PwC International Arbitration damages research

2017 update

December 2017

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Content

Arbitral awards in focus

In 2015, we undertook a research project into the assessment of damages in international arbitration cases, analysing 95 publically available awards, to examine some of the underlying issues. We have updated our research, analysing a further 21 cases in which damages were awarded[1]. All cases are entered into our Damages Database, allowing us to quickly examine specific issues and trends with respect to damages across all 116 cases reviewed.

Arbitrations in the Mining, Oil and Gas or Utilities industries are particularly prevalent, representing two thirds of the new cases. South America continues to be a 'hot spot' and there are still comparatively few cases in Western Europe and North America. The new cases we reviewed provided a significant, and welcome, amount of detail in respect of quantum.

2017 update to our 2015 damages research

95 awards in our original sample

21 new awards reviewed

Time period of new awards

Jan 2015-Jun 2017

50% of new cases in South America

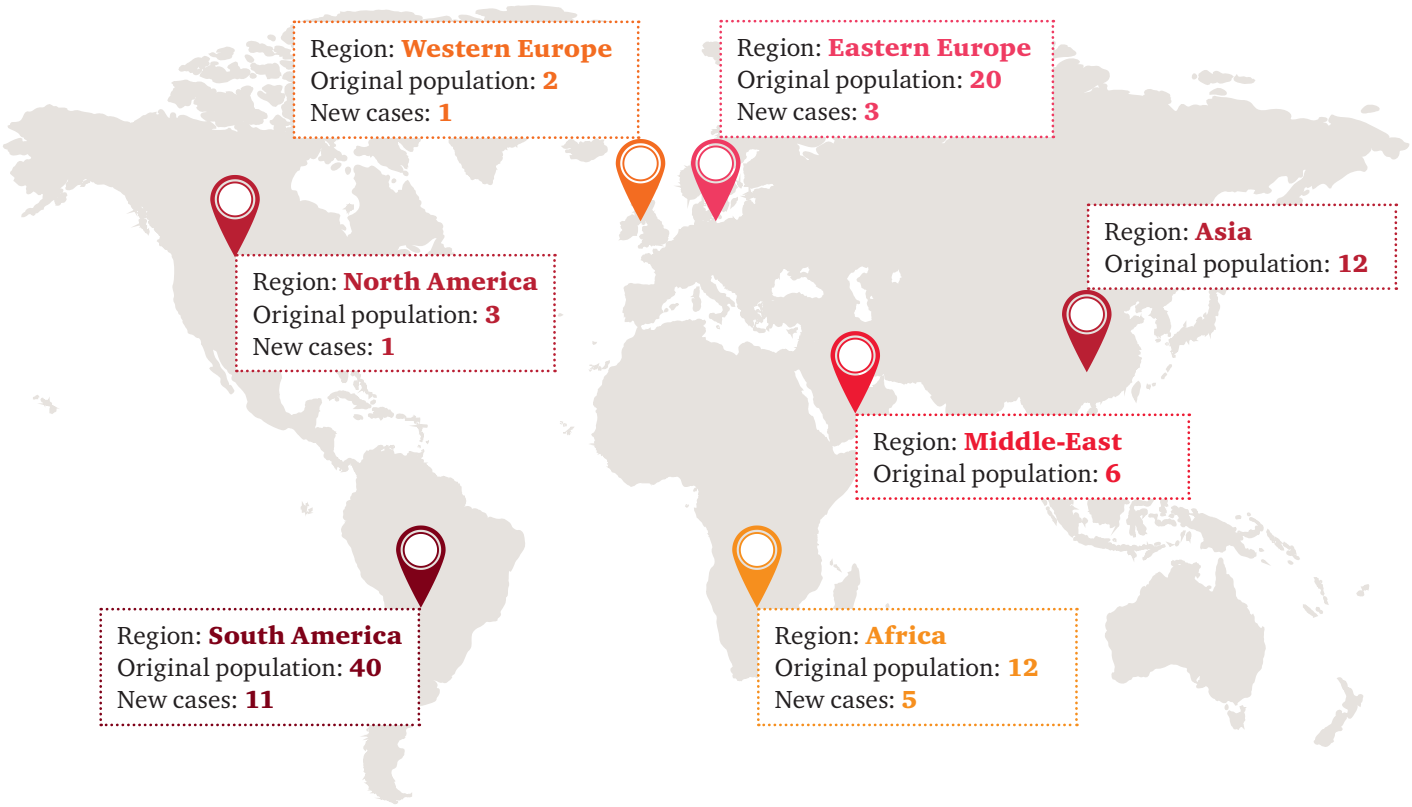
Awards range from **$0.2 – $1,200** million

2/3 of new cases in Oil and Gas, Mining or Utilities

[1] As explained in our original article (http://bit.ly/IAdamages) awards reviewed primarily relate to investment treaty arbitration and are published on the italaw website.

Geography of cases reviewed

95 original population: **21** new cases



Mind the Gap (again)

Still a huge disparity in valuations between parties, experts and Tribunals

Our 2015 research identified a huge disparity in the parties' relative positions and the proportion of the claim actually awarded by Tribunals. This gap remains wide.

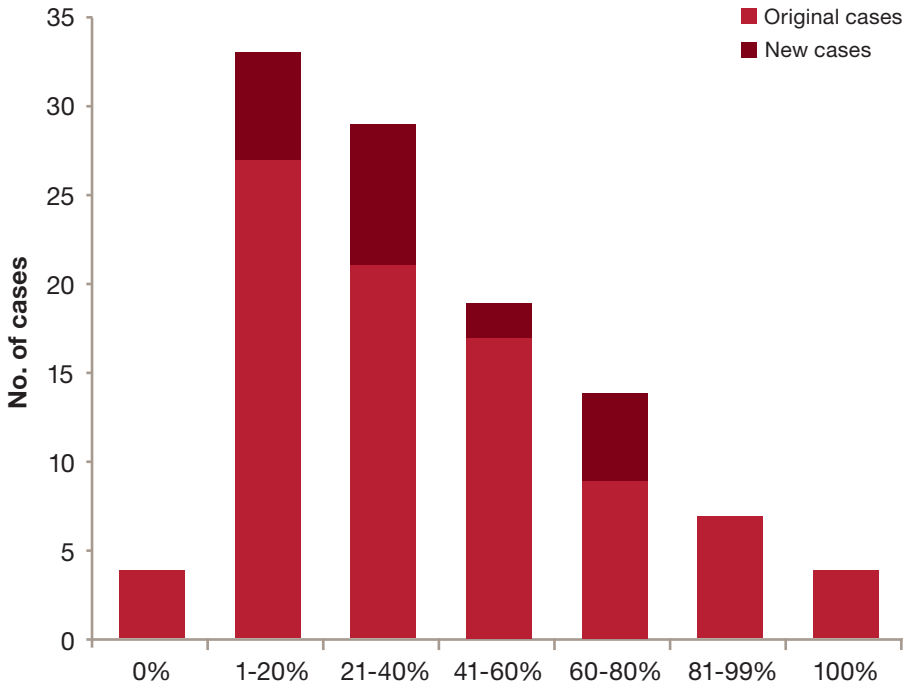
Respondents sometimes refuse to put a value on damages for legal reasons. However, in cases where they do provide an alternative valuation, this tends to be significantly lower than the Claimant's valuation. Our 2015 research found that Respondents on average value a claim at a fraction (13%) of the value ascribed to it by the Claimant. The updated research confirms this trend: the overall average has dropped a little to 12%, with Respondent valuations ranging from 0% to 26% of the Claimant's claim in the new cases, including 11 cases where the Respondent valued damages at less than 1% of the Claimant's figure.

The gap between Claimants' valuations and Tribunal awards remains reasonably consistent with our previous research, with Tribunals in the new cases awarding on average 34% of the total amount claimed, reducing the overall average from 37% to 36%. The average again covers a wide distribution and there continues to be no real evidence of Tribunals 'splitting the baby' as often suggested by commentators. Most of the awards provide detailed reasoning justifying the Tribunal's quantum decision, reinforcing the trend towards longer and more detailed explanations noted in our 2015 research.

Average awards as % of total amount claimed is

Now 36%
Was 37%

Award as % of claim



Why is there a gap?

In our 2015 research and a follow-up article[2] we noted that the gap between Claimant and Respondent experts is often the result of experts receiving different instructions as well as genuine differences of opinion between them. We identified the following key reasons why differences arise.

If you ask a different question, you'll get a different answer	Genuine differences of opinion
Assumptions differ regarding:	**Experts can reasonably disagree on the appropriate:**
• Valuation date	• Methodology
• Fact pattern	• Discount rates
• Lawful vs unlawful expropriation	• Cash flows
• Ex-ante vs ex-post valuation basis	

New cases illustrate the varied reasons for differences

The new cases we reviewed provide examples of all of the above, often with multiple factors affecting the cases. For example, in *Flemingo Duty Free Shop v Poland*[3] (which involved the shut-down of various duty free shops for the modernisation of Chopin airport), the Claimant's claim of €85 million[4] was, in the Respondent's opinion, worth a mere 4% of this sum at €3.3 million[5]. The parties disagreed factually in respect of (inter alia) passenger numbers, the appropriate valuation date and the length of the leases[6].

- €57 million of the Claimant's claim related to a lease extension that the Respondent claimed it would never have granted.[7]
- The Claimant's expert was instructed to use post-valuation data[8], the Respondent's expert was instructed to ignore it. The use of hindsight had a pronounced effect on the Claimant's numbers: the Claimant's alternative valuation without hindsight was €41 million[9].
- The experts disagreed in respect of the gross profit margin and the appropriate discount rate.[10]

Risk that Tribunals will ignore both experts

Where experts' opinions diverge dramatically there is a risk that the Tribunal will ignore both experts completely in favour of a more certain approach. In *Copper Mesa Mining v Ecuador,* the differences between the experts' valuations led to the Tribunal dismissing several valuations methodologies put forward by the experts in favour of the comparative certainties of a historical cost approach, noting:

'Save for one method, the Tribunal decides not to accept the several valuation methodologies advanced by the parties' respective expert witnesses. In the Tribunal's view, applied in this case, those methodologies are too uncertain, subjective and dependent upon contingencies, which cannot fairly be assessed by the Tribunal. For example, wholly extraneous factors significantly affect the different figures resulting from the parties' different methodologies. These huge differences, with insufficient explanations, suggest that extreme caution is required in assessing compensation in this case. This is hardly surprising, given that the Claimant's concessions remained in an early exploratory stage with no actual mining activities, still less any track record as an actual mining business…rather than seeking to value an elusive loss of a chance to the extent permissible under international law, the Tribunal here prefers to select the Claimant's alternative valuation method of proven expenditure.[11]'

[2] https://www.pwc.co.uk/forensic-services/disputes/assets/bridging-the-gap-between-experts.pdf
[3] Flemingo Duty Free Shop Private Limited v The Republic of Poland, award dated 12 August 2016 under UNCITRAL rules
[4] Flemingo v Poland award dated 12 August 2016, paragraphs 854 and 857
[5] Flemingo v Poland award dated 12 August 2016, paragraph 638 (EUR 3.07 million based on Respondent's calculation for Scenario B, the scenario favoured by the Claimant plus EUR 0.2 million additional costs incurred (paragraph 634)
[6] Flemingo v Poland award dated 12 August 2016, paragraphs 668 to 677
[7] Flemingo v Poland award dated 12 August 2016, paragraph 847
[8] Flemingo v Poland award dated 12 August 2016, paragraphs 702 to 703
[9] Flemingo v Poland award dated 12 August 2016, paragraph 855
[10] Flemingo v Poland award dated 12 August 2016, paragraphs 734 to 740
[11] Copper Mesa Mining Corporation v Republic of Ecuador UNCITRAL award paragraph 7.24 to 7.25

Narrowing the gap

Bifurcating hearings

While bifurcation is a legal issue and beyond the scope of this article, we note that a number of new awards were the result of bifurcated hearings: such bifurcation can narrow the number of outstanding issues for the quantum phase and allow for more focus on the quantum issues. The Tribunal in *Suez and Vivendi v Argentina*[12] specifically noted that it decided to create a separate procedural phase devoted to damages *'because of the complexity involved in ascertaining damages, a matter extensively argued with widely differing conclusions by each party with the assistance of financial specialists who prepared extensive reports and testified at the hearing on the merits'*[13].

Joint meetings, witness conferencing and Tribunal-led quantum scenarios

While witness conferencing appears to remain uncommon (in marked contrast to the volume of commentary on the subject), the new population of awards does provide examples of Tribunals requesting alternative calculations from experts based on fact patterns and assumptions dictated by them. Such directions from Tribunals can prove very helpful in narrowing the quantum differences between experts.

In *Flemingo v Poland,* the Tribunal asked the parties' experts to provide calculations based on alternative scenarios[14]. In *Burlington Resources v Ecuador*[15], the Tribunal relied on a joint DCF model provided by the parties' damages experts pursuant to the Tribunal's invitation and specifications: the model allowed the Tribunal to choose between the different variables proposed by the parties. A similar course was followed in *Rusoro Mining v Venezuela,* in which the experts jointly prepared tables of discounted cash flow valuations under alternative sets of assumptions.[16]

Tribunal-set parameters can be helpful in narrowing differences. However, we have seen cases where parties feel that the instructions place too many constraints on the calculation of damages, leading to a result which does not fairly reflect the loss suffered. Whatever the parties' private opinions of the instructions, however, it may be wise to carry them out as requested. In *SCB v TANESCO,* the Tribunal set out parameters for the parties to use in calculating an appropriate new tariff. The Tribunal subsequently found that neither of the experts' approaches '*focus on what the Tribunal had identified as the principal problem with the tariff*' and that although the Tribunal had said *'the calculation of the tariff could not be based on any new assumptions'*, both of the experts had ignored this stipulation. On that basis, the Tribunal rejected both the Claimant's and the Respondent's proposed internal rate of return and made its own estimate of IRR.[17]

The parties' experts themselves could consider emphasising or even quantifying the extent to which differences between the parties' cases rest purely on fact patterns or legal questions. It can be helpful to show how far apart the parties would be if certain facts were agreed. Experts' ability to do this of course depends on their instructions.

Tribunal appointed experts

We have noted before that where there is a great deal of divergence between experts and/or calculations are highly complex, a Tribunal might appoint its own expert to help navigate the differences. The Tribunal in *Suez and Vivendi v Argentina*[18] appointed an independent expert to assist it due to the perceived complexity of the case and the widely differing conclusions reached by the parties' experts. This can also happen where the Tribunal lacks confidence in the evidence given by the parties' experts. In *HEP v Slovenia,* the Tribunal appointed its own expert, partly due to the complexity of the case and partly *'because neither party's experts provided a clear and convincing damages case.'*[19]

Although such an appointment is likely to increase costs, it can also help Tribunals address issues outside their own expertise when all other approaches have failed. In *HEP v Slovenia,* the Tribunal commented that it had *'benefited significantly'* from its expert's insights, *'especially given the vastly differing assessments offered by the party-appointed experts. The Tribunal has found Mr Jones' analysis most useful and has to a significant extent followed his recommendation.'*[20]

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[12] Suez Sociedad General de Aguas de Barcelona S.A, and Vivendi Universal S.A v The Argentine Republic, ICSID case ARB/03/19, award dated 9 April 2015

[13] Suez and Vivendi v Argentina, award dated 9 April 2015, paragraph 7

[14] Flemingo v Poland award dated 12 August 2016, paragraph 877

[15] Burlington Resources Inc. v Republic of Ecuador, ICSID case ARB/08/5

[16] Rusoro Mining Limited v The Bolivarian Republic of Venezuela, ICSID case ARB(AF)/12/5, award dated 22 August 2016, paragraph 644

[17] Standard Chartered Bank (Hong Kong) Limited v Tanzania Electric Supply Company (TANESCO), ICSID case ARB/10/20, award dated 12 September 2016, paragraph 371 to 377

[18] Suez and Vivendi v Argentina, award dated 9 April 2015

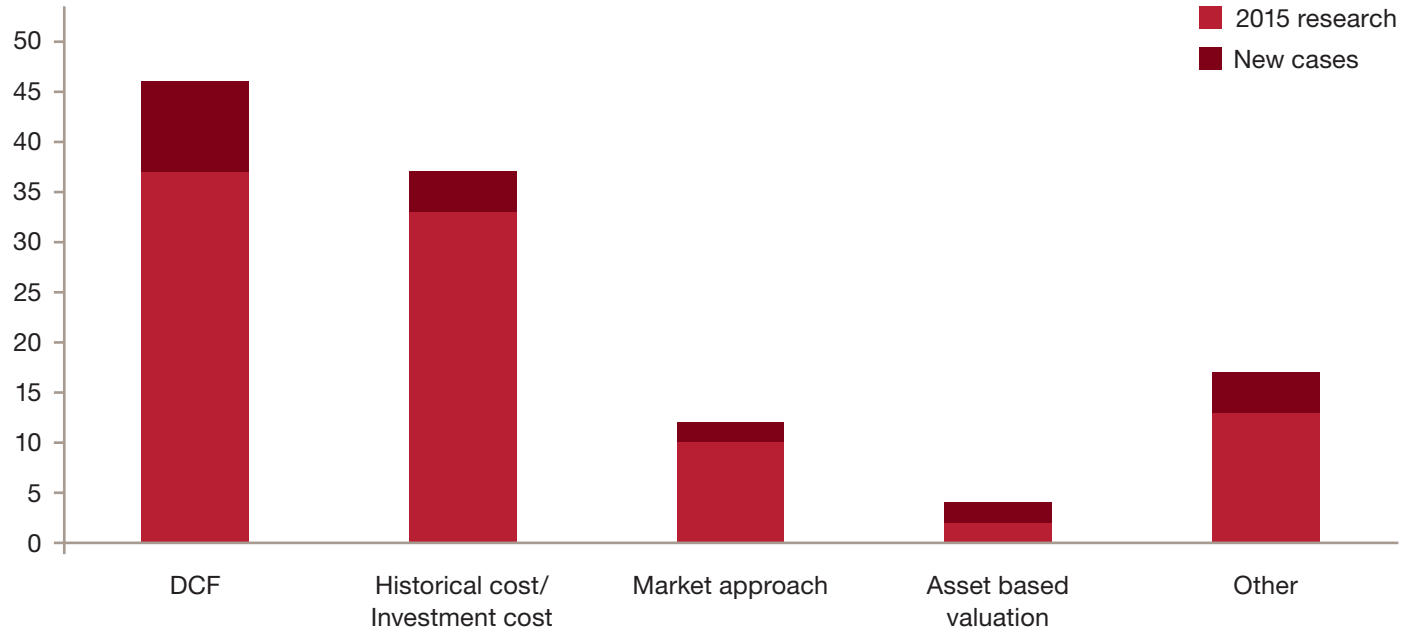
[19] Hrvatska Elecktroprivreda D.D v Republic of Slovenia, ICSID case ARB/05/24, award dated 17 December 2015, paragraphs 174 and 609

[20] Hrvatska Elecktroprivreda D.D v Republic of Slovenia, ICSID case ARB/05/24, award dated 17 December 2015, paragraph 174

Tribunals favour forward-looking methodologies

A range of valuation methodologies are applied by Tribunals as their primary approach

Valuation methodologies adopted by Tribunals



Trend toward income-based approaches

Our original research found that, although DCF and historical cost/ investment cost approaches were used in roughly the same proportion, the trend over time was for Tribunals to prefer forward-looking, income based approaches over reliance on historical figures. This preference for income based approaches continues although the data shows a decline in relative popularity compared to the previous period. This drop appears to be due to the particular characteristics of the latest cases, for a number of which, a forward-looking methodology was inappropriate.

DCF remains popular and is increasingly accepted by Tribunals

Our original research showed DCF and/ or lost profits being rejected in 22 out of 59 cases where it was proposed by the Claimant, largely where the Tribunal considered the result to be too uncertain or speculative.

In the new cases, the DCF methodology was accepted in 9 of the 11 cases in which it was proposed. This is a lower rejection rate (18%) than the historical average shown in the 2015 research (37%). Moreover, only one of the claims was rejected on the grounds of uncertainty as to the reliability of future cash flow projections. In that case, *Tenaris v Venezuela,*[21] although DCF was used by both Claimant and Respondent, the Tribunal felt that there was an insufficient history of operations, and that was a barrier to reliable projections of future free cash flow. Further uncertainties arose from government interventions in the market place as well as unstable inventories and shortages of a wide range of products in the Venezuelan market. The other rejection[22] was due to the primary claim (based on a DCF) being dismissed entirely by the Tribunal, leaving only a treaty breach in respect of taxes, for which a historical cost methodology was appropriate.

The new cases reinforce our impression that Tribunals have become increasing comfortable with DCF methodologies over the years but remain unwilling to accept valuations which they consider are based on overly speculative data.

[21] Tenaris SA and Talta v Bolivarian Republic of Venezuela as noted in our previous article, Discounting DCF (https://www.pwc.co.uk/services/forensic-services/disputes/discounting-dcf.html)

[22] Oxus Gold plc v Republic of Uzbekistan (UNCITRAL case)

Isn't interest interesting?

Tribunals are devoting more attention to interest

We noted in our Dispute Perspectives publication[23] on interest that, even though the amount of interest awarded can be significant – sometimes even exceeding the value of the award itself – awards devote comparatively little space to discussing it. Furthermore our 2015 research found that in 60% of cases, there was no explicit discussion of what interest represents. As the Tribunal pointed out in *Murphy Exploration v Ecuador, 'The Tribunal has reviewed the practice of past Tribunals on the award of interest and considers it varied and inconsistent, falling short of providing clear guidance.'*[24]

Encouragingly, in the new cases we have reviewed, most awards devoted a number of pages to the subject and there is evidence that Tribunals have thoroughly considered the purpose for which interest is awarded, the appropriate rate and the justification for awarding compound vs simple interest. However, there remain a few Tribunals which did not explain clearly the rationale behind their award of interest. In some cases, less than half a page was devoted to the subject.

Are Tribunals converging on LIBOR + 2%?

Margins over an interbank rate have historically been popular with Tribunals and this continues to be the case. 12 of the 21 new cases were based on a margin over LIBOR or EURIBOR and 7 of these applied a 2% uplift.

There is some evidence that some Tribunals are taking the interest rate from previous awards as a precedent. The prevalence of LIBOR +2% as an interest rate in arbitration cases was explicitly used as a precedent by the Tribunal in *Von Pezold v Zimbabwe*[25]. Pre-award interest rates put forward by the Claimants based on returns from two of their investments were rejected as *'anomalously high compared with the rates of interest granted by other ICSID Tribunal Awards'...for this reason, the Tribunal finds the six-month USD LIBOR rate plus 2% to be appropriate.'*[26] In *Joseph Houben v Burundi,* the Tribunal also selected a rate of LIBOR + *2%, which it described as being 'a rate reasonably frequently used by arbitral Tribunals in investment matters.'*[27]

Whilst there are often cases in which LIBOR +2% represents an appropriate interest rate, we note that each case should be considered on its merits rather than adopting LIBOR + 2% by default.

Compound interest is favoured over simple interest

The trend we originally identified towards compound interest continues. Although many Respondents continue to argue in favour of simple interest[28], Tribunals acknowledge that the award of compound interest has become established practice, reflecting variously the economic reality that companies that borrow pay compound interest, the length and complexity of the proceedings and (where relevant) ensuring full reparation.

Of 21 new cases, compound interest was awarded in respect of 19 of them. Of the other two, a counter-claim by Ecuador in *Burlington Resources v Ecuador,* simple interest was awarded in conformity with Ecuadorian law. *Standard Chartered Bank v Tanzania* awarded simple interest as stipulated by the contract between the parties. This strongly suggests that Tribunals continue to consider compound interest to be a better reflection of commercial realities and a better way of achieving full reparation.

[23] https://www.pwc.co.uk/tax/assets/Tribunals-conflicts-on-interest-new.pdf

[24] Murphy Exploration and Production Company-International v The Republic of Ecuador, Partial final award dated 6 May 2016, paragraph 514

[25] Von Pezold family v Zimbabwe, ICSID case ARB/10/15, award dated 28 July 2015

[26] Von Pezold family v Zimbabwe, paragraph 947

[27] Joseph Houben v Burundi, ICSID case ARB/13/7, award dated 12 January 2016, paragraph 258 (translated from the French)

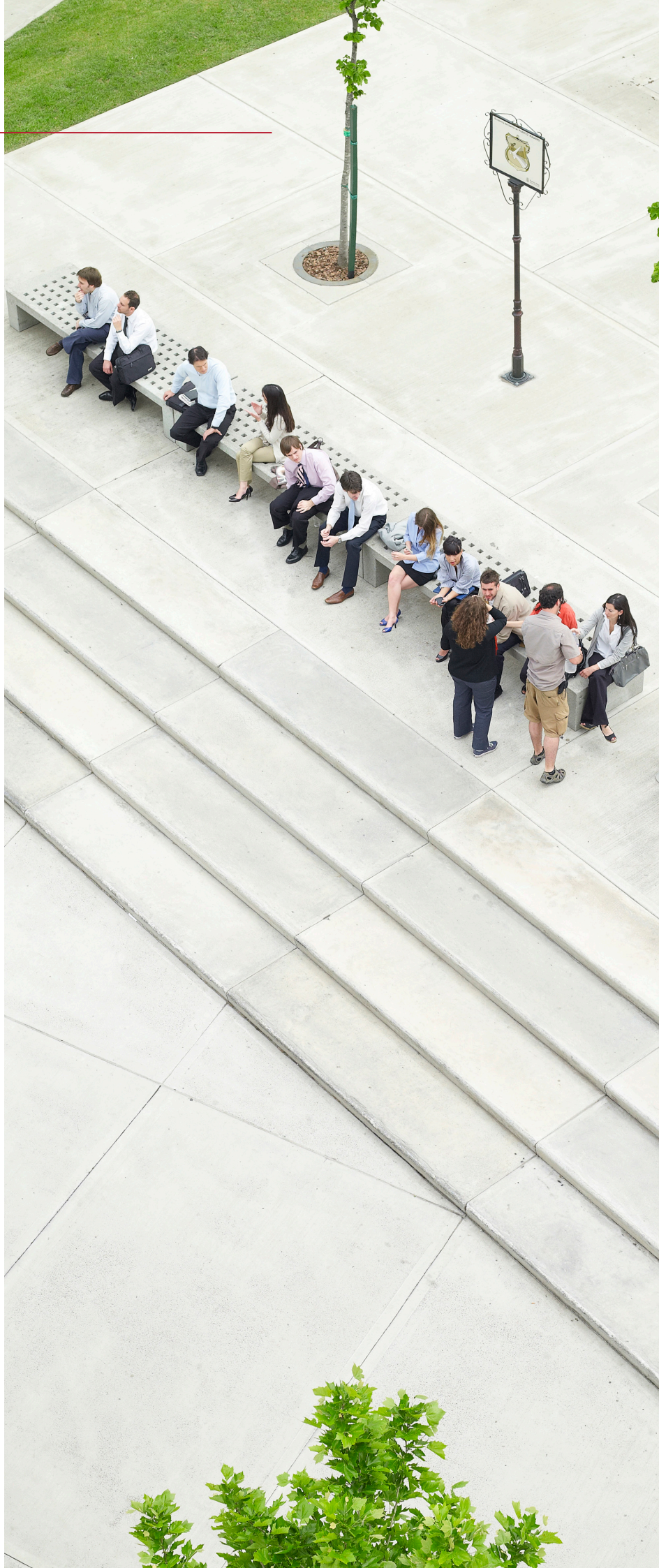
[28] See for example Copper Mesa Mining v Ecuador, UNCITRAL award dated 15 March 2016

Closing thoughts

Our 2015 research showed that there is often a significant gap between experts, a finding which has sparked debate amongst the arbitration community. It showed that treatment of damages varied enormously between cases but there were encouraging trends in the way Tribunals views damages – growing commerciality, evidence of more consistency between awards. The 2017 update to our research shows those trends continue.

There continue to be significant differences between the parties' positions and that difference is reflected in differences between experts. Our analysis suggests that there can be good reasons for such differences but that some of the difference is to be expected as experts quantify very different opposing scenarios.

There is evidence, empirical and anecdotal, that Tribunals are being increasingly proactive in trying to narrow the gap. Their tools include setting out a range of assumptions and sensitivities to be adopted by both experts or requesting a joint model. It's probably a bit optimistic to suggest our research has driven such progress but we hope that casting some illumination on damages in these cases contributes to the ongoing debate around making Arbitration a more efficient and effective dispute resolution process.



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