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Analysis of Compensation System for Investor-State Dispute Settlement

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Investor-State Dispute Settlement, abbreviated as ISDS, constitutes a fundamental component of the international legal field. It provides foreign investors with the opportunity to pursue arbitration instead of relying on the domestic court system of the host country when their international investment agreements or treaty obligations are violated by the host government. Typically embedded in bilateral or multilateral investment treaties and free trade agreements, Investor-State Dispute Settlement offers investors a means to seek fair and reasonable compensation for investment losses resulting from unfair or discriminatory measures taken by the host government. However, due to a significant increase in arbitration cases, the shortcomings of Investor-State Dispute Settlement have become increasingly apparent, leading to growing criticism and dissatisfaction that even questions its legitimacy along with its affiliated international investment system. In light of this legitimacy crisis within the international investment law system, particularly concerning ISDS, compensation was initially overlooked as a technical issue but has now gained prominence. The ultimate goal for investors initiating arbitration is seeking relief while states aim to avoid liability through their defense strategies. Consequently, compensation has emerged as both an essential objective and top priority for reforming investment arbitration. Against the backdrop of ongoing adjustments in international investment law and reforms within Investor-State Dispute Settlement, this article aims to re-examine issues pertaining to the investment arbitration compensation system, explore potential reform approaches, and propose suggestions for enhancing China's own investment arbitration system.

Keywords: Investor-State Dispute Settlement (ISDS), compensation system, investment arbitration

Introduction to the Compensation System

The compensation system of the Investor-State Dispute Settlement (ISDS) is established and outlined in international investment treaties, with variations depending on specific international investment agreements. The design and implementation of compensation systems are subject to individual international investment agreements and relevant laws. Generally speaking, the Investor-State Dispute Settlement's compensation system typically includes the following elements:

Compensation Procedures Under International Investment Agreements

The compensation system of the Investor-State Dispute Settlement will provide for a specific set of procedures and rules for determining whether compensation should be paid and the amount to be paid. Usually,

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this involves an investor filing a claim against the host country of the obligation for infringement of its alleged rights and conducting independent and impartial arbitration proceedings.

Form of Compensation

The compensation can be paid in various forms, including monetary payment, equity compensation, franchise, etc. Compensation may include different aspects such as direct loss, indirect loss, future loss, and non-material damage.

Calculation Method of Compensation

The calculation of compensation may be based on the investment loss of the investor, the specific circumstances of the damage suffered, the relevant provisions in the investment agreement, and the norms of international law. Investment agreements will generally stipulate that the amount of compensation should be reasonable and fair, and may claim compensation that should be sufficient to cover the losses of investors.

Enforcement and Enforcement of Compensation

Once the arbitral tribunal has made a decision on compensation, the decision is usually enforceable. The host country is obliged to perform lawful compensation in accordance with the arbitral award.

Existing Issues in the Compensation System

High Compensation Issues

A number of studies over different periods have shown that the amount of compensation in investment arbitration has been on the rise. For example, a study by Franck in 2007 showed that the average amount of compensation between 1990 and 2006 was $25 million (Franck, 2007). The study of Hodgson in 2017 indicated that the average amount of compensation increased to $76 million between 1990 and 2012. Hodgson points out that in the period 2013 to 2017, excluding the three cases of Yukos (the total amount of compensation exceeds $50 billion, which has a greater impact on the calculation of the average amount of compensation), the average amount of compensation was $171 million (Hodgson & Campbell, 2017). In 2021, the study of Hodgson, Kryvoi, and Hracka showed an average compensation of $315 million over the period 2017 to 2020.

The trend of claims and compensation related to Investor-State Dispute Settlement gradually increase over time.

The high compensation given by investment arbitration tribunals may have disastrous effects on countries, especially developing countries with limited resources, such as the $8.5 billion ruling in the case of Conoco Phillips v Venezuela. Venezuela has stated that the amount of the ruling accounts for 13.5% of Venezuela's GDP in 2019, and it is currently in an economic crisis. Venezuela said that implementing the ruling would have a punishing effect on Venezuela's economy and citizens. In the case of Tethyan Copper v Pakistan, Pakistan pointed out during the application for suspension of execution that immediately implementing the $5.9 billion ruling in the case would have dire consequences for it. Pakistan emphasized its current economic difficulties, indicating that if the ruling in the case is immediately implemented, it would be like adding insult to injury to its already fragile economy. The implementation of the ruling will crowd out funds originally used for public health, social welfare, and other projects, which will have disastrous consequences for the Pakistani people, especially vulnerable groups.

Scholar David Collins (2017) has attempted to explain the emergence of these high awards in terms of behavioral economics. He first described two types of losses that might be compensable, the first being the actual loss of the investment and the second being the loss of the expected profits of the investment. Compensation calculated on the basis of actual loss might more accurately reflect the market value of the assets and tend to result in lower compensation. However, the current approach to compensation adopted by investment arbitration tribunals centers on forward-looking and loss of expected profits, the assessment of which is often fraught with predictability and uncertainty and usually results in higher awards. In some cases, such as where the investment infringed upon by the host state had no prospect of future profitability or where the measures taken by the host state were in the public interest (e.g., lawful expropriation), it would be more reasonable to calculate compensation on the basis of actual damages. The tendency of arbitral tribunals to calculate compensation in a profit-oriented manner may be based on a behavioral economics bias, i.e., the fear of missing out, in which human beings seek to avoid missing out on future opportunities.

There are at least several reasons for the high compensation awards in investment arbitration: First, in the application of compensation standards, the arbitral tribunal often ignores the differences in language in investment treaties. For example, when the treaty requires compensation for the "fair", "true", and "genuine" value of the investment ("fair/just/equitable value", "true value", "genuine value"), the clauses are interpreted as fair market value standards, resulting in excessive compensation levels. The generation of these high awards is related to the arbitral tribunal's application of the full compensation standard of customary international law. The compensation standard of customary national law is mainly stipulated in the Draft Articles on the Liability of States for Internationally Wrongful Acts. The author points out that there is no provision in the Draft Articles on the Liability of States for Internationally Wrongful Acts that restricts compensation beyond the national affordability. However, this is not the case in investment arbitration. Therefore, new rules need to be formulated for investment arbitration to deal with the frequent occurrence of excessive compensation in investment arbitration. Second, when conducting valuation, the arbitral tribunal often emphasizes investors' expected profits and chooses a revenue-based valuation method. However, there are many uncertainties in expected profits, especially when choosing the Discounted Cash Flow method (DCF method) (which first predicts the future funds of an investment and then applies a discount rate to estimate the current value of the investment). A small change in one variable can have a significant impact on the valuation results. Third, the arbitral tribunal lacks sufficient consideration of the host country's regulatory authority. For example, when the host country takes regulatory measures that cause investors to fail to obtain expected returns, the arbitral tribunal should take into account the possible impact of legal and operating environment changes caused by normal regulatory measures taken by the host country.

Inconsistency and Unpredictability Issues in Arbitral Awards

The scholar Irmgard Marboe's book *Damages in Investor-State Arbitration: Current Issues and Challenges* (2018) explores in detail the inconsistency and consequent unpredictability of investment arbitral tribunals' treatment of compensation issues. The lack of consistency in arbitration practice leaves the impression that compensation issues are dealt with in a rather random manner, and that the success of a party depends essentially on the quality of its arguments and submissions. This is unsatisfactory, both from an academic point of view and

from other considerations such as predictability. Over time, some of the principles governing compensation have become generally accepted, yet their application by arbitral tribunals in practice remains unpredictable. The authors specified three areas of inconsistency in the treatment of compensation. First, the question of whether the mere fact that an expropriation was carried out in the public interest, in accordance with due process and meeting the conditions of non-discrimination, and that the investor has not been compensated, in itself renders the expropriation unlawful, and thus the standard of compensation for a lawful expropriation (i.e., adequate compensation, where the amount of compensation is equal to the fair market value of the expropriated property) cannot be applied, and the standard of compensation for an unlawful expropriation (e.g., compensation for the expropriated property) can instead be applied (e.g., compensation for the expropriation of the property). The tribunal was divided on the application of compensation criteria for unlawful expropriation, such as the Chorzów factory principle (i.e., full restitution, which should eliminate all the consequences of the unlawful act and restore, as far as possible, the state of things that would have existed if the unlawful act had not occurred). Secondly, the tribunal's choice of valuation method and valuation date is unpredictable. There are broadly three types of valuation methods in practice: market or comparable sales valuation (valuing an asset by comparing relevant market data such as sales of the same or similar assets), income-based valuation (estimating the current value of an asset by assessing the expected future earnings that the asset is likely to generate from its income and expense data), and asset or cost-based valuation (valuing an asset on the basis of the difference between the value of the enterprise's assets and its liabilities). The tribunals have chosen different valuation methods and valuation dates for similar situations, resulting in significant differences in valuation results. Thirdly, there was a lack of consistent practice with respect to interest-related issues, such as the choice of the appropriate rate of interest, the duration of the interest period, the question of compounding, and whether to distinguish between interest before and after the arbitral award.

Doubts on the Accuracy of the Arbitration Tribunal's Award on Issues of Inconsistency and Unpredictability

Scholars Jonathan Bonnitcha, Malcolm Langford, Jose M. Alvarez-Zarate, and Daniel Behn (2021) have explored the correctness of the arbitral tribunal's handling of compensation issues from the perspective of the choice and application of valuation methods. Currently, the correctness of the selection and application of the DCF method in some cases is questionable. When referring to the DCF method in the commentary on Article 36 of the Draft Articles on the Liability of States for Internationally Wrongful Acts, it is pointed out that there will be a series of difficulties in determining the value of capital using the discounted cash flow method. This method involves the analysis of various speculative factors such as discount rate, currency fluctuation, inflation figure, commodity price, interest rate, and other business risks, which have a significant impact on the results. Compared with tangible assets, profits (as well as intangible assets calculated based on income) are more susceptible to business and political risks, especially when predicting the future. In previous cases where arbitral tribunals awarded future loss of profits, the expected income stream involved had often been sufficiently determined and considered as an interest protected by law. This is usually achieved through contractual arrangements or reliable transaction history. However, the circumstances involved in the case of Tethyan Copper v Pakistan call into question the correctness of the valuation obtained by the arbitral tribunal's choice of the DCF method. In this

case, when investors were denied the right to grant mining leases, they had not yet reached any mining agreement with Pakistan to stipulate royalty rates and other issues. Therefore, even if Pakistan complied with its obligations under the investment treaty and issued mining leases required for the project, there is still great uncertainty about whether mining agreements can be signed and how financial-related terms are stipulated. However, the arbitral tribunal ignored this uncertainty and adopted the expert witness's opinion from the investor side, based on the assumption that Pakistan would sign mining agreements and that these agreements included terms favorable to investors. The correctness of this method is questionable because even if Pakistan issued mining leases, it still had great freedom to decide whether to sign mining agreements with investors and how to stipulate the terms of these agreements. The investor's expectations of future income do not constitute a legally protected interest with sufficient certainty.

The accuracy of the award of compensation is closely linked to the extent to which the arbitral tribunal has elucidated its decision-making process regarding compensation. Investment arbitration tribunals often fall short in explaining their methodology for determining the amount of compensation, and there is a lack of specific discourse on why a particular valuation method was selected. In certain instances, it appears that arbitral tribunals have simply opted for a middle ground between parties' valuations. Furthermore, despite a significant increase in claimed damages over time, the ratio between investors' claims and final awards by arbitral tribunals has remained consistent for decades, lending some support to the argument that tribunals have anchored their decisions based on investors' initial claims.

Independence and Impartiality of Arbitrators and Expert Witnesses

Due to the professional nature of compensation issues, the arbitral tribunal often needs to rely on the opinions of expert witnesses. However, it seems that valuation experts have formed two camps, with some repeatedly being hired by investors and others being hired by the host country. There are often significant differences in the calculation of damages between the two sides, which makes the expert witnesses hired by both parties to the dispute considered as "hired guns". This leads to doubts about the credibility of expert opinions. However, there is currently a lack of regulations in investment arbitration on the independence, impartiality, and credibility of expert witnesses, as well as the withdrawal of experts when they do not meet such qualifications. Due to the lack of uniform rules of evidence and conduct in investment arbitration, the regulations for expert participation in the proceedings vary from arbitration to arbitration. For example, Article 35 of the ICSID Arbitration Rules stipulates that experts can be questioned by parties and the tribunal. It requires each expert witness to make the following statement: "I solemnly declare on my honor and conscience that my statement is in accordance with my true beliefs". This provision seems to aim to ensure the independence and impartiality of experts; however, it does not involve relevant regulations on the examination of the independence, impartiality, and credibility of expert witnesses, nor does it provide for handling methods when experts do not meet these regulations. Similarly, Article 29 of the UNCITRAL Rules on Transparency in Treaty-Based Investor-State Arbitration stipulates the requirements for designated expert witnesses by the arbitral tribunal, but does not involve relevant provisions for expert witnesses designated by parties. Article 29 of the UNCITRAL Rules on Transparency in Treaty-Based Investor-State Arbitration indicates that before the arbitral tribunal designates expert witnesses, parties may inform the arbitral tribunal whether they have any objections to the qualifications, impartiality, or independence

of the experts designated by the arbitral tribunal. Although Articles 5 and 6 of the IBA Rules on Taking of Evidence in International Arbitration provide more detailed regulations on expert witnesses participating in arbitration, they do not involve rules on questioning experts or their opinions.

Reform Path of Compensation System

The analysis above shows that the problems existing in the present compensation system are the common result of both substantive and procedural issues. Therefore, the direction of reform includes the following aspects.

1. A multifaceted strategy should be adopted to reduce the probability of extreme levels of compensation in awards. Firstly, the compensation criteria in the ISDS mechanism should be re-examined to better reflect the principles of fairness and justice in international law. This includes the inclusion of more restrictive factors in the compensation criteria, such as consideration of the impact of the compensation on the economy and society of the host country. Secondly, arbitral tribunals should be more prudent in selecting and applying valuation methods in calculating compensation, especially when using the DCF method, which should take into account the specific risks of the project and the uncertainty of the market, so as to avoid over-prediction of future returns. Once again, it was advocated that the arbitral tribunal should adopt a mixed valuation methodology in practice, so as to consider various valuation factors in a more comprehensive manner through the comprehensive consideration and mutual corroboration of different valuation methods, and fully explain the reasons for choosing a particular valuation date and methodology in the award, so as to enhance the legitimacy and fairness of the award.

2. The inconsistency of existing compensation standards affects the predictability and legitimacy of awards. The key to solving this problem lies in enhancing the transparency and consistency of compensation standards in international investment law. Firstly, international investment agreements should be more explicit and detailed in their compensation provisions to reduce uncertainty in their application by arbitral tribunals. Secondly, more uniform guidelines should be established to provide arbitral tribunals with standards to refer to when making awards. In addition, the strengthening of academic research on international investment law and the interaction between arbitration practice would help to form a more consistent standard of compensation. Through these measures, the consistency and fairness of compensation awards in international investment arbitration can be gradually improved, thereby enhancing the effectiveness and legitimacy of the international investment legal system.

3. In selecting a valuation methodology, the complexity and uniqueness of the case should be taken into account. A hybrid valuation approach can be used, combining income-based (e.g., DCF method) and asset-based (e.g., book value, replacement value) approaches to take into account a fuller range of factors. For example, the potential value and market prospects of an investment project that has not yet generated profits can be considered, rather than just the current book or liquidation value. At the same time, double counting should be avoided to ensure that the valuation is reasonable. To achieve a reasonable choice of valuation date and valuation method, experienced economists, accountants, and legal experts could be engaged as expert witnesses to provide specialized advice on complex valuation issues. These experts can help the arbitral tribunal understand the characteristics of a particular industry, assess market dynamics, and provide advice on valuation methods. In addition, in arbitral awards, the tribunal should fully explain the reasons for choosing a particular valuation date and methodology. Transparent and detailed explanations could increase the acceptability of decisions and provide

guidance for future cases. At the same time, it would help to enhance the legitimacy of the decision-making and the fairness of the arbitration process.

4. With the increasing frequency of multi-million and multi-billion dollar awards, the issue of the qualifications of expert witnesses cannot be ignored. The credibility of valuation opinions was at the heart of the legitimacy of the investment arbitration system, and there should therefore be a systematic set of criteria for the participation of expert witnesses in investment arbitration. Secondly, the transparency, detail, and professionalism of arbitral awards should be enhanced. Arbitral tribunals should be transparent and impartial throughout the award process, provide detailed reasons to support their awards, and ensure the professionalism of their economic and financial analyses. These measures will help to enhance the credibility and acceptance of the awards and ensure that the awards are based on full consideration and comprehensive analysis rather than on simple compromises or estimates, which is essential to ensure the independence and impartiality of the ISDS mechanism and the awards it makes.

Suggestions for Improving China's Investment Arbitration Compensation System

As China gradually becomes a two-way power in the field of international investment, the legislative and judicial practices involving ISDS compensation are increasing, but at the same time, challenges such as high compensation, inconsistent rulings, and conflicts of interest are also brought. China should proceed from the balance between state sovereignty and investment protection to promote the improvement and specific practice of the ISDS compensation system. On the one hand, China should promote the construction and improvement of the ISDS compensation system at the domestic and international law levels, and on the other hand, we should make full use of the existing ISDS mechanism to deepen the practice of issues related to the ISDS compensation system.

Perfection of the ISDS Compensation Entity Rules

Firstly, China should emphasize the significance of national sovereignty in the substantive rules pertaining to investment compensation. A notable illustration of this stance is evident in the EU-China Comprehensive Agreement on Investment, which was negotiated between China and the European Union. While safeguarding the rights and interests of foreign investors, this agreement also underscores the importance of national security and sovereignty. Similarly, China's Foreign Investment Law, implemented in 2019, reflects a legal framework that strikes a balance between protecting foreign investors' rights and interests and safeguarding national interests. The law not only emphasizes equitable treatment for foreign investors but also establishes a mechanism for conducting national security reviews to assess potential threats posed by foreign investments.

Secondly, it is crucial for China to further elucidate the applicable standards, valuation methods, and restrictive factors concerning investment compensation within the substantive rules governing such matters. This clarity plays an essential role in ensuring a fair and transparent compensation process—a growing focus within international investment law practice as well. When formulating or revising laws related to compensation, China should consider international practices such as adhering to principles like "fair and just treatment" along with adopting standards like "full compensation". These internationally recognized principles should be incorporated into China's domestic legal system to provide a clear and equitable benchmark for handling international investment disputes.

Improvement of ISDS Compensation Procedure Rules

In arbitration proceedings, China actively supports and promotes the transparency of the International Investment Dispute Settlement, both in multilateral and bilateral investment treaty negotiations. It advocates for increased openness in judicial proceedings, allowing non-parties to submit amicus curiae briefs and implementing other measures. China proposes enhancing the existing two-level system for arbitrator selection and supervision mechanism, as well as improving transparency within the ISDS compensation system. By establishing a clear compensation policy and fostering a stable investment environment, China aims to enhance its appeal as a host country while simultaneously cultivating a more positive and trustworthy image within the international investment community.

Conclusion

This article provides a concise analysis of the current state of compensation settlement issues in investment arbitration and explores the underlying reasons for these challenges. Based on this, we propose a targeted reform plan aimed at establishing a compensation system that balances the interests of host countries and investors while promoting the healthy operation of the international investment law system. The ISDS compensation system is facing increasingly prominent challenges regarding the reasonableness of compensation amounts, consistency in rulings, and handling conflicts of interest. To address these challenges, China should adopt a more comprehensive and forward-looking strategy. On one hand, we need to re-examine existing ISDS compensation rules from an institutional design perspective to ensure they meet current international investment needs and challenges. On the other hand, we must continuously assess and update mechanisms based on specific implementation effects analyzed through ISDS practice analysis mechanisms while making necessary adjustments according to changes in global economic and legal environments. Through these efforts, we can promote establishing a more just and efficient ISDS ensuring continued stability and prosperity within global investment environments—which holds great significance towards long-term construction & development within international investment law systems.

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