolution. Finally, giving the ECT a robust textual provision for damages would increase consistency and predictability in the interpretation of the ECT, as well as the investment arbitration system as a whole.

To read our coverage of the ECT Modernisation process to date, click here.

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References

?1 On the reliability of DCF, *see* ECT cases *PV Investors v. Spain*, *Masdar v. Spain*, *Antin v. Spain*, *9REN v. Spain*, *SolES Badajos v. Spain*, *Operafund v. Spain*, *Watkins v. Spain*, *Greentech* v. Spain, *CEF Energia v. Italy*; *see also*, on the "modern DCF" methodology adopted in the *Tethyan* case: R. BARNES (2017) "Not so rare : the valuation method behind the Tethyan case", Global Arbitration Review: "rather than capturing both the time value of money and risk in the discount rate, risk is accounted for in the cash flows being discounted, and only the time value of money is captured by the discount rate" *but see*, *Nextera v. Spain*, in which the tribunal rejected the DCF for one year of operating profits.

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