

REGULATORY EXPROPRIATION IN THE JURISPRUDENCE OF ICSID ARBITRAL TRIBUNAL

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Table of contents

Introduction.....	1
Chapter 1. Sole Effect Doctrine	8
1.1. Substantial deprivation rule	8
a) Deprivation in value.....	10
b) Loss of control	13
c) Duration	17
1.2. Assessment of criteria	19
Chapter 2. Police Powers Doctrine	25
2.1. Criteria for non expropriatory regulatory measure	28
a) Public purpose.....	29
b) Nondiscriminatory	33
c) Proportionality	37
2.2. Assessment of criteria	41
Conclusion	50
Bibliography	53

Abstract

Regulatory expropriation is an uncertain concept that raised wide discussions in international investment law regarding determining the compensable and non-compensable regulatory measures and balance of investors' interests and States' interests. Practice of arbitral tribunals is contradictory and does not provide for clear distinction between such measures. There have been developed two approaches to determine compensable and non-compensable regulatory measures which are the sole effect doctrine and police powers doctrine. Analysis of the case law, arbitral tribunals' practice and scholarly writings and critical assessment of these two approaches revealed numerous shortcomings. This thesis is limited to ICSID cases.

For the more comprehensive and balanced approach in determining the regulatory expropriation these two approaches shall be used both. Analysis showed that it is problematic to provide for clear and distinct criteria for expropriatory and non-expropriatory regulatory measures. It is suggested that the States shall provide for qualifying or exceptional criteria of indirect expropriation in investment treaties to avoid uncertainty and broad interpretation by arbitral tribunals.

Introduction

Indirect expropriation or regulatory expropriation is one of the mostly debated topics in international investment law since there is no clear definition of it and it clashes with the State's right to regulate. It is not clear when the State's actions and measures aimed at regulating public welfare that might adversely affect investments may qualify as expropriation and when not. Arbitral tribunal's practice is contradictory in this matter and does not provide for a clear answer as well.

However, in order to understand the nature and issues of the regulatory expropriation, it is first necessary understand the concept of expropriation in general. Expropriation is when the State is taking property of private entity (investor) without its will. Taking is expressed in the transfer of the title of the investment and deprivation of the property rights.¹ The concept of expropriation is well known in international investment law and the State's right to expropriate has been well recognized.² State is not precluded to exercise expropriation condition to meet certain requirements.

There are different types of expropriation. It can be direct and indirect. In case of direct expropriation, the State implements its right to expropriate, it is 'a clear action by the State that transfers title of the project from the investors to the State and as such provides clear grounds for the deprived investors to seek compensation from the State'.³ Example of the

¹ Surya P Subedi, *International Investment Law Reconciling Policy and Principle* (2nd edn, Hart Publishing 2012) 118.

² Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (2nd edn, Oxford University Press 2012) 98-99.

³ 'Expropriation - Investment Protection and Mitigating the Risks' (*Nortonrosefulbright.com*, 2010) <<http://www.nortonrosefulbright.com/knowledge/publications/30459/expropriation-investment-protection-and-mitigating-the-risks>> accessed 26 October 2016.

direct expropriation can be nationalization program of the State, where there is a clear, open act of the State requiring transfer of the property rights of investor.

It shall be noted that most of the Bilateral Investment Treaties and International Investment Treaties contain provisions regarding expropriation, stipulating that State may expropriate investors property under certain conditions. Such conditions are also part of the international customary law. Expropriation shall be conducted in ‘public interest’, measures taken by the State shall not be ‘arbitrary, discriminatory’ and the State shall ‘promptly, adequately, and effectively’ compensate the investor.⁴ Mentioned conditions are derived from the traditional principle called ‘Hull doctrine’ that provides ‘under every rule of law and equity, no government is entitled to expropriate private property, for whatever purpose, without provision for prompt, adequate and effective payment therefore’.⁵ Usually compensation is understood when investors shall receive market value of the investment. However, direct expropriations nowadays happen rarely. States tend to avoid direct expropriation measures to keep investment climate of State attractive.⁶

States are likely to exercise indirect measures not to impose themselves to obligation of compensation. Therefore, the most common form of expropriation is an indirect expropriation or measures that have similar effect or as usually referred as having ‘equivalent effect’ or measures ‘tantamount to expropriation’.⁷ In case of indirect expropriation there is no clear definition and it’s based on different factors. The main feature of indirect expropriation is that

⁴ Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (2nd edn, Oxford University Press 2012) 98-99.

⁵ Meg N Kinnear and others, *Building International Investment Law: The First 50 Years of ICSID* (Kluwer Law International 2016) 448.

⁶ Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (2nd edn, Oxford University Press 2012) 100.

⁷ Peter D. Isakoff, ‘Defining the Scope of Indirect Expropriation for International Investments’, (2013) 3 Global Bus. L. Rev. 189 <<http://engagedscholarship.csuohio.edu/gblr/vol3/iss2/4>> accessed 14 February 2017.

property rights of investors are not transferred, investors remains as an owner of the property. However, the State implements such actions that practically investors cannot enjoy its property rights through inability to exercise control, management, operate and derive benefits from investments even though he still has title over the investment. States usually do not declare and recognize expropriation in such cases and therefore do not compensate investors. Consequently, investors usually bring proceedings against the State claiming that expropriation took place and therefore compensation shall be paid.⁸

Correspondingly, investment treaties reflect this issue and it can be stated with certainty that most of the Bilateral Investment Treaties include indirect expropriation in its provisions. For example, Canada-Hong-Kong Bilateral Investment Treaty entered into force in September 2016 states that party

“may not expropriate a covered investment either directly or *indirectly* through measures having an *effect equivalent* to expropriation, except for a public purpose, in accordance with due process of law, in a non-discriminatory manner and on payment of compensation” (emphasis added).⁹

It is apparent that protection of investors’ rights is the center of concern in international investment law, which creates imbalance of rights and interests between investors and the host States. Such imbalance of rights and interests led to one of the disputed and contradictory issues in international investment law, the issue of ‘regulatory expropriation’.¹⁰ Regulatory

⁸ Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (2nd edn, Oxford University Press 2012) 101.

⁹ Agreement between The Government of Canada and the Government of the Hong Kong Special Administrative Region of the People’s Republic of China for the Promotion and Protection of Investments, 10.02.2016, <<http://investmentpolicyhub.unctad.org/Download/TreatyFile/5094>> accessed 15 February 2017.

¹⁰ Surya P Subedi, *International Investment Law Reconciling Policy and Principle* (1st edn, Hart Publishing 2008) 160-161.

expropriation is when the State exercises its right to regulate by implementing regulatory measures aimed at protecting general welfare of public. Such measures may affect investors, where they might be deprived of enjoyment of investment benefits, investment project might become less profitable and burdensome to implement because of the imposed regulatory measures.¹¹ For example, the State may impose compliance with the environmental protection standards or ban import of some material, substance that has adverse effects on environment and people's health.

The issue arises is whether such measures will amount to expropriation or not? There is no definite answer to this question. Arbitral tribunals' practice is contradictory. In some cases, arbitral tribunals decided that the State's measures aiming at protecting environment constituted expropriation and accordingly compensation to the investor shall be paid and in other cases it decided that environmental measures were implementation of the State's police powers and therefore did not entail compensation.¹²

International law nowadays does not provide for a distinct, clear line between the regulatory measures that are non expropriatory which are accordingly do not entail compensation and measures that considered as expropriation and compensable.¹³ Arbitral tribunal addressed this problem of uncertainty in case of *Saluka v. Czech Republic*:

“International law has yet to identify in a comprehensive and definitive fashion precisely what regulations are considered ... as falling within the police or regulatory power of State and, thus, non-compensable. In other words, it has yet to draw a bright

¹¹ A. Newcombe, 'The Boundaries of Regulatory Expropriation In International Law' (*Oxford Journals, Law and Social Sciences*, 2005) <<http://icsidreview.oxfordjournals.org/content/20/1/1.extract>> accessed 9 December 2016.

¹² Meg N Kinnear and others, *Building International Investment Law: The First 50 Years of ICSID* (Kluwer Law International 2016) 447-449.

¹³ *ibid* 461.

and easily distinguishable line between non-compensable regulations on the one hand and, on the other, measures that have the effect of depriving foreign investors of their investment and are thus unlawful and compensable in international law.”¹⁴

Therefore, it is problematic to predict the outcome of the dispute between the State and investors. For example, there is a case where award has not been rendered yet, but raised a lot of discussions and disputes. This case is between Germany and Swedish investor (Vattenfall AB and others v. Germany) who invested in the nuclear power plants. However, in 2011 Germany after the Fukushima disaster amended its Atomic Energy Act that led to shut down of power plants that investor was operating in order to protect public health, environment and public welfare. Investor claimed that such actions constitute indirect expropriation and therefore compensation shall be paid.¹⁵ It is disputed whether adopted measures by Germany constitute expropriation because investor was deprived of his investments or it is an exercise of its sovereign right to regulate and protect public interests and therefore not an expropriation. This example perfectly illustrates the problem of uncertainty in regulatory expropriation issues. It is hard to determine when expropriation took place and when there is exercise of the State’ regulatory power. Moreover, it is not clear how arbitral tribunal will decide this case.

There have been two doctrines developed that aimed to determine whether the State’s regulatory measure will amount to indirect expropriation or not. They are ‘sole effect doctrine’ and ‘police powers doctrine’. Sole effect doctrine is focused on evaluating what effect, economic impact measure had on the investment. While police powers doctrine on the opposite

¹⁴ Meg N Kinnear and others, *Building International Investment Law: The First 50 Years of ICSID* (Kluwer Law International 2016) 461

¹⁵ Nathalie Bernasconi-Osterwalder and Martin Dietrich Brauch, 'The State Of Play In Vattenfall V. Germany II: Leaving The German Public In The Dark' (*International Institute for Sustainable Development*, 2014) <: <http://www.iisd.org/sites/default/files/publications/state-of-play-vattenfall-vs-germany-II-leaving-german-public-dark-en.pdf>> accessed 5 February 2017.

focused on the intent, purpose, character of the measure even in case of economic deprivation of the investments.¹⁶

Purpose of this research paper is to extent possible distinguish between compensable and non-compensable regulatory expropriation. Analyze two approaches used by the arbitral tribunals and provide critical assessment of them and whether these approaches are reconcilable. Thus, focus of this paper are the sole effect doctrine and police power doctrine. Comparative analysis and assessment of these approaches will be conducted through the case study on expropriation issues and scholarly writings. This paper is limited to ICSID arbitral tribunal cases.

This research paper adds to the discussions concerning the regulatory expropriation by clarifying, providing critical assessment and distinguishing between the two opposite approaches taken by the arbitral tribunals.

Sole effect doctrine and police powers doctrine are completely different and opposite approaches. For the more comprehensive and balanced approach in determining the regulatory expropriation these two approaches shall be used both. Analysis showed that it is problematic to provide for clear and distinct criteria for expropriatory and non-expropriatory regulatory measures. It is suggested that the States shall provide for qualifying or exceptional criteria of indirect expropriation in investment treaties.

The first Chapter will look at the sole effect doctrine, go through the criteria that are used to assess the substantial deprivation of the investment which includes deprivation in value, loss of control and duration of the regulatory measure. The second Chapter will assess the police power doctrine and criteria that are used to evaluate the regulatory measure which are

¹⁶ Ben Mostafa, "The Sole Effects Doctrine, Police Powers and Indirect Expropriation under International Law" (2008) 15 (1) Australian International Law Journal
<<http://www.austlii.edu.au/au/journals/AUIntLawJl/2008/12.pdf>> accessed 15 February 2017.

public purpose, nondiscrimination and proportionality. Conclusion of this research paper will provide overall assessment of the carried-out research, its implications and recommendations.

Chapter 1. Sole Effect Doctrine

There is no clear and certain definition of indirect expropriation and uniform approach to determine it. Arbitral tribunals developed several different approaches to determine indirect expropriation and one of the dominant approach applied is known as the “sole effect doctrine”.¹⁷ This approach was termed by Rudolf Dolzer as such because it concentrates only on the effect that the State’s measure had on the investment.¹⁸

1.1. Substantial deprivation rule

Mostly cited cases by arbitral tribunals in determining indirect expropriation and evaluating the effect of the measure are *Santa Elena v. Costa Rica* and *Tecmed v. Mexico* ICSID cases. In particular, *Tecmed v. Mexico* arbitral tribunal stated that “it must first be determined if the Claimant... was *radically deprived* of the economical use and enjoyment of its investments... assets involved have *lost their value*...” (emphasis added), arbitral tribunal also added that measures are expropriatory if they are “irreversible and permanent.”¹⁹

What is important that these cases examined not only whether the property, title to it were taken away from the investor but went further and looked at the impact of regulatory measure on the investment. Especially in cases where investor holds property title over its

¹⁷ Maurizio Brunetti, 'Introduction' (2003) 5 International Law FORUM du droit international <<http://booksandjournals.brillonline.com/content/journals/10.1163/138890303322398350>> accessed 24 March 2017.

¹⁸ Ben Mostafa, “The Sole Effects Doctrine, Police Powers and Indirect Expropriation under International Law” (2008) 15 (1) Australian International Law Journal. <<http://www.austlii.edu.au/au/journals/AUIntLawJl/2008/12.pdf>> accessed 15 February 2017.

¹⁹ *Tecnicas Medioambientales Tecmed, S.A. v. United Mexican States*, ICSID case No. ARB(AF)/00/2, Award (29 May 2003) p. 115-116, <<http://www.italaw.com/sites/default/files/case-documents/ita0854.pdf>> accessed 15 February 2017 (hereinafter *Tecmed v. Mexico*).

investment after regulatory measure was adopted, evaluation of investor's capability to enjoy, benefit from its investments is an important step on determining indirect expropriation.²⁰

After this kind of examination of regulatory measures in light of expropriation, this approach was followed in other ICSID cases by arbitral tribunals. Arbitral tribunal in *Roussalis v. Romania* case stated that when deciding whether indirect expropriation took place the main issue that tribunal need to address is the effect of the measure on the investment.²¹

Burlington Resources v. Ecuador arbitral tribunal provided that "there is an indirect expropriation when the effects of the challenged measure are *equivalent to a taking*. In particular, the investor must show that the challenged measure caused a *total and permanent loss of value or control* of the investment." (emphasis added)²²

In *Electrabel v. Hungary* arbitral tribunal stated that investor shall provide that following occurred "substantial, radical, severe, devastating or fundamental deprivation of its rights or the virtual annihilation, effective neutralization or factual distraction of its investment, its value or enjoyment."²³

Based on the mentioned above arbitral tribunals' statements it can be drawn that the core issue that shall be examined is the effect that regulatory measure had on the investment and to what extent it impacts it. Analysis of arbitral tribunals provides for a threshold to evaluate the effect of the measure which is known as "substantial deprivation" of an

²⁰ Meg N Kinnear and others, *Building International Investment Law: The First 50 Years of ICSID* (Kluwer Law International 2016) 355.

²¹ Spyridon Roussalis v. Romania, ICSID case No. ARB/06/1, Award (7 December 2011) 328, <<http://www.italaw.com/cases/927>> accessed 14 February 2017 (hereinafter Roussalis v. Romania).

²² Burlington Resources Inc. Republic of Ecuador, ICSID case No. ARB/08/5, Decision on Liability (14 December 2012) 156, <<http://www.italaw.com/cases/181>> accessed 16 February 2017 (hereinafter Burlington Resources v. Ecuador).

²³ Electrabel S.A. v. Republic of Hungary, ICSID case No. ARB/07/19, Decision on Jurisdiction (30 November 2012), <<http://www.italaw.com/cases/380>> accessed 14 February 2017 (hereinafter Electrabel v. Hungary).

investment.²⁴ Effect of the measure shall deprive investor fundamentally, substantially of its rights. Such measure shall have same or equivalent effect as direct expropriation would have. The effect shall lead to substantial deprivation of the value of investment and inability to control it. In addition, duration of the effect shall be permanent or last for an extensive period.

Therefore, substantial deprivation analysis provides for criteria which are: examination of decrease of investments' value, loss of control over the investment and duration of the regulatory measure.

a) Deprivation in value

Measure adopted by the State shall have such effect that will decrease the value of investment substantially. A good example of application of this criterion can be the ICSID case *Metalclad v. Mexico*. In this case investor is a U.S. corporation bought company that had federal permits to build hazardous waste landfill in Guadalupe, Mexico. However, after 5 months since construction began, municipal authorities of Guadalupe, Mexico informed Metalclad that it was operating unlawfully that it shall obtain municipal construction permit. Investor submitted application for municipal construction permit. While the application was reviewed by municipal authorities, Metalclad finished construction of the landfill relying on federal permits. Municipal authorities denied investor's application even though landfill was already completed. In addition, municipal authorities stated that land in question became protected area for the reservation of rare cacti by adopting ecological decree. As a result, investor could not operate landfill and claimed that expropriation took place. Arbitral tribunal

²⁴ Ben Mostafa, "The Sole Effects Doctrine, Police Powers and Indirect Expropriation under International Law" (2008) 15 (1) Australian International Law Journal
<<http://www.austlii.edu.au/au/journals/AUIntLawJl/2008/12.pdf>> accessed 15 February 2017.

found that actions of municipal authorities amounted to indirect expropriation.²⁵ Arbitral tribunal in its analysis provided that:

“expropriation...not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title... but also covert or incidental interference with the use of property which has the effect of depriving the owner in *whole* or in *significant part*, of the use of reasonably-to-be-expected *economic benefit of property* even if not necessarily to the obvious benefit of the host State (emphasis added).”²⁶

Arbitral tribunal when evaluating the losses stated that “the complete frustration of the operation of the landfill and negate the possibility of any meaningful return on Metalclad's investment.”²⁷ In this case, measures adopted by municipal authorities, i.e. denial of issuing permit and adoption of ecological decree had effect on the investment that led to complete loss of investment's value. Since Metalclad was not able to operate the landfill and it could not be used for other purposes investor therefore lost his investments.

The question that arises when considering substantial deprivation is what is the threshold for decrease of investment's value? When is it enough to constitute substantial decrease of value? In *Tokios Tokeles v. Ukraine* case arbitral tribunal stated that:

“Although neither the relevant treaty text nor existing jurisprudence have clarified the precise degree of deprivation that will qualify as “substantial”, one can reasonably infer

²⁵ Metalclad Corporation v. The United Mexican States, ICSID Case No. ARB(AF)/97/1, Award (30 August 2000), < <http://www.italaw.com/sites/default/files/case-documents/ita0510.pdf>> accessed 9 December 2016 (hereinafter Metalclad v. Mexico).

²⁶ Ibid., p. 103.

²⁷ Ibid., p. 113.

that a diminution of 5% of the investment's value will not be enough for a finding of expropriation, while a diminution of 95% would likely be sufficient.”²⁸

However, there are cases when arbitral tribunal did not follow this reasoning. In case of *LG&E v. Argentina* arbitral tribunal found that there was no substantial deprivation of investments. Investor claimed expropriation due to the measures that Argentina adopted because of the economic crisis in the country. LG&E acquired shares of 3 companies in the field of gas distribution under the privatization program of Argentina. In order to attract investors Argentina granted licenses for a long period, adopted several laws that provided for different guarantees, like calculation of tariffs in US Dollars, semi-annual tariff adjustments and other guarantees related to tariffs providing high degree of protection of investor's interests. However due to the economic crisis in the country, Argentina abolished provided earlier guarantees, adopted new laws, and forced renegotiation of the contracts. Investor claimed that there was an indirect expropriation, regulatory measures taken by the state substantially effected the shares value they reduced for more than 90%. Argentina in opposite argued that there is no causal link between the adopted measures and the value of the investment.²⁹

Arbitral tribunal's analysis in terms of the decrease of value claim looked at the extent the measure interfered, specifically its economic impact. The latter shall be “sufficiently severe”, “substantial” to result in compensation. Arbitral tribunal acknowledged that Argentina adopted “severe measures” that in some way impacted the investment, however such measures “did not deprive the investors of the right to enjoy their investment”.³⁰ Investment was still

²⁸ Tokios Tokeles v. Ukraine, ICSID case No. ARB/02/18, Award (26 July 2007) 120, <<http://www.italaw.com/cases/1099>> accessed 18 February 2017.

²⁹ LG&E Energy Corp., LG&E Capital Corp., LG&E International Inc. v The Argentine Republic, ICSID case No. ARB/02/1, Award (27 July 2007), <<http://www.italaw.com/cases/documents/623>> accessed 18 March 2017 (hereinafter *LG&E v. Argentina*).

³⁰ Ibid, 198.

present it has not “ceased to exist” and investor did not lose control over his investments. It did not impact all or substantial part of the investment’s value. Arbitral tribunal stated that there is no indirect expropriation “without a permanent, severe deprivation... with regard to its investment or almost complete deprivation of the value of LG&E’s investment”.³¹

Therefore, even though adopted measures were harsh and it was claimed that value of investments decreased for more than 90% this is not the only factor taken into account. Investor was still able to enjoy his investments. There was no total deprivation or nearly to it, value of the shares fluctuated for some time during the crisis, but it is a usual business risk.

There is no definite threshold to determine substantial deprivation of investment’s value. However, approach developed by arbitral tribunals is that it shall be severe, complete loss or close to it. Investment shall cease to exist; no income or benefits could be obtained. Whole investment shall be effected or its substantial part that is close to total loss.

b) Loss of control

Another criterion in determining substantial deprivation is loss of control over the investment. In case of indirect expropriation as it was mentioned above title of property may not be transferred to State, investor might be still legal owner of the investment. However, regulatory measures of State may affect investment in such a way that in practice investor is not able to control, manage its investment, for example carry out day to day operations.³²

One of the first and mostly cited cases that dealt with the issue of investor’s ability to control are *Starrett Housing Corp. v. Iran* and *Tippetts* cases. These cases were considered by

³¹ LG&E Energy Corp., LG&E Capital Corp., LG&E International Inc. v The Argentine Republic, ICSID case No. ARB/02/1, Award (27 July 2007) p. 200, <<http://www.italaw.com/cases/documents/623>> accessed 18 March 2017.

³² Ben Mostafa, “The Sole Effects Doctrine, Police Powers and Indirect Expropriation under International Law” (2008) 15 (1) Australian International Law Journal.

Iran-United States Claims Tribunal and provide a good example and understanding of loss of control criterion.³³ In *Starrett Housing Corp. v. Iran* investor contracted with the State to carry out project on construction of apartments. Shah Goli Apartment Company was established under the laws of Iran to carry out the project. Investor through the subsidiaries owned 79.7% of shareholding of Shah Goli Apartment Company. Starrett Housing Corp. claimed that government of Iran indirectly expropriated its investments by appointing temporary manager in Shah Goli Apartment Company. Thus, investor as a shareholder of the mentioned company could not carry out its management rights. Arbitral tribunal in this case found in favor of investor and stated:

“the succinct language of this act makes it clear that the appointment of... a Temporary Manager in accordance with its provisions deprived the shareholders of their right to manage Shah Goli. As a result of these measures the Claimants could no longer exercise their rights to manage Shah Goli and were deprived of their possibilities of effective use and control of it”.³⁴

In *Tippetts* case there was similar situation Government of Iran appointed temporary manager and arbitral tribunal found in favor of investor stating that:

“While assumption of control over property by a government does not automatically and immediately justify a conclusion that the property has been taken by the government, thus requiring compensation under international law, such a conclusion is

³³ Rudolf Dolzer and Felix Bloch, 'Indirect Expropriation: Conceptual Realignment?' (2003) 5 International Law FORUM du droit international
<<http://booksandjournals.brillonline.com/content/journals/10.1163/138890303322398350>> accessed 27 March 2017.

³⁴ *Starrett Housing Corporation, Starrett Systems, Inc., Starrett Housing International, Inc., v. The Government of the Islamic Republic of Iran, Bank Omran, Bank Mellat, Interlocutory, No ITL 32-24-1, Award* (19 December 1983), summary of the case available at
<https://www.biicl.org/files/3945_starrett_housing_synopsis.pdf> accessed 20 March 2017 (hereinafter *Starrett Housing Corp. v. Iran*).

warranted whenever events demonstrate that the owner was deprived of fundamental rights of ownership and it appears that this deprivation is not merely ephemeral.”³⁵

In this case, arbitral tribunal pointed out that investor was denied of his fundamental property rights since he could not control his investments. As professor Christie pointed out that “the most fundamental right an owner of property has is the right to participate in its control and management.”³⁶

ICSID arbitral tribunal in *Santa Elena v. Costa Rica* case cited the *Tippetts* case and relied on the mentioned above statement. Investor bought several land plots in Costa Rica to create resorts and attract tourists, however State by adopting decree expropriated those lands for environmental purposes, to create national parks. Investor was still owner of those lands however could not implement his project. Loss of control in this case was discussed when determining the moment when expropriation took place. Arbitral tribunal pointed out that it needs to determine to what degree that adopted measure denied investor of “the normal control of his property”.³⁷ Whether adopted decree prevented investor “reasonably to exploit the economic potential of the property”.³⁸ Arbitral tribunal found that regulatory measure adopted by the State prevented investor to use his investment, its property rights were “effectively

³⁵ Tippetts, Abbott, McCarthy, Stratton v TAMS-AFFA, No 141-7 Award (29 June 1984), reprinted in 6 Iran-US CTR, available at

<[http://portaldace.mineco.gob.gt/sites/default/files/unidades/DefensaComercial/soluciondediferencias/Casos%20Soluci%C3%B3n%20de%20Controversias/Centro%20Internacional%20de%20Arreglo%20de%20Diferencias%20Relativas%20a%20Inversi%C3%B3n/Inversionista%20-%20Estado/Etapa%20de%20Meritos%2007-23%20\(Ferrovias\)/Claimants%20Experts/Expert%20Docs/Reisman/FN%2020%20\(a\).pdf](http://portaldace.mineco.gob.gt/sites/default/files/unidades/DefensaComercial/soluciondediferencias/Casos%20Soluci%C3%B3n%20de%20Controversias/Centro%20Internacional%20de%20Arreglo%20de%20Diferencias%20Relativas%20a%20Inversi%C3%B3n/Inversionista%20-%20Estado/Etapa%20de%20Meritos%2007-23%20(Ferrovias)/Claimants%20Experts/Expert%20Docs/Reisman/FN%2020%20(a).pdf)> accessed 20 March 2017 (hereinafter “Tippetts”).

³⁶ Magdalena Pucher Holmer, “Regulatory expropriation under international investment law” (Master thesis, University of Lund 2006).

³⁷ *Compañía del Desarrollo de Santa Elena, S.A. v. Republic of Costa Rica*, ICSID Case No. ARB/96/1, Final Award (17 February 2000) p. 76 <http://www.italaw.com/documents/santaelena_award.pdf> accessed 20 March 2017 (hereinafter *Santa Elena v. Costa Rica*).

³⁸ *ibid.*

blighted or sterilised because the Property could not, thereafter, be used for the development purposes for which it was originally acquired”.³⁹

An illustrative example of the case when arbitral tribunal did not find loss of control can be the described earlier *LG&E v. Argentina* case. In this case investor, did not lose control over the investment, i.e. shares in the companies although value of investment was changing due to the crisis, he was still able to manage companies and carry out its day to day tasks in the same way even after measures were adopted.⁴⁰ Another case that also loss of control was not found is *Marvin Feldman v. Mexico*. Investor was an exporter of cigarettes and the issue was that Mexico denied him tax refunds. Mexico adopted such laws that precluded investor to export cigarettes and he claimed that he lost control of his investments. Arbitral tribunal did not consider such measures as depriving investor of control over his investments, it also stated that investor did not lose shareholding in the company. Even though he was precluded exporting cigarettes he still may conduct other activities that company was carrying out. Arbitral tribunal found that there was no expropriation because investor was not deprived of his right to control.⁴¹ Decision was based solely on the deprivation of control criterion and arbitral tribunal looked at the investment as a whole, it did not review exporting part of the business separately.

When considering loss of control criterion arbitral tribunals analyzed practical impact of the measure, to what extent it had effect on investor’s ability to control investments. It can

³⁹ *Compañía del Desarrollo de Santa Elena, S.A. v. Republic of Costa Rica*, ICSID Case No. ARB/96/1, Final Award (17 February 2000) p. 81 <http://www.italaw.com/documents/santaelena_award.pdf> accessed 20 March 2017.

⁴⁰ *LG&E Energy Corp., LG&E Capital Corp., LG&E International Inc. v The Argentine Republic*, ICSID case No. ARB/02/1, Award (27 July 2007) p. 199, <<http://www.italaw.com/cases/documents/623>> accessed 18 March 2017.

⁴¹ *Marvin Roy Feldman Karpa v. United Mexican States*, ICSID Case No. ARB(AF)/99/1, Award (16 December 2002) p. 142, <<http://www.italaw.com/sites/default/files/case-documents/ita0319.pdf>> accessed 20 March 2017 (hereinafter *Marvin Feldman v. Mexico*).

be done through inability to manage company, implement ownership rights as a shareholder or measures had such an effect that investor could no longer implement the project that it was established for. Even if there was deprivation in value of the investment, there might be no deprivation in control.

c) Duration

Time is also an essential element in determining substantial deprivation. Measures that the States adopts in order to constitute expropriation shall have a permanent effect or last for an extensive period. As arbitral tribunal stated in *Tecmed v. Mexico* “...measures adopted by the State, whether regulatory or not, are an indirect de facto expropriation if they are *irreversible and permanent...*” (emphasis added).⁴²

In *Metalclad v. Mexico* case as it was mentioned above local authorities adopted ecological decree which had effect of prohibiting forever the operation of the landfill. Duration of such regulatory measure is unquestionably permanent.⁴³

In *Wena Hotels v. Egypt* case UK company concluded long-term lease agreements of two hotels in Egypt with Egyptian Hotels Company that was owned by Government of Egypt. However, dispute arose between the parties and Egyptian Hotels Company seized hotels by force. Only after 1 year Wena Hotels regained these hotels. Arbitral tribunal cited *Tippetts* case stating that measures that Egyptian Hotels Company took were lasting for almost a year and were not “ephemeral” and therefore constituted expropriation. In this case 1 year of deprivation

⁴² *Tecnicas Medioambientales Tecmed, S.A. v. United Mexican States*, ICSID case No. ARB(AF)/00/2, Award (29 May 2003) p. 115-116, < <http://www.italaw.com/sites/default/files/case-documents/ita0854.pdf>> accessed 15 February 2017.

⁴³ *Metalclad Corporation v. The United Mexican States*, ICSID Case No. ARB(AF)/97/1, Award (30 August 2000), < <http://www.italaw.com/sites/default/files/case-documents/ita0510.pdf>> accessed 9 December 2016.

of ownership rights were considered by arbitral tribunal as a long term enough to amount to expropriation.⁴⁴

Interesting conclusion had arbitral tribunal in *Starrett Housing Corp. v. Iran* and *Tippetts* cases where temporary managers were appointed in the companies depriving investors of their fundamental ownership rights to control and manage their investments. One could argue that measure that was imposed on the investment was temporary and cannot amount to expropriation. However, arbitral tribunal looked on the real effect that measure had and for how long it may possibly last. The fact that it was called temporary manager does not mean that there will not be substantial deprivation. Arbitral tribunal pointed out that due to the revolution in Iran it is doubtful that investors will regain control in several years or at all.⁴⁵

In *LG&E v. Argentina* case arbitral tribunal did not find that effect of the adopted measures was permanent because “investment has not ceased to exist” and value of the shares rebounded. Expropriation cannot be found if it is not permanent and there is no substantial deprivation.⁴⁶

Therefore, if the effect of the measure resulted in temporary decrease of investment value or loss of control, generally it will not be considered as expropriation. However, due to

⁴⁴ Wena Hotels Limited v. Arab Republic of Egypt, ICSID Case No. ARB/98/4, Award (8 December 2000) p. 98-99, <<http://www.italaw.com/sites/default/files/case-documents/ita0902.pdf>> accessed 21 March 2017 (hereinafter Wena Hotels v. Egypt).

⁴⁵ Tippetts, Abbett, McCarthy, Stratton v TAMS-AFFA, No 141-7 Award (29 June 1984), reprinted in 6 Iran-US CTR, available at <[http://portaldace.mineco.gob.gt/sites/default/files/unidades/DefensaComercial/soluciondediferencias/Casos%20Soluci%C3%B3n%20de%20Controversias/Centro%20Internacional%20de%20Arreglo%20de%20Diferencias%20Relativas%20a%20Inversi%C3%B3n/Inversionista%20-%20Estado/Etapa%20de%20Meritos%2007-23%20\(Ferrovias\)/Claimants%20Experts/Expert%20Docs/Reisman/FN%2020%20\(a\).pdf](http://portaldace.mineco.gob.gt/sites/default/files/unidades/DefensaComercial/soluciondediferencias/Casos%20Soluci%C3%B3n%20de%20Controversias/Centro%20Internacional%20de%20Arreglo%20de%20Diferencias%20Relativas%20a%20Inversi%C3%B3n/Inversionista%20-%20Estado/Etapa%20de%20Meritos%2007-23%20(Ferrovias)/Claimants%20Experts/Expert%20Docs/Reisman/FN%2020%20(a).pdf)> accessed 20 March 2017.

⁴⁶ LG&E Energy Corp., LG&E Capital Corp., LG&E International Inc. v The Argentine Republic, ICSID case No. ARB/02/1, Award (27 July 2007) p. 199, <<http://www.italaw.com/cases/documents/623>> accessed 18 March 2017.

the circumstances of the case arbitral tribunals may also look at the further possibility of investor to enjoy and benefit from his investments.

1.2. Assessment of criteria

As it was demonstrated above sole effect doctrine concentrates only on the effect that measure had on the investment. Case study shows that the State's regulatory measures shall substantially deprive investors of their property rights, ability to enjoy and benefit from their investments in order to constitute indirect expropriation. However, arbitral tribunals do not provide for clear explanation of what is *substantial* deprivation, its qualifying extent? Shall it be 100% of deprivation or more than half is enough? Some tribunals stated that there shall be complete and permanent deprivation of investment's value or control and be equivalent to a taking⁴⁷, meaning that investors shall lose their investments at all, entirely, so there is no possibility for them to use their investments. Also, it shall be equivalent to effect that direct expropriation has. However, in *Metalclad v. Mexico* case arbitral tribunal stated that deprivation of the significant part of investment may also amount to expropriation.⁴⁸ However, in *Marvin Feldman v. Mexico* case, arbitral tribunal disregarded part of investor's business, i.e. export of cigarettes, that was affected by the measure, and looked at the investment in general.⁴⁹ It can be argued that exporting of cigarettes might have been significant part of his investment. There is no unified approach regarding this matter and vague language that arbitral tribunal uses gives possibility to broad interpretation of substantial deprivation rule and it depends on arbitral tribunals' view.

⁴⁷ Burlington Resources Inc. Republic of Ecuador, ICSID case No. ARB/08/5, Decision on Liability (14 December 2012) 156, <<http://www.italaw.com/cases/181>> accessed 16 February 2017.

⁴⁸ Metalclad Corporation v. The United Mexican States, ICSID Case No. ARB(AF)/97/1, Award (30 August 2000) p. 103, <<http://www.italaw.com/sites/default/files/case-documents/ita0510.pdf>> accessed 9 December 2016.

⁴⁹ Marvin Roy Feldman Karpa v. United Mexican States, ICSID Case No. ARB(AF)/99/1, Award (16 December 2002) p. 142, <<http://www.italaw.com/sites/default/files/case-documents/ita0319.pdf>> accessed 20 March 2017.

Arbitral tribunals elaborated criteria they rely on when evaluating deprivation that were in detail described above: deprivation in value, loss of control and duration. Whether these criteria shall be considered all together or separately. Practice here is also different. Some arbitral tribunals look whether all criteria present, for some deprivation of one criteria is enough to amount to expropriation. In *LG&E v. Argentina* arbitral tribunal examined all criteria whether investor suffered deprivation of value, control and duration of the measure's effect was permanent. Even though there was economic impact on the investment, loss of control and duration were absent and therefore there was no substantial deprivation and accordingly no expropriation.⁵⁰ This case demonstrates that simply loss of value is not enough. In *Starrett Housing Corp. v. Iran* and *Tippetts* cases it was enough to have loss of control to amount expropriation even though it was not permanent. Such different and contradictory practice of arbitral tribunals does not add to clarity and predictability of so itself complex indirect expropriation.

In my opinion sole effect doctrine approach is too narrow it considers only the effect of the measure on the investments disregarding intent of the State and context of circumstances of the case. Arbitral tribunal in *Tecmed v. Mexico* case stated that “The government’s *intention is less important* than the effects of the measures on the owner of the assets or on the benefits arising from such assets affected by the measures; and the form of the deprivation measure is less important than its actual effects. (emphasis added)”⁵¹ Arbitral tribunal in *Metalclad v.*

⁵⁰ LG&E Energy Corp., LG&E Capital Corp., LG&E International Inc. v The Argentine Republic, ICSID case No. ARB/02/1, Award (27 July 2007) p. 199, <<http://www.italaw.com/cases/documents/623>> accessed 18 March 2017.

⁵¹ Tecnicas Medioambientales Tecmed, S.A. v. United Mexican States, ICSID case No. ARB(AF)/00/2, Award (29 May 2003) p.116, <<http://www.italaw.com/sites/default/files/case-documents/ita0854.pdf>> accessed 15 February 2017.

Mexico expressed similar opinion that there is no need to look at the intent of the adopted measure.⁵²

As it can be seen when determining indirect expropriation intent of the State is not taken into consideration, only economic factors.⁵³ Thus, sole effect doctrine is purely pro-investor approach, only investor's interests are considered. However, I think that investment relations involve two parties and therefore interests and rights of both of them shall be considered and protected. The State as a sovereign entity has its inherent right to regulate public matters within its territory to protect public welfare, health, environment.⁵⁴

In ICSID case of *Santa Elena v. Costa Rica* tribunal stated:

“Expropriatory environmental measures – no matter how laudable and beneficial to society as a whole are, in this respect similar to any other expropriatory measures that a state may take in order to implement its policies: where property is expropriated, even for environmental purposes, whether domestic or international, the state's obligation to pay compensation remains.”⁵⁵

Tribunal in this case did not consider purpose of the measure, the State's intent, it focused only on obligation to compensate investor no matter what. This approach deprives the State of the opportunity to regulate, fulfill its functions and responsibilities. Therefore, sole effect doctrine creates disbalance of interests and rights.

⁵² *Metalclad Corporation v. The United Mexican States*, ICSID Case No. ARB(AF)/97/1, Award (30 August 2000) p. 111, <<http://www.italaw.com/sites/default/files/case-documents/ita0510.pdf>> accessed 9 December 2016.

⁵³ Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (2nd edn, Oxford University Press 2012) 112-113.

⁵⁴ Aikaterini Titi, *The Right To Regulate In International Investment Law* (1st edn, Nomos 2014) 32-33.

⁵⁵ *Compania del Desarrollo de Santa Elena S.A. v Republic of Costa Rica*, ICSID Case No. ARB/96/1, Final Award (17 February 2000), <http://www.italaw.com/documents/santaelena_award.pdf> accessed 15 February 2017.

However, some arbitral tribunals that examined case using sole effect doctrine also considered intent and context of the regulatory measure. *LG&E v. Argentina* case arbitral tribunal discussed the issue whether it shall consider State's intent and context. Arbitral tribunal opined that there shall be balance when considering the case, take into account both effect of the measure and its purpose and not to confuse the State's ordinary right to regulate and adopt expropriatory measures.⁵⁶

Ben Mustafa argues that sole effect doctrine is the best approach to use when determining the case and that it does not conflict with the State's right to regulate. He argues that the sole effect doctrine has narrow scope and high threshold for the regulatory measure amount to expropriation.⁵⁷ I disagree with it. For example, the State due to its international obligations may implement severe regulatory measure to protect environment, impose high standards on the investments. Such measure could deprive investor to use and benefit from his investments completely or significant part of it. So, regulatory measure can easily reach the threshold of the sole effect doctrine. How can it not conflict with the State's right to regulate if it is at all do not consider intent of the State on adopting measures? I think this sole fact is already conflicting with the State's right to regulate. I agree with an approach that *LG&E v. Argentina* arbitral tribunal applied, because it is not sufficient to consider the case applying only the sole effect doctrine. For the case to be considered fairly it shall evaluate all possible aspects, interests and rights of the parties involved.

⁵⁶ LG&E Energy Corp., LG&E Capital Corp., LG&E International Inc. v The Argentine Republic, ICSID case No. ARB/02/1, Award (27 July 2007) p. 194, <<http://www.italaw.com/cases/documents/623>> accessed 18 March 2017.

⁵⁷ Ben Mostafa, "The Sole Effects Doctrine, Police Powers and Indirect Expropriation under International Law" (2008) 15 (1) Australian International Law Journal.

Andrew Necombe one of the known scholars in international investment law supports the concept of the State “appropriation”.⁵⁸ As it was mentioned above sole effect approach focuses on the effect that impacts investors but it does not take into account effect that impacts the State itself. The appropriation concept provides that effect of the regulatory measure shall also be considered towards the host State. In other words, for the measure to constitute expropriatory, the State shall acquire economic benefits from the adopted regulatory measure and from which investors suffered deprivation. Consequently, in case the State does not acquire economic benefits from the measure then it will not be considered as expropriatory. For example, direct expropriation clearly illustrates the State’s appropriation because title of the investment, i.e. economic benefit is transferred to the State. In case of indirect expropriation title of investments is not transferred, however the State still may have economic benefits, for example in case the State bans certain activity and as a result acquires monopoly in that area. If the State adopts measures to protect environment and public health in this case it might not acquire economic benefits, therefore no duty to compensate investors.⁵⁹

However, application of appropriation approach by the arbitral tribunals is rather low.⁶⁰ For example, in case of *Eudoro A. Olguín v. Republic of Paraguay* arbitral tribunal applied the appropriation approach, it states that:

“For an expropriation to occur, there must be actions that can be considered reasonably appropriate for producing the effect of depriving the affected party of the property it owns, in such a way that *whoever performs those actions will acquire, directly or indirectly, control, or at least the fruits of the expropriated property.* Expropriation

⁵⁸ A. Newcombe, 'The Boundaries of Regulatory Expropriation In International Law' (*Oxford Journals, Law and Social Sciences*, 2005) <<http://icsidreview.oxfordjournals.org/content/20/1/1.extract>> accessed 9 December 2016.

⁵⁹ Ibid.

⁶⁰ Suzy H. Nikièma, *Best Practices: Indirect Expropriation* (IISD 2012) <http://www.iisd.org/pdf/2012/best_practice_indirect_expropriation.pdf> accessed 30 March 2017.

therefore requires a teleologically driven action for it to occur; omissions, however egregious they may be, are not sufficient for it to take place.” (emphasis added)⁶¹

As it was stated above there are two parties in investment relations so why not consider the effect of the measure on the State as well. Appropriation concept can be viewed as a logical and additional helpful approach in the sole effects doctrine when assessing the effect of the measure.

The sole effect doctrine itself is not the best approach in my opinion to consider indirect expropriation. Vague terms used by arbitral tribunal led to broad interpretation of this doctrine and different and contradicting practice of application of it does not bring clarity to the issue. This doctrine is narrow considering only effect of the measure creating contradiction and conflict with the State’s right to regulate.

Next chapter of this paper will discuss in more detail another approach developed recently that envisages the State’s right to regulate that does not entail expropriation and compensation to investors.

⁶¹ Eudoro A. Olguín v. Republic of Paraguay, ICSID Case No. ARB/98/5, Award (26 July 2001) p.84, <<http://www.italaw.com/sites/default/files/case-documents/ita0587.pdf>> accessed 20 March 2017.

Chapter 2. Police Powers Doctrine

Regulatory measures adopted by the State may also be considered as non-expropriatory and non-compensatory even if they impacted investments. It is possible under the police powers doctrine which is an exception to expropriation. It is another approach used by arbitral tribunals that is completely opposite to the sole effect doctrine because it considers intent of the State, purpose, and context of the adopted regulatory measure.⁶²

Nowadays police powers doctrine is a widely-accepted concept, however there is no commonly recognized definition of it.⁶³ The name of this term came from the US style of calling the regulatory power of the State. For example, police powers concept mentioned in such documents like Third Restatement of Foreign Relations Law of the United States of 1987 (Third Restatement) and Harvard Draft Convention on the International Responsibility of States for Injury to Aliens of 1961 (Harvard Draft Convention). These instruments do not have binding power; however, they are authoritative sources and have been cited by many arbitral tribunals.⁶⁴

Purpose of the Third Restatement was to provide clarification and distinction between indirect expropriation and non-compensable State regulation. Particularly, it provides that the State bears responsibility if it expropriates foreigners' property by tax regulation, seizure of

⁶² Maurizio Brunetti, 'Introduction' (2003) 5 International Law FORUM du droit international <<http://booksandjournals.brillonline.com/content/journals/10.1163/138890303322398350>> accessed 24 March 2017.

⁶³ *Expropriation UNCTAD Series On Issues In International Investment Agreements II* (1st edn, United Nation Publication 2012) <http://unctad.org/en/Docs/unctaddiaeia2011d7_en.pdf> accessed 27 March 2017.

⁶⁴ "'Indirect Expropriation' and the 'Right to Regulate' in International Investment Law" (OECD Publishing 2004/04), OECD Working Papers on International Investment <<http://dx.doi.org/10.1787/780155872321>> accessed 20 January 2017.

property and if “unreasonably interferes” with “effective enjoyment” of property.⁶⁵ However the State is not responsible for

“... loss of property or for other economic disadvantage resulting from *bona fide* general taxation, regulation, forfeiture for crime, or other action of the kind that is *commonly accepted* as within the *police power* of states, if it is *not discriminatory* and is not designed to cause the alien to abandon the property to the State or sell it at a distress price.” (emphasis added).⁶⁶

Harvard Draft Convention also provides that there is no compensation in case of a taking and deprivation of investment from tax measures, regulations aimed at protecting “public order, health, or morality” or “valid exercise of belligerent rights or otherwise incidental to the normal operation of the laws of the State...”⁶⁷

Among scholars, police powers doctrine is also well recognized and discussed extensively. For example, Brownlie provided that “State measures, *prima facie* a lawful exercise of powers of governments, may affect foreign interests considerably without amounting to expropriation.”⁶⁸ Other scholars stated that police powers are the State’s sovereign right to regulate and no compensation could be sought.⁶⁹ Newcombe also added

⁶⁵ ““Indirect Expropriation” and the “Right to Regulate” in International Investment Law” (OECD Publishing 2004/04), OECD Working Papers on International Investment <<http://dx.doi.org/10.1787/780155872321>> accessed 20 January 2017, citing “Restatement of the Law Third, the Foreign Relations of the United States,” American Law Institute, Volume 1, 1987, Section 712, Comment g.

⁶⁶ Ibid.

⁶⁷ Ibid.

⁶⁸ Ian Brownlie, *Principles Of Public International Law* (1st edn, Oxford University Press 2008).

⁶⁹ *Expropriation UNCTAD Series On Issues In International Investment Agreements II* (1st edn, United Nation Publication 2012) <http://unctad.org/en/Docs/unctaddiaecia2011d7_en.pdf> accessed 27 March 2017, citing Sornarajah M.

that “... no right to compensate arises for reasonable necessary regulations passed for the protection of public health, safety, morals or welfare.”⁷⁰

The police powers notion contradicts traditional Hull doctrine, where the State cannot take investors’ property for any reason without compensation. Nevertheless, the State remains its sovereignty, even if it is limiting it by concluding treaties, contracts it does not mean that it loses its sovereign right to regulate at all. It is a fundamental and inherent right of the State.⁷¹ Aikaterini Titi one of the scholars, experts in this area suggested definition of the State’s right to regulate as following:

“...the right to regulate denotes the legal right *exceptionally permitting* the host *state to regulate* in derogation of international commitments it has undertaken by mean of an investment agreement *without incurring a duty to compensate*” (emphasis added).⁷²

It is interesting that Aikaterini Titi suggests narrow meaning of the legal right indicated in the definition as “legitimate regulatory interests” of the State not as its general right to regulate.⁷³ It can be assumed that as investor has protection of legitimate expectations under standards of protection provided by international law, so the State shall have protection of its legitimate interests by exercising regulation.

Practice of arbitral tribunals for most of the times was following traditional view applying sole effect doctrine, protecting investors’ rights and prioritized them over the State’s rights. Thus, prevailing arbitral tribunals’ findings were that regulatory measures were

⁷⁰ *Expropriation UNCTAD Series On Issues In International Investment Agreements II* (1st edn, United Nation Publication 2012) <http://unctad.org/en/Docs/unctaddiaeia2011d7_en.pdf> accessed 27 March 2017, citing Newcombe A and Paradell L (2009). *Law and Practice of Investment Treaties: Standards of Treatment*. Kluwer Law International. The Hague.

⁷¹ Surya P Subedi, *International Investment Law Reconciling Policy and Principle* (1st edn, Hart Publishing 2008) 160-161.

⁷² Aikaterini Titi, *The Right To Regulate In International Investment Law* (1st edn, Nomos 2014) 33.

⁷³ *ibid*.

considered as expropriation and therefore compensation shall be paid to investors. However, in recent years, arbitral tribunals started to recognize the State's right to regulate and concept of police powers became effective and enforceable.⁷⁴ In *Tecmed v. Mexico* case arbitral tribunal discussed the State's right to regulate and acknowledged police powers:

“The principle that the State's exercise of its sovereign powers within the framework of its police power may cause economic damage to those subject to its powers as administrator without entitling them to any compensation whatsoever is undisputable.”⁷⁵

Therefore, the essence of the police powers concept is that regulatory measure will not entail obligation to pay compensation to investor by the host State because it will not be considered as expropriation but the State's right to regulate.⁷⁶

2.1. Criteria for non expropriatory regulatory measure

The principle of police powers doctrine is that the State's implementation of regulatory measures, taking of investment are non-compensable if it meets following criteria: public purpose, non-discriminatory and proportionality.⁷⁷

⁷⁴ Meg N Kinnear and others, *Building International Investment Law: The First 50 Years of ICSID* (Kluwer Law International 2016) 448-449.

⁷⁵ *Tecnicas Medioambientales Tecmed, S.A. v. United Mexican States*, ICSID case No. ARB(AF)/00/2, Award (29 May 2003) p.119, <<http://www.italaw.com/sites/default/files/case-documents/ita0854.pdf>> accessed 15 February 2017.

⁷⁶ ““Indirect Expropriation” and the “Right to Regulate” in International Investment Law” (OECD Publishing 2004/04), OECD Working Papers on International Investment <<http://dx.doi.org/10.1787/780155872321>> accessed 20 January 2017.

⁷⁷ Meg N Kinnear and others, *Building International Investment Law: The First 50 Years of ICSID* (Kluwer Law International 2016) 449.

a) Public purpose

The State's regulatory measures shall pursue protection of public interests. The Third Restatement states that "action... that is commonly accepted as within the police power".⁷⁸ What measures are considered as within the police powers doctrine? As it can be seen from the scholarly writings actions that are usually considered within the police powers are taxation, protecting public order, morality, health, welfare, environment and many other areas. Public interest concept is broad itself and it can be assumed that any regulation of the State may pursue common good and therefore fall under the police powers exception.

For example, ICSID arbitral tribunal in *Marvin Feldman v. Mexico* case citing Third Restatement supported principle of police powers and provided what measures are considered within public purpose:

"Governments must be free to act in the broader public interest through protection of the environment, new or modified tax regimes, the granting or withdrawal of government subsidies, reductions or increases in tariff levels, imposition of zoning restrictions and the like. *Reasonable government regulation of this type cannot be achieved if any business that is adversely affected may seek compensation*, and it is safe to say that customary international law recognizes this." (emphasis added).⁷⁹

In this case as it was described in Chapter 1 Mexico adopted tax regulations, invoicing requirements regarding the export of tobacco products. Investor was claiming that he could not rebate taxes and was deprived of exporting cigarettes. Arbitral tribunal analyzed public purpose

⁷⁸ "'Indirect Expropriation" and the "Right to Regulate" in International Investment Law" (OECD Publishing 2004/04), OECD Working Papers on International Investment <<http://dx.doi.org/10.1787/780155872321>> accessed 20 January 2017, citing "Restatement of the Law Third, the Foreign Relations of the United States," American Law Institute, Volume 1, 1987, Section 712, Comment g.

⁷⁹ *Marvin Roy Feldman Karpa v. United Mexican States*, ICSID Case No. ARB(AF)/99/1, Award (16 December 2002), <<http://www.italaw.com/sites/default/files/case-documents/ita0319.pdf>> accessed 14 February 2017.

of the adopted measures. Mexico adopted such measures in order to prevent unauthorized sales of tobacco products or also referred as “grey market” that deprived Mexico of significant amount of tax proceeds. Purpose of invoicing requirements is to regulate and avoid inaccurate tax rebate claims. Relying on the Third Restatement arbitral tribunal found that measures which Mexico adopted had “rational public purposes” and they were measures of general taxation that are widely used in public policy matters.⁸⁰ Arbitral tribunal in this case found that actions of Mexico did not amount to expropriation not on the basis of the police powers doctrine but due to the lack of substantial deprivation.⁸¹ Nevertheless, arbitral tribunal in its analysis supported police powers doctrine.

One of the recent cases where arbitral tribunal supported police powers doctrine is *Philip Morris v. Uruguay* case. Award was rendered in 2016.⁸² In this case Uruguay adopted several regulations in order to protect public health. Philip Morris challenged particularly measures called “Single Presentation Requirement” (SPR) and “80/80 Regulation”.⁸³

SPR was adopted by the Ministry of Public Health of Uruguay and required tobacco companies to have in cigarette brand “single presentation” and forbid various packaging “variants” for cigarettes that are presented under one brand. For example, investor had brand named “Marlboro” and under this brand name it had different types of cigarettes like “Marlboro Gold” “Marlboro Red” and many others. As a result, investor had to remove from market all

⁸⁰ Marvin Roy Feldman Karpa v. United Mexican States, ICSID Case No. ARB(AF)/99/1, Award (16 December 2002) p. 113, 136, <<http://www.italaw.com/sites/default/files/case-documents/ita0319.pdf>> accessed 14 February 2017.

⁸¹ Ibid. p. 153.

⁸² Philip Morris Brands Sàrl, Philip Morris Products S.A. and Abal Hermanos S.A. v. Oriental Republic of Uruguay, ICSID Case No. ARB/10/7, Award (8 July 2016), <<http://www.italaw.com/sites/default/files/case-documents/italaw7417.pdf>> accessed 27 March 2017 (hereinafter Philip Morris v. Uruguay).

⁸³ Ibid., p. 9.

variants of cigarettes per brand except for one. Investor claimed that this regulation had adverse economic impact on the value of investment.⁸⁴

Under 80/80 Regulation that was adopted by Presidential Decree introduced “increase in the size of prescribed health warnings of the surface of the front and back of the cigarette packages from 50% to 80%, leaving only 20% of the cigarette pack for trademarks, logos and other information.”⁸⁵ Investor claimed that its intellectual property rights, goodwill were limited, depriving him to use them properly and which led to decrease in the value of the investment as well. Investor claimed that there was expropriation of his investments.⁸⁶

Uruguay argued that these measures did not amount to expropriation but it is an implementation of its fundamental right to regulate and exercise of police powers and no compensation shall be paid. Uruguay also stated that police powers concept is not absolute it is limited to bona fide, non-discriminatory and for legitimate public purpose regulation.⁸⁷

Arbitral tribunal in this case examined whether there was substantial deprivation of the investment. It concluded that the threshold was not met, investor lost its profits partially and value of investment was not decreased substantially.⁸⁸ Arbitral tribunal examined scholarly writings and arbitral tribunal practice regarding exercise of police powers. It found that:

“Protecting public health has since long been recognized as an essential manifestation of the State’s police power, as indicated also by Article 2(1) of the BIT which permits

⁸⁴ Philip Morris Brands Sàrl, Philip Morris Products S.A. and Abal Hermanos S.A. v. Oriental Republic of Uruguay, ICSID Case No. ARB/10/7, Award (8 July 2016), <<http://www.italaw.com/sites/default/files/case-documents/italaw7417.pdf>> accessed 27 March 2017

⁸⁵ Ibid.

⁸⁶ Ibid.

⁸⁷ Ibid., p. 219.

⁸⁸ Ibid., p. 276.

contracting States to refuse to admit investments “for reasons of public security and order, public health and morality.””⁸⁹

Therefore, arbitral tribunal concluded that measures adopted by Uruguay for the protection of public health were lawful implementation of its police powers and thus, do not amount to expropriation.⁹⁰ This case shows that the police powers doctrine can be acknowledged and proved even if Bilateral Investment Treaty does not provide explicit language of it. Measures adopted by Uruguay were harsh on the tobacco companies. However, public purpose was so apparent and significant that it outweighed the losses that investor might have. Given the fact that investor was engaged in tobacco products that are harmful to health it is justified to impose restrictions on them and investor shall expect it and bear the risks.

Case where the State failed to prove public interest is *ADC v. Hungary*. Here investor was implementing project concerning the building and operating terminals in one of the airports of Hungary. Investor was operating terminals for some time when Minister of Transport in Hungary adopted regulation that led to appropriation of all assets and activities that investor was carrying out.⁹¹ Arbitral tribunal in its analysis acknowledged that the State has the right to regulate however to certain limits provided by obligations under Bilateral Investment Treaty. Hungary claimed that purpose of the measures was to bring in compliance its legislation with European Union requirements and it was “*the strategic interest of the State*”⁹² Arbitral tribunal was not convinced that such measures were adopted in the public interest and it did not see “genuine interest of the public” in these measures because Hungary failed to provide persuasive

⁸⁹ Philip Morris Brands Sàrl, Philip Morris Products S.A. and Abal Hermanos S.A. v. Oriental Republic of Uruguay, ICSID Case No. ARB/10/7, Award (8 July 2016) p. 291, <<http://www.italaw.com/sites/default/files/case-documents/italaw7417.pdf>> accessed 27 March 2017

⁹⁰ Ibid. p. 307.

⁹¹ ADC Affiliate Limited and ADC & ADMC Management Limited v. The Republic of Hungary, ICSID Case No. ARB/03/16, Award (2 October 2006), <<http://www.italaw.com/documents/ADCvHungaryAward.pdf>> accessed 27 March 2017 (hereinafter *ADC v. Hungary*).

⁹² Ibid., p. 431.

facts and reasoning. It further provided that mere indication or calling it public interest does not mean that it actually exists.⁹³

In this case, it seemed that adopted measures were more in the interest of the State itself but not public's in general. Hungary did not prove and showed how people would benefit from the fact that the State would operate terminals and not the investor. Of course, public interest if it is not apparent could be found indirectly in any regulatory measure of the State. However then absolutely any measure can satisfy such requirement and therefore become pointless. Therefore, in order to satisfy the requirement of public purpose interest of the public of such measure shall be apparent and undisputable.

b) Nondiscriminatory

When evaluating police powers concept arbitral tribunal shall determine whether the measure is nondiscriminatory. Nondiscriminatory measure means the one that is not targeted to one particular investor or national investors influenced in the same way as foreign investors. Regulatory measure shall have equal effect on everybody that it is relevant to. In case nondiscriminatory measure is implemented and enforced in a discriminatory manner the measure can be qualified as expropriatory. Also, nondiscriminatory measure might be constructed in such a way that it involves particular investors in this case other details of the case shall be considered to determine whether such measure is genuine.⁹⁴

For example, *LG&E v. Argentina* case where during economic crisis Argentina abolished provided earlier guarantees. Investors claimed that adopted measures were

⁹³ ADC Affiliate Limited and ADC & ADMC Management Limited v. The Republic of Hungary, ICSID Case No. ARB/03/16, Award (2 October 2006) p. 432, < <http://www.italaw.com/documents/ADCvHungaryAward.pdf> > accessed 27 March 2017.

⁹⁴ *Expropriation UNCTAD Series On Issues In International Investment Agreements II* (1st edn, United Nation Publication 2012) <http://unctad.org/en/Docs/unctadaddiaeia2011d7_en.pdf> accessed 27 March 2017.

discriminatory because they targeted only gas distribution area, since it was mostly owned by foreign investors and that other fields of public services like electricity and water supply were not affected the same way as them. Arbitral tribunal stated that for measures to be discriminatory there shall be “(i) an intentional treatment (ii) in favor of a national (iii) against a foreign investor, and (iv) that is not taken under similar circumstances against another national.”⁹⁵ Argentina argued that adopted measures were not discriminatory and measures of general application. Also, it stated that each sector of public services supply does not have same regulation and requirements and the effect of the adopted measures therefore could be different depending on the public service.⁹⁶ Nevertheless, arbitral tribunal in its analysis concluded that discrimination of gas distribution sector compared to other utility sectors was “evident” because Argentina postponed tariff adjustments of investors before the law was adopted and did not apply same actions to other utility companies. However, it shall be noted that investors failed to prove that discriminatory measures were intentionally targeting only foreign investments.⁹⁷

Even though discriminatory intent of the State was not proved circumstances of the case showed that investors were treated differently putting them to unfavorable situation compared to others. It can be argued that distribution and transportation of gas is one sector and shall be viewed separately forming one area of economy and since measures applied to the whole gas distribution sector there cannot be discrimination. For example, water or electricity supply are different sectors. However, on the other hand gas distribution, water and electricity sectors are all segments of utility services area of the State. Should it be viewed narrowly or have more

⁹⁵ LG&E Energy Corp., LG&E Capital Corp., LG&E International Inc. v The Argentine Republic, ICSID case No. ARB/02/1, Award (27 July 2007) p. 146, <<http://www.italaw.com/cases/documents/623>> accessed 18 March 2017.

⁹⁶ Ibid., p.145.

⁹⁷ Ibid., p.148.

broad approach to such matter. Arbitral tribunals interpreted such issues broadly with wide implication when determining issues regarding the national treatment.⁹⁸ This approach by analogy can also be applied in matters of discrimination assessment because national treatment concept to a certain degree also considers relation and positions that investors have in the economy of the State.

In the described above *Philip Morris v. Uruguay* case, State adopted several measures for the protection of public health towards the tobacco companies. Arbitral tribunal found that adopted regulations were nondiscriminatory implementation of the State's police powers because they were applied equally to all tobacco companies, i.e. national and foreign investors.⁹⁹

It is worth mentioning the *Methanex v. USA* the UNCITRAL case that is often cited and relied by ICSID arbitral tribunals. In this case investor is a producer of methanol. California state prohibited use of gasoline additive methyl tertiary-butyl ether's (MTBE) that is produced from the methanol. California state based its decision on the scientific research and studies carried out by the University of California. The studies showed that MTBE contaminates water and have dangerous consequences on people's health. Several counties of California state had to close public water system because of its contamination by MTBE. Investor is a big corporation having 17% of the worlds share of methanol production. California state held 40% of the US fuel market and refiners mostly used MTBE. Therefore, ban of MTBE had significant impact on the investor's sales, it lost its share in the market and access to it. Thus, investor claimed that such measures constituted indirect expropriation. Investor also claimed that

⁹⁸ Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (2nd edn, Oxford University Press 2012) 200.

⁹⁹ Philip Morris Brands Sàrl, Philip Morris Products S.A. and Abal Hermanos S.A. v. Oriental Republic of Uruguay, ICSID Case No. ARB/10/7, Award (8 July 2016) p. 402, <<http://www.italaw.com/sites/default/files/case-documents/italaw7417.pdf>> accessed 27 March 2017.

measure was discriminatory because California state was protecting its domestic competing company but environment and public health.¹⁰⁰ USA argued that it did not regulate the methanol use but MTBE. Arbitral tribunal in its analysis provided that

“... as a matter of general international law, a *non-discriminatory* regulation for a public purpose, which is enacted in accordance with due process and, which affects, inter alios, a foreign investor or investment is *not deemed expropriatory* and *compensable* unless specific commitments had been given...” (emphasis added).¹⁰¹

Arbitral tribunals found that ban of MTBE was a nondiscriminatory regulation in public purpose and thus do not constitute expropriation and compensation. It stated that California state based its decision on the scientific, reliable studies that proved the adverse impact of MTBE on the environment and public health. There was no intention to target foreign investor in order to protect national companies, prohibition applied to all sellers and importers equally.¹⁰²

Even though investor suffered significant losses, adopted regulation was not discriminatory. It shall be noted that arbitral tribunal also introduced limitation to non-compensable regulation concerning the commitments of the State. In case Methanex and USA had contractual relations and State had obligations and made certain commitments to investor not to adopt such measures then State would have been held liable and such ban of MTBE would have been considered as expropriation. Since, no such commitments were given to the investor, the State is free to regulate.

¹⁰⁰ Methanex Corporation v. The United States of America, UNCITRAL Case, Award (3 August 2005), <<http://www.italaw.com/sites/default/files/case-documents/ita0529.pdf>> accessed 28 March 2017 (hereinafter Methanex v. USA).

¹⁰¹ Ibid.

¹⁰² Ibid.

The main point in determining whether the regulatory measure is discriminatory or not is to look if it is applied equally to all subjects national and foreign of particular business or economic sector. There is no intent to target particular investor or only foreign investors.

c) Proportionality

Along with requirements for regulation to be for public purpose and nondiscriminatory, it also shall be proportionate. Proportionality rule is rather new in the field of indirect expropriation. It was first suggested by scholars and then arbitral tribunals applied it in their decisions. Principle of proportionality is aimed at reconciling the public and private interests together, finding balance between them. Adopted regulatory measure by the State in order to fall under the police powers exception shall be protecting public interests and be proportionate to the effect on investor.¹⁰³

One of the first cases that applied proportionality principle is *Tecmed v. Mexico*.¹⁰⁴ In this case investor through its subsidiaries was operating a hazardous waste landfill under the renewable license. However, the landfill became the subject of the aggressive protests by the citizens claiming to shut down the landfill since it was close to the town and its adverse impact on the environment and public health. Tecmed claimed that protests were also supported and encouraged by the municipal authorities. Reports have been made stating that there are no environmental issues regarding the location of the landfill. Investor agreed with authorities to relocate the landfill and was waiting for authorities to provide new place for the landfill. However, authorities refused investor to renew the operating license based on some minor breaches of environmental regulations. As a result, investor could not operate landfill and

¹⁰³ Suzy H. Nikièma, *Best Practices: Indirect Expropriation* (IISD 2012)

<http://www.iisd.org/pdf/2012/best_practice_indirect_expropriation.pdf> accessed 30 March 2017.

¹⁰⁴ Ben Mostafa, "The Sole Effects Doctrine, Police Powers and Indirect Expropriation under International Law" (2008) 15 (1) Australian International Law Journal, <<http://www.austlii.edu.au/au/journals/AUIntLawJl/2008/12.pdf>> accessed 10 February 2017.

claimed that such regulatory measure led to a total loss of the investment, profits and that it is impossible to reimburse expenses made by investor.¹⁰⁵

Investor claimed that he completely lost his investments, he could no longer use and benefit from them and therefore such regulatory measure amounts to expropriation. Mexico on the other hand argued that it was exercise of its police powers to regulate in order to protect environment and public health, given that such area is highly regulated in terms of compliance with environmental standards.¹⁰⁶ When determining proportionality of the measure arbitral tribunal stated that:

“Although the analysis starts at the due deference owing to the State when defining the issues that affect its public policy or the interests of society as a whole, as well as the actions that will be implemented to protect such values, such situation does not prevent the Arbitral Tribunal, without thereby questioning such due deference, from examining the actions of the State in light of Article 5(1) of the Agreement to determine whether such measures are *reasonable with respect to their goals, the deprivation of economic rights and the legitimate expectations* of who suffered such deprivation. There must be a *reasonable relationship of proportionality* between the charge or *weight imposed* to the foreign investor and the *aim sought* to be realized by any expropriatory measure.” (emphasis added).¹⁰⁷

Therefore, proportionality consists of assessment of three issues: effect of the measure, its public purpose and necessity.¹⁰⁸ Arbitral tribunal stated that an economic impact of the

¹⁰⁵ Tecnicas Medioambientales Tecmed, S.A. v. United Mexican States, ICSID case No. ARB(AF)/00/2, Award (29 May 2003) p. 35-40, < <http://www.italaw.com/sites/default/files/case-documents/ita0854.pdf>> accessed 15 February 2017.

¹⁰⁶ Ibid., p. 97.

¹⁰⁷ Ibid., p. 122.

¹⁰⁸ Suzy H. Nikièma, *Best Practices: Indirect Expropriation* (IISD 2012)

<http://www.iisd.org/pdf/2012/best_practice_indirect_expropriation.pdf> accessed 30 March 2017.

measure is the main part of determining proportionality.¹⁰⁹ When assessing the effect of the measure arbitral tribunal used sole effect doctrine, applying substantial deprivation threshold. Arbitral tribunal found that adopted measure had permanent and irrevocable character. Since investor could no longer operate the landfill and the latter could not be used for any other purposes, investment completely lost its value and therefore substantial deprivation principle was met.¹¹⁰

Concerning the public purpose of the measure, arbitral tribunal stated that it should determine whether the public interest was the true reason of non-renewing the license. Arbitral tribunal found that the true purpose of the measure was not protection of environment and public health but political and social problems associated with the landfill. Authorities based its decision on minor breaches of the investor that could be solved and in addition investor consented to relocate the landfill.¹¹¹

The remaining part of proportionality assessment is whether the measure was necessary to achieve its public purpose, i.e. it shall be the only one option or the least harmful one. In this regard arbitral tribunal established that adopted measure was not necessary to achieve its purpose, meaning that non-renew of the license was not the only necessary measure to protect environment and public health. As it was mentioned above investor agreed to relocate the landfill, thus there was more favorable alternative.¹¹²

Considering that adopted measure entailed substantial deprivation of investment, its purpose did not correspond to reality and there was alternative option, arbitral tribunal

¹⁰⁹ Tecnicas Medioambientales Tecmed, S.A. v. United Mexican States, ICSID case No. ARB(AF)/00/2, Award (29 May 2003) p. 122, < <http://www.italaw.com/sites/default/files/case-documents/ita0854.pdf>> accessed 15 February 2017.

¹¹⁰ Ibid., p. 117.

¹¹¹ Ibid., p. 129.

¹¹² Suzy H. Nikièma, *Best Practices: Indirect Expropriation* (IISD 2012)

<http://www.iisd.org/pdf/2012/best_practice_indirect_expropriation.pdf> accessed 30 March 2017.

concluded that adopted measure was disproportionate measure and therefore expropriatory. Reasonable proportionality between the detriment that investor suffered and pursued purpose was not achieved in this case, losses of the investor outweighed the purpose of the regulatory measure.

One of the subsequent cases that followed *Tecmed v. Mexico* approach applying proportionality principle is *Azurix v. Argentina* case which stated that

““a reasonable relationship of proportionality between the means employed and the aim sought to be realized”. This proportionality will not be found if the person concerned bears “an individual and excessive burden”. “a measure must be both appropriate for achieving its aim and not disproportionate thereto.””¹¹³

Discussed above *Philip Morris v. Uruguay* case also cited *Tecmed v. Mexico* case. Even though *Philip Morris v. Uruguay* arbitral tribunal did not provide detailed analysis of the proportionality it stated that adopted regulatory measures of the State were proportionate to the purpose they intended to reach given the fact that there was no substantial deprivation of investments. Adopted measures were not “arbitrary and unnecessary” however were “effective means to protecting public health...”¹¹⁴

Investor claimed that requirement that 80% of the package shall be warnings is a disproportionate measure. Arbitral tribunal stated that:

¹¹³ *Azurix Corp. v The Argentine Republic*, ICSID Case No. ARB/01/12, Award (14 July 2006) p. 311, <<http://www.italaw.com/sites/default/files/case-documents/ita0061.pdf>> accessed 31 March 2017 (hereinafter *Azurix v. Argentina*).

¹¹⁴ *Philip Morris Brands Sàrl, Philip Morris Products S.A. and Abal Hermanos S.A. v. Oriental Republic of Uruguay*, ICSID Case No. ARB/10/7, Award (8 July 2016) p. 306, <<http://www.italaw.com/sites/default/files/case-documents/italaw7417.pdf>> accessed 27 March 2017.

“How a government requires the acknowledged health risks of products, such as tobacco, to be communicated to the persons at risk, is a matter of public policy, to be left to the appreciation of the regulatory authority.”¹¹⁵

In this case adopted measures had minor impact on investor, protection of public health was considered as justified and commonly accepted public purpose within the police powers of the State. Proportionality between the public interest and impact on investments were met.

Proportionality principle is a complex test that considers various factors. First of all, it examines the effect of the measure, deprivation in value then public interest and whether there is “reasonable proportionality”¹¹⁶ between those factors. Proportionality test considered to be a balanced approach in determining expropriation. Public interest of the measure shall be balanced with the suffered losses by investors. As Necombe stated: “Where the investor has suffered “an individual and excessive burden”, the measure will fail the proportionality analysis.”¹¹⁷

2.2. Assessment of criteria

Police powers doctrine emerged as a balancing tool of the State’s interests versus interests of investors. On the one hand, it is clear that investors shall not be deprived of their private property rights and government cannot expropriate this property without fair compensation. However, on the other hand, the State also has its regulatory rights and

¹¹⁵ Philip Morris Brands Sàrl, Philip Morris Products S.A. and Abal Hermanos S.A. v. Oriental Republic of Uruguay, ICSID Case No. ARB/10/7, Award (8 July 2016) p. 419, <<http://www.italaw.com/sites/default/files/case-documents/italaw7417.pdf>> accessed 27 March 2017.

¹¹⁶ Tecnicas Medioambientales Tecmed, S.A. v. United Mexican States, ICSID case No. ARB(AF)/00/2, Award (29 May 2003) p. 122, <<http://www.italaw.com/sites/default/files/case-documents/ita0854.pdf>> accessed 15 February 2017.

¹¹⁷ A. Newcombe, 'The Boundaries of Regulatory Expropriation In International Law' (*Oxford Journals, Law and Social Sciences*, 2005) <<http://icsidreview.oxfordjournals.org/content/20/1/1.extract>> accessed 9 December 2016.

legitimate interests in protecting public interests, it cannot to the detriment of the society and environment observe its obligations under investment relations.¹¹⁸

Police powers doctrine is a commonly accepted principle that was recognized by scholars, arbitral tribunals and States themselves. It was developed as an independent concept rather than additional tool in determining regulatory expropriations. There is no clear definition of it, however if generalize practice of arbitral tribunals police powers doctrine means that measure that is legitimate, nondiscriminatory and protects public interest such as protection of environment, public health, morals, safety and etc. However, scope of the doctrine is very broad. Such definition might cover all regulatory measures of the State and all indirect expropriation claims might fall under the police powers exception. Some scholars suggest narrow definition of police powers. It is suggested to limit its scope to certain public interest measures such as taxation, public order and morality and crimes.¹¹⁹ Such narrow scope might be good in terms of clarity of the exception and its predictability. However, on the other hand such limitations might strike out legitimate regulations and not correspond to parties' relations.

Some recent Bilateral Investment Treaties started to contain the State's regulatory right. For example, USA Model Bilateral Investment Treaty in its Annex B provides for exceptions of indirect expropriation. Particularly, it states that:

¹¹⁸ A. Newcombe, 'The Boundaries of Regulatory Expropriation In International Law' (*Oxford Journals, Law and Social Sciences*, 2005) <<http://icsidreview.oxfordjournals.org/content/20/1/1.extract>> accessed 9 December 2016.

¹¹⁹ Ben Mostafa, "The Sole Effects Doctrine, Police Powers and Indirect Expropriation under International Law" (2008) 15 (1) *Australian International Law Journal*, <<http://www.austlii.edu.au/au/journals/AUIntLawJl/2008/12.pdf>> accessed 10 February 2017.

“Except in rare circumstances, non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations.”¹²⁰

Bilateral Investment Treaty concluded between Canada and Hong Kong, China that entered into force in September 2016 contains identical provision as provided above.¹²¹ Having such exception in Bilateral Investment Treaty the State may rely on it and argue that parties have agreed that the State may exercise its regulatory powers, condition to meeting requirements set out in this provision. Such provision in case of a dispute will bring clarity on the scope of the State’s police powers. However, it will still depend on the arbitral tribunal’s interpretation of the facts and circumstances of the case and how it will interpret such clause.

One of the criteria of police powers doctrine is that adopted measure shall be for the public purpose. However public purpose criterion at the same time is also a requirement for lawful expropriation. These two principle have same requirement of public purpose and therefore contradict each other and create confusion. Arbitral tribunals itself note and rise this issue of confusion and contradiction. For example, in the case of *Azurix v. Argentina* arbitral tribunal said:

“According to it, the BIT would require that investments not be expropriated except for a public purpose and there be compensation if such expropriation takes place and, at

¹²⁰ Paragraph 4(b), Annex B of US Model BIT, <<https://ustr.gov/sites/default/files/BIT%20text%20for%20ACIEP%20Meeting.pdf>> accessed 16 February 2017.

¹²¹ Agreement between The Government of Canada and the Government of the Hong Kong Special Administrative Region of the People’s Republic of China for the Promotion and Protection of Investments, 10.02.2016, <<http://investmentpolicyhub.unctad.org/Download/TreatyFile/5094>> accessed 16 February 2017.

the same time, regulatory measures that may be tantamount to expropriation would not give rise to a claim for compensation if taken for a public purpose.”¹²²

Therefore, it is not clear when the State acts, implements measures to protect public welfare will it amount to expropriation or be considered as the State’s right to regulate and therefore non-compensable. For example, in *Methanex v. USA* case adopted measures were for the protection of environment and public health and were not considered as indirect expropriation. However, *Santa Elena v. Costa Rica* case measure was adopted to protect environment as well, but arbitral tribunal considered it as expropriation. It did not acknowledged protection of environment as significant equating it to any measures that the State might adopt stating that notwithstanding the purpose of the measure investor shall be compensated.¹²³

Arbitral tribunals have different views on protection of public interests. In such a contradictory practice, it is hard to determine and distinguish between the measures that will be considered as expropriation entailing compensation and as police powers of the State that does not entail compensation.

The other point is that there might be a situation where regulatory measure was adopted to protect public interests such as environment, health, however at the same time this measure had an effect of protecting national investors. In such situation where measure serves few purposes public and protectionist will it justify police powers exception? As Newcombe suggested in such situations it also shall be evaluated whether the measure for protecting public interests was “reasonable necessary”. He also stated that: “The fact that the ban might also

¹²² Azurix Corp. v The Argentine Republic, ICSID Case No. ARB/01/12, Award (14 July 2006), <<http://www.italaw.com/sites/default/files/case-documents/ita0061.pdf>> accessed 31 March 2017

¹²³ Compania del Desarrollo de Santa Elena S.A. v Republic of Costa Rica, ICSID Case No. ARB/96/1, Final Award (17 February 2000) p. 72, <http://www.italaw.com/documents/santaelena_award.pdf> accessed 15 February 2017.

serve a protectionist purpose is in itself not determinative, although it clearly raises suspicions about the measures taken.”¹²⁴

Therefore, the fact that measures are adopted to protect public interests is not enough to claim non-compensation. Regulatory measures shall also be nondiscriminatory and proportionate.

Under police powers doctrine nondiscriminatory measure in general are not considered as expropriatory. Arbitral tribunal in *El Paso v. Argentina* provided that: “...in principle, general non-discriminatory regulatory measures, adopted in accordance with the rules of good faith and due process, do not entail a duty of compensation.”¹²⁵

However, nondiscriminatory measure nevertheless can be considered as expropriatory. First of all, nondiscriminatory criterion is also a requirement of a lawful expropriation. Same as public purpose requirement, it also creates contradiction and confusion. Mentioned above case of *El Paso v. Argentina* arbitral tribunal acknowledged that nondiscriminatory measures adopted to protect public interest can be considered as expropriatory if there is “neutralization of property rights”, i.e. substantial deprivation of the investments.¹²⁶

Nondiscriminatory criterion is used in determining both lawful expropriation and police powers exception. Therefore, even though measure might be nondiscriminatory it still might amount to expropriation. This criterion does not bring clarity and does not contribute to distinguishing compensatory and non-compensatory regulatory measures.

¹²⁴ A. Newcombe, 'The Boundaries of Regulatory Expropriation In International Law' (*Oxford Journals, Law and Social Sciences*, 2005) <<http://icsidreview.oxfordjournals.org/content/20/1/1.extract>> accessed 9 December 2016.

¹²⁵ *El Paso Energy International Company v. The Argentine Republic*, ICSID Case No. ARB/03/15, Award (31 October 2011) p. 240, <<http://www.italaw.com/sites/default/files/case-documents/ita0270.pdf>> accessed 1 April 2017 (hereinafter *El Paso v. Argentina*).

¹²⁶ *Ibid.*, p. 254.

The other criterion used is a complex proportionality test, where the public purpose, necessity and effect of the measure are weighed. The main point of this test is to determine whether the public purpose of the measure proportionate to the effect that it had on the investor. As *LG&E v. Argentina* arbitral tribunal rightly stated that “to establish whether State measures constitute expropriation ... the Tribunal must balance two competing interests: the degree of the measure’s interference with the right of ownership and the power of the State to adopt its policies.”¹²⁷

Proportionality test can be viewed as a more balanced and impartial approach, because it reconciles two opposite interests public v. private and effect v. public purpose. Sole effect doctrine as you may recall only considers the effect of the measure on the investment, i.e. protects investors’ interests, however proportionality test takes into account both effect and purpose and whether they correlate with each other and have “reasonable relationship of proportionality”¹²⁸. However, what is considered as a reasonable relationship of proportionality? It is hard to define what can be considered as reasonable and proportionate separately. Such requirement is vague and broad. Arbitral tribunal in *Tecmed v. Mexico* that used this wording did not provide explanation of it.

Also, arbitral tribunals state that there cannot be proportionality if investor had “an individual and excessive burden”¹²⁹. The same question is here what is an “excessive burden” is substantial deprivation threshold used in this case? However, there were cases when investor

¹²⁷ LG&E Energy Corp., LG&E Capital Corp., LG&E International Inc. v The Argentine Republic, ICSID case No. ARB/02/1, Award (27 July 2007) p. 189, <<http://www.italaw.com/cases/documents/623>> accessed 18 March 2017.

¹²⁸ Tecnicas Medioambientales Tecmed, S.A. v. United Mexican States, ICSID case No. ARB(AF)/00/2, Award (29 May 2003) p. 122, <<http://www.italaw.com/sites/default/files/case-documents/ita0854.pdf>> accessed 15 February 2017.

¹²⁹ Ibid.

was substantially deprived of his investments but arbitral tribunal held that regulatory measure was within the police powers of the State.¹³⁰

Arbitral tribunal in *Tecmed v. Mexico* relied on the European Court of Human Rights (ECHR) application of proportionality test. However, some scholars are reluctant to apply the proportionality test and contested the applicability of ECHR to investment disputes.¹³¹ Particularly, investment disputes and disputes that ECHR decides are completely different areas and therefore proportionality test will have different application and it is highly dependent on the circumstances of the case, which will lead to varying results.¹³²

Thus, on the one hand proportionality test has its benefits as it is more neutral and balanced approach to consider regulatory expropriation issues. However, it has its disadvantages as broad and vague requirements, contradictory case practice that do not contribute to predictability of the case and certainty regarding the distinguishing the compensable and non-compensable regulatory measures.

It can be seen that in most of the cases provided above when claim of expropriation is viewed the State claims that it exercised its sovereign right to regulate and police powers exception shall be applied. How do arbitral tribunals determine the case, do they look first on the substantial deprivation or police powers concept? In the provided cases, arbitral tribunals first started to examine the effect of the measure, substantial deprivation of the investments and then police powers exception. But what should be viewed first? There might be risk that if arbitral tribunal first evaluates the effect and if it finds substantial deprivation then it might not go further and apply police powers exception. As it was mentioned above regulatory measure

¹³⁰ See *Methanex v. USA* case.

¹³¹ Kevin Winters, 'Indirect and Regulatory Expropriation in International Investment Law: a Critical Review.' (LLM thesis, University of Glasgow 2015).

¹³² *Ibid.*

can be considered as non-expropriatory even if there is substantial deprivation of the investments value.

There are cases when States claimed police powers exception, however arbitral tribunals just examined the substantial deprivation and did not look at and applied police powers concept.¹³³ For example in *Mamidoil v. Albania* case investor was involved in petroleum business in Albania and claimed that change of the land use plan and non-renew of the license constituted indirect expropriation.¹³⁴ Albania on the opposite claimed that it was within its police powers, a “...bona fide exercise of regulatory power aimed at the general welfare...”¹³⁵ Arbitral tribunal did not evaluate the police powers doctrine when determining indirect expropriation, even though it was claimed by the State, it just applied sole effect doctrine using the substantial deprivation test. Even though arbitral tribunal rejected expropriation claim that there was no substantial deprivation of investments, it should have evaluated police powers concept as well, not just substantial deprivation test.¹³⁶

Therefore, in my opinion it is incorrect just determine the case evaluating the substantial deprivation, given that party argues for police powers exception and it has been widely recognized approach. Moreover, police powers exception when applying proportionality criterion also takes into account the effect of the measure anyways.

The scope of police powers doctrine is also broad and vague which led to contradictory arbitral tribunal practice. It has many overlaps with the requirements of lawful expropriation. Police powers doctrine same as lawful expropriation requires that regulatory measure shall be

¹³³ Kevin Winters, ‘Indirect and Regulatory Expropriation in International Investment Law: a Critical Review.’ (LLM thesis, University of Glasgow 2015).

¹³⁴ *Mamidoil Jetoil Greek Petroleum Products Societe S.A. v. Republic of Albania*, ICSID Case No. ARB/11/24, Award (30 March 2015) p.500, <<http://www.italaw.com/sites/default/files/case-documents/italaw4228.pdf>> accessed 1 April 2017 (hereinafter *Mamidoil v. Albania*).

¹³⁵ *Ibid.*, p.527.

¹³⁶ *Ibid.*, p. 536-580.

for public purpose and nondiscriminatory. Under lawful expropriation compensation shall be paid and under police powers doctrine compensation is not paid because measure will not be considered as expropriation. Expropriatory and non-expropriatory two opposite measures have same requirements that create contradiction and confusion. Thus, police powers doctrine also not an absolutely perfect approach to determine indirect expropriation due to the problematic aspects assessed above.

Conclusion

Regulatory expropriation is widely discussed topic because it does not have certain definition and subject to different interpretations and the main issue is the clash of investors' interests and the States' interests. Arbitral tribunals have applied different approaches to distinguish between expropriatory and non expropriatory regulatory measures. Therefore, there is no clear and distinct line between what measures are considered as compensatory and non-compensatory.

To address this problem this research paper has examined regulatory expropriation by analyzing the sole effect doctrine and police powers doctrine that are developed and used by arbitral tribunals when determining whether the adopted measures of States are expropriatory or not. The purpose of this paper was to distinguish between the compensatory and non-compensatory regulatory measures through the critical assessment of two approaches. As well as whether there can be found balance between the interests of investors and States and whether these two opposite approaches are reconcilable. Analysis of the case law, arbitral tribunals' practice and scholarly writings was carried out in order to achieve mentioned goals of the thesis.

Assessment of the case law revealed numerous shortcomings of the sole effect doctrine and police powers doctrine. The sole effect doctrine is a dominant approach used by arbitral tribunals. It has narrow scope considering only the effect that measure had on investors and investments. The threshold used to evaluate the effect of the measure is substantial deprivation of the value of investments, loss of control and duration of the adopted measure. Analysis of the case law showed that arbitral tribunals' practice is contradicting when applying the substantial deprivation threshold. One of the main shortcoming of this approach is that it views the issue from investors' perspective only disregarding the intent of the State and purpose of the adopted regulatory measures. This makes arbitral tribunals' findings one-sided. However,

they shall view the issue from all possible perspectives. Suggested the State appropriation approach can serve as an additional helpful mean to determine the compensatory and non-compensatory regulatory measure. In general, the sole effect doctrine in my opinion cannot be solely used when deciding the expropriation.

Police powers doctrine on the other hand is rather new however widely accepted approach under which regulatory measure can be justified and considered to be non-expropriatory even if there was substantial deprivation of investments. It is completely opposite approach to the sole effect doctrine because it considers purpose of the adopted measure and intent of the State. For a measure to be non-expropriatory it shall pursue public purpose, shall be non-discriminatory and proportionate. Assessment of this doctrine identified problematic aspects as well. This approach has broad scope which might cover all regulatory measures of the State and all indirect expropriation claims might fall under the police powers exception. It also overlaps with the requirements of lawful expropriation which creates contradictions and confusions which makes it complicated to distinguishing between compensatory and non-compensatory measures.

Both doctrines are completely different in approaches they have in determining the regulatory expropriation claims. Analysis of two approaches in my opinion suggests that they cannot be used separately in distinguishing the expropriatory and non-expropriatory measures. Sole effect doctrine aims at evaluating only the effect of the measure, what economic impact it had on the investor. While police powers doctrine takes into account the purpose of the measure. Therefore, for the determination of the case to be comprehensive and fair both doctrines shall be taken into account when considering the case. In my opinion these two approaches are reconcilable and can be used both in determining the case which will create more balanced approach.

The solution to such uncertainty can be found in investment treaties. Since there is contradictory case practice and no clear distinctions can be provided, States when concluding investment treaties therefore shall themselves provide certainty. Particularly, as mentioned above USA Model Bilateral Investment Treaty provides clarifications. First of all, provide for the definition of indirect expropriation even though there is no established definition, criteria to qualify it could be provided or by providing exceptions to indirect expropriation.¹³⁷ As USA Model Bilateral Investment Treaty provides exceptions for non-discriminatory regulatory measures that are for specific public interests like environment, public health and others.¹³⁸

As the assessment of regulatory expropriation shows it is problematic or even practically impossible to create clear guidelines or checklist to distinguish the regulatory measures because arbitral tribunals' practice is inconsistent and contradictory and decisions highly depend on facts and circumstances of the case. However, this thesis by analyzing the regulatory expropriation, critically evaluating its approaches contributed to the overall attempts to make regulatory expropriation more clear and the measures distinguishable.

¹³⁷ Suzy H. Nikiéma, *Best Practices: Indirect Expropriation* (IISD 2012)

<http://www.iisd.org/pdf/2012/best_practice_indirect_expropriation.pdf> accessed 30 March 2017.

¹³⁸ Paragraph 4(b), Annex B of US Model BIT,

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