King & Spalding

Quantum Quarterly

The Damages Newsletter

A publication of King & Spalding's International Arbitration Group

Issue 04 | 3Q 2012

We are pleased to present the latest edition of *Quantum Quarterly*, a publication of King & Spalding's International Arbitration Group. This edition includes an interview with noted damages academic John Y. Gotanda, an article on the potential effect of derivatives on damages claims, and summaries of recent damages awards. In addition, our "Old But Still (Very) Useful" section highlights the famous *LIAMCO v. Libya* case. As always, we welcome any feedback you may have.

All the best.

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An Interview with Professor John Y. Gotanda

John Y. Gotanda, Dean and Professor of Law at Villanova University in Philadelphia, is one of the leading academics and authors on damages in international law and international commercial arbitration. He is the author of *Supplemental Damages in Private International Law*, which was published by Kluwer Law International, as well as numerous articles that have been published in the *American Journal of International Law*, the *Columbia Journal of Transnational Law*, the *Georgetown Journal of International Law*, the *Harvard International Law Journal*, the *Michigan Journal of International Law*, the *Oxford University Comparative Law Forum*, and the *Vanderbilt Journal of Transnational Law*. Professor Gotanda also acts as arbitrator, including in investor-State arbitrations.

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Interview with Professor John Y. Gotanda

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Q: How did you become interested in damages issues?

A: I first became interested in damages issues while working as an associate at a law firm in Washington, D.C. My first assignment upon joining the firm was to work on a dispute between an American party and a foreign government, that was being resolved through arbitration under the auspices of the International Chamber of Commerce. Among my many tasks were to work on the damages claims to determine whether interest was owed. Because a significant period of time would elapse between the date the claim arose and the award, the issues concerning the awarding of interest were of paramount importance. Indeed, the amount of the interest claimed ultimately exceeded the principal damages claimed. It was from working on this matter that I first was exposed to the complexity of damages issues, including the lack of uniformity among national laws, court decisions, and legal commentary on the resolution of issues relating to the awarding of damages and interest, and the interplay between law, economics, and finance. These issues were among the most interesting that I had ever encountered. Thus began my long-standing interest in damages issues, which has been the focus of my scholarly interests ever since. Incidentally, my work on that matter resulted in another long-standing relationship — the client's general counsel introduced me to my wife.

"Until recently, it had been a widely accepted practice in international disputes that simple interest was the norm. However, tribunals, particularly those involving investment disputes, began awarding compound interest, and today the practice has become so wide-spread that it is now considered the new norm."

Q: Can you think of any recent developments in the case law regarding damages that are worth mentioning?

A: One significant development in recent years is the acceptance of compound interest. Until recently, it had been a widely accepted practice in international disputes that simple interest was the norm. However, tribunals, particularly those involving investment disputes, began awarding compound interest, and today the practice has become so widespread that it is now considered the new norm. In my view, this is a welcome development as it reflects modern finance practices with regard to the payment of interest.

Q: Do you perceive there to be any material differences between how domestic courts deal with damages issues versus international arbitration tribunals generally or investment arbitration tribunals in particular?

A: In my view, tribunals handling international investment disputes are better at resolving complicated damages issues. First, many arbitrators involved in international investment disputes have considerable expertise in the area. Indeed, a number of decisions reflect a sophisticated approach to resolving damages claims. Second, arbitrators involved in international investment disputes seem to be more flexible in considering theories of economics and finance. Third, perhaps because of the high stakes involved in international investment disputes, the experts' opinions on the damages issues can be superb. By contrast, many domestic courts may not handle complicated damages issues on a regular basis and thus have not developed an expertise in handling such matters. Of course, there are a number of courts that do have such expertise — such as the courts in the state of Delaware in the U.S. Domestic courts are also more likely to take a homeward view toward damages issues, even if the dispute is governed by an international treaty, international law, or a foreign law. I should add that some domestic courts, including some jurisdictions in the U.S. do not allow legal experts to testify on damages issues.

“As lawyers and tribunals have become more familiar with damages issues, it should come as no surprise that the decisions concerning damages are better reasoned ...”

Q: Do you sense that tribunals are currently more prepared to deal with damages issues than, say, 20 years ago?

A: Yes. As I mentioned, the trend to award compound interest today vividly illustrates a more sophisticated approach employed by tribunals with regard to economic remedies. I should also mention that today there are many more decisions and commentary discussing the issue of damages. And 20 years ago, there were very few conferences on damages. Today such conferences are common. As lawyers and tribunals have become more familiar with damages issues, it should come as no surprise that the decisions concerning damages are better reasoned (or at least contain a detailed statement as to why the tribunal reached a particular decision with respect to damages). I should note, however, that there remains today a lack of uniformity in approaches to the calculation of damages, which is unfortunate because it results in similarly situated parties receiving vastly different awards, and this ultimately hinders parties from being able to settle their disputes.

Q: Any common misconceptions that practitioners and arbitrators should try to avoid?

A: There is a significant difference between interest as damages and interest on damages. The former typically requires a party to plead and prove its claim (e.g., the claimant would have to show there exists the authority to award interest as damages, that the loss was caused by the respondent, that it was foreseeable, and that the claimant could prove its loss with the requisite degree of certainty). By contrast, the latter is often awarded without proof of actual loss as courts and tribunals presume that the delayed payment of money deprives an injured party of the ability to invest the sum owed.

Q: Any recent publications on damages that you would encourage our readers to read?

A: My Hague Academy lectures on the subject in Recueil des Cours, volume 326. I also recommend Sergey Ripinsky and Kevin Williams, *Damages in International Investment Law* (2008), and Mark Kantor, *Valuation for Arbitration* (2008).

Q: Any piece of advice regarding advocating damages issues?

A: Be clear, be concise, and be reasonable. ✦

Impact of Derivatives on Damages in Oil & Gas Arbitrations

In 2008, Augustin Carstens, Mexico's finance minister, decided to hedge the country's entire oil export production, agreeing on a locked-in price per barrel. This insurance strategy required Mexico to buy put options (derivatives contracts that give the holder the right, but not the obligation, to sell oil at a predetermined price and date) for an ultimate cost of US$1.5 billion. But the gamble paid off: when world oil prices plummeted, Mexico made an US$8 billion profit on its hedge, and Augustin Carstens came to be known as the "world's most successful, but worst paid, oil manager."[1]

Mexico is far from being the only player in the oil & gas field to rely heavily on derivatives. Most of the large hydrocarbons producers, traders, and end-users hedge part or all of their exposure to price fluctuations. Extreme market volatility over the last year or so increased this need. In October 2011, Qatar became the first OPEC member to publicly acknowledge implementing a hedging strategy.[2] Hedging also increased on the users' end: Southwest Airlines saved about US$1.3 billion from its hedging program in 2008, and the merged United and Continental airlines hedged about 40% of their planned 2011 fuel consumption.[3] A little-discussed but central consequence of this increased reliance on derivatives is its potential impact on damages claims in oil & gas disputes, particularly in arbitration proceedings.

"Hedging also increased on the users' end: Southwest Airlines saved about $1.3 billion from its hedging program in 2008, and the merged United and Continental airlines hedged about 40% of their planned 2011 fuel consumption."

Derivatives' Impact on Monetary Damages

Derivatives contracts can increase or reduce the ultimate financial outcome of an oil & gas operation by limiting (through hedging) or exacerbating (by speculating on) the impact of price variations for the underlying commodity.[4] Energy derivatives constitute an extremely varied group, encompassing thousands of different contracts, serving a seeming infinity of purposes. Derivatives are either standardized and traded in regulated exchanges or customtailored to a specific situation and traded over the counter.[5] The following (deliberately simplistic) examples illustrate how derivatives contracts can affect the monetary outcome of oil & gas disputes.

In the first case, a hydrocarbons producer enters into a long-term supply agreement with a refiner. The price set for the successive oil deliveries is roughly indexed on the spot price of West Texas Intermediate, which rose considerably since the contract entered into force. Dissatisfied with the producer's performance, the refiner unilaterally decides mid-course to terminate the contract. The producer initiates arbitration proceedings, claiming for its lost profit on the remaining deliveries. That monetary claim proves substantial, the price increase having resulted in a large upside for the producer on each delivery. The producer, however, had decided to limit its risk at the time of entering into the supply agreement and hedged its entire contractual output, limiting its losses in case of price decrease, but also limiting its profits in case of price increase. As a result of this strategy, the producer's actual lost profits are considerably smaller than its damages claim, which is based on the contractually agreed prices.

Can the refiner argue before an arbitral tribunal that the producer's claims should be proportionally reduced to actual lost profits? In that case, can the producer claim for the costs of hedging its output?

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1 Daniel Yergin, THE QUEST (*hereinafter* "THE QUEST") 186 (2011).

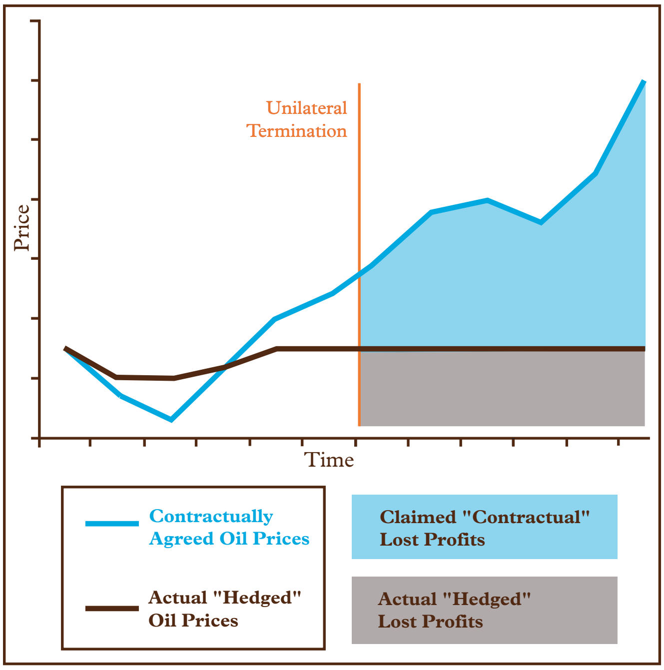
2 See Javier Blas, *Qatar joins Mexico with oil hedge*, THE FINANCIAL TIMES 20 (October 27, 2011).

3 Edward McAllister, *U.S. airlines more cautious on '10 fuel hedges*, REUTERS (February 25, 2010); Jenalia Moreno, *Airline fortunes fall as crude price rises*, THE HOUSTON CHRONICLE 13 (MARCH 8, 2011).

4 See THE QUEST at 166-69.

5 The New York Mercantile Exchange (NYMEX) is the world's largest physical commodity futures exchange. NYMEX has been part of the Chicago Mercantile Exchange Group (CME) since August 2008. Another major exchange is the Intercontinental Exchange (ICE), where Brent crude oil is traded amongst other energy commodities.

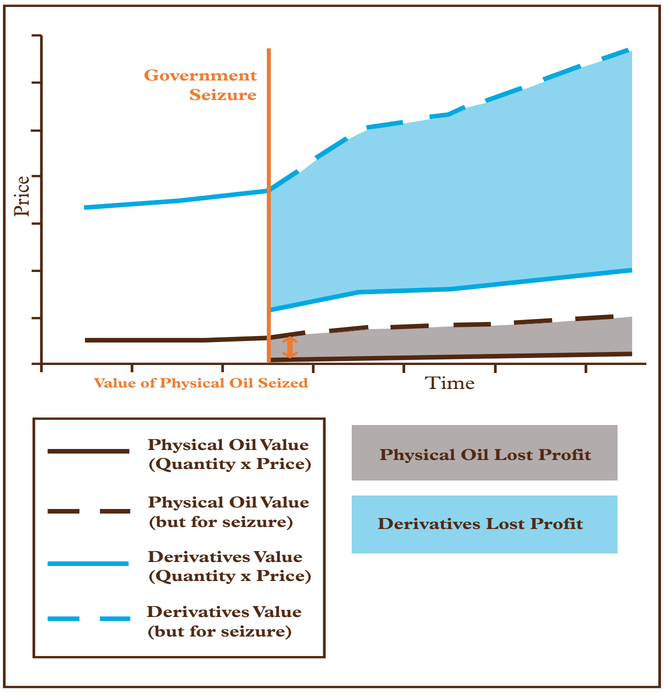
FIG. 1: Producer's "Contractual" and "Hedged" Lost Profits



The second situation is diametrically different: A crude oil trader stores vast quantities of oil in the terminal it owns in the territory of a sovereign State. Betting on an increase in oil price, the trader decides to augment its exposure (and therefore its expected profits) to a price upswing by purchasing exchange-traded crude oil futures. These contracts allow (actually require) the trader to buy determined oil volumes in six months at today's price. In the event of a price increase, the trader will profit from the difference between today's price and the higher market prices six months from now.[6] As a condition to the purchase of these crude futures, the trader posts as a deposit (also called "collateral" or "initial margin") the physical quantities of oil stored in the tank farm, representing 15% of the value of its future contracts. Exchange rules require for the posted margin to never represent less than 10% of the trader's position value, under penalty of immediate proportional reduction of that position.[7] Two months later, the State where the "physical" oil is stored decides to crack down on foreign speculators and implements an 80% tax on all quantities of crude oil stored on its territory, seizing 80% of the trader's crude. Not only does the trader lose large quantities of "physical" oil, but it also loses 80% of its posted collateral. The exchange immediately reduces its position by approximately 70%. Four months later, the trader's market insight proves correct — oil prices have increased significantly. But the trader realizes little more than 30% of its expected gains because it was forced to unwind the largest part of its position before the oil prices started climbing. Assuming the trader is appropriately protected under a bilateral investment treaty and that the new 80% tax effectively violates its rights as an investor, the trader commences arbitration proceedings against the sovereign State.

Could the trader claim not only for the value of the seized quantities of "physical" oil but also for the profit lost because it was forced to reduce its position on the futures market after the seizure of its collateral?

FIG. 2: Trader's "Physical" and "Derivatives" Lost Profits



These two situations, albeit simplistic, illustrate how derivatives can impact the damages claimed in oil & gas disputes. Practical situations are varied, as reflected by the large variety of existing derivatives products. However, parties to international arbitration proceedings very rarely take the impact of derivatives into account when assessing damages. Two main reasons explain why derivatives are so seldom used in that context. The first relates to the exigency of factoring derivatives into the damages equation. The second pertains to the difficulty of identifying and assessing the derivative's precise impact on oil & gas disputes.

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[6] In that case, the trader is not necessarily looking to acquire the physical quantities of crude oil but might also be looking for a purely financial gain by cash-settling its trades when the futures contracts come to maturity. In fact, only a negligible fraction of the crude futures traded over the NYMEX are physically settled.

[7] The exchange or clearing agent will unwind the "un-margined" trades by reselling the excess of futures contracts at current market prices.

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Foreseeability of Hedging and Speculative Strategies

Can the parties to an arbitration include derivatives in their damages assessment? In concrete terms, could they rely on derivatives in order to reduce or augment the amount of damages they claim? In the first of the two above examples, could the refiner argue for a reduction of the producer's damages claim based on the fact (or mere intuition) that the producer had hedged its output? In the second situation, could the oil trader claim for increased damages based on the profits lost from its derivatives trades?

Of crucial importance in answering these questions is determining whether the impact of derivatives on the damages claims is foreseeable or not. The foreseeability of damages remains a cardinal tenet of the legal theories of damages, both under the civil law and common law systems. Damages become compensable when the parties could have foreseen them at the moment of the commission of the action causing that damage. Conversely, damages that were unforeseeable when that action was committed are unlikely to be compensable. In the present case, this translates into determining whether or not the party at fault could have foreseen that the use of derivatives would have an impact on the victim's ultimate prejudice.

This central issue raises several related questions: Is the mere use of derivatives foreseeable in the context of the present dispute? Is the use of a particular type of derivatives more foreseeable than another (for instance, a "vanilla" exchange-traded crude oil futures instead of a customtailored swap aimed at covering a specific set of commercial risks)? Is the derivatives operation so risky or so highly leveraged that it will result in an unforeseeable outcome? Should hedges be treated differently from speculative operations? Many other issues come to mind when addressing real-life situations.

Determining the foreseeable character of derivatives' impacts ultimately remains a factual issue, subject to the arbitral tribunal's discretion. Derivatives are thus much more likely to be taken into account in a complex dispute opposing two large and sophisticated parties involved daily in the global oil & gas markets, than what would be the case in a dispute involving a small and unsophisticated respondent with limited market knowledge. Likewise, the tribunal could have to determine whether the nature, object, degree of sophistication, or even outcome of a derivatives operation could be reasonably foreseen. This factual approach is not exempt from drawbacks, particularly in that it provides for differentiated treatment based on the parties' individual situations.

Difficulty of Assessing Derivatives' Impact on Damages

If the parties to an arbitration can take into account the impact of reasonably foreseeable derivatives when discussing damages issues, they might still face considerable difficulties in doing so. The first difficulty would be to fix: indentify the derivatives at stake, which starts by forcing the parties to acknowledge they entered into a derivatives contract and to disclose the nature, importance, and specificities of these operations. Confidentiality, or at least discretion, constitutes a prerequisite for derivatives trading, particularly in the energy field. It therefore becomes extremely difficult to determine a party's derivatives position precisely. The trading of these derivatives further complicates the picture — trading can result in significant changes in a party's derivatives position over a short period of time. In the case of publicly traded futures or options, confidentiality becomes paramount to avoid unwanted market reactions. Likewise, investment banks or commodity traders often create over-the-counter swaps, forwards, and "exotic" derivatives contracts to suit the specific need of a particular client on the basis of confidential information and proprietary algorithms. Detailing the functionality and even disclosing the mere existence of these contracts could result in significant commercial or financial disadvantages for the party required to do so. For all these reasons, parties to an energy dispute are very unlikely to voluntary disclose how derivatives would affect their damages. Any effort to compel an opposing party to do so is therefore likely to require an important discovery process, often at a significant expense.

The second difficulty would be to assess precisely what these derivatives' actual outcome would have been "but for" the subject event. It took more than two years for the most sophisticated financiers to unwind derivatives portfolios involving Lehman Brothers and AIG after those institutions collapsed in late 2008. Although often less complex than most of the now infamous credit-default swaps, commodities derivatives allow assessment of their interplay with a separate dispute only at considerable cost. In other terms, seeking to factor the impact of derivatives into a damages calculation (be it to augment or to discount the outcome) comes only at significant expense. Any ensuing "battle of experts" over these derivatives' role further increases these costs.

That last consequence of involving derivatives in damages discussions may well constitute one of the best reasons for doing so: Derivatives likely represent an expensive and cumbersome tool to increase or decrease the damages at stake, which makes them a powerful weapon to force a settlement or limit the opposing party's ability to claim for specific damages. A respondent could be well advised to raise an argument based on derivatives when answering a damages claim. The opposing party, now facing the potential for a costly, unilateral, and probably damaging discovery process, might well decide that limiting a particular quantum claim, or dropping it altogether, constitutes a preferable course.

Conversely, a claimant could invoke the impact of its own derivatives trades to claim disproportionately larger amounts than those at stake in the underlying dispute. The opposing party, facing massive damages claims and the unappealing prospect of a costly counter-expertise, could then be tempted to agree on quantum before the tribunal's decision on the merits or simply initiate settlement discussions. In a nutshell, parties to an oil & gas dispute should not overlook the possibility of factoring derivatives into their damages claims — not only as a means to directly influence the tribunal's decision but also as a strategic component in a sophisticated damages strategy. ✦

"Derivatives likely represent an expensive and cumbersome tool to increase or decrease the damages at stake, which makes them a powerful weapon to force a settlement or limit the opposing party's ability to claim for specific damages."

Mobil Cerro Negro, LTD. v. Petróleos de Venezuela S.A. ET AL., ICC CASE NO. 15415/JRF

Date of the Award:
23 December 2011

The Parties:
Mobil Cerro Negro, Ltd. (Claimant), Petróleos de Venezuela, S.A and PDVSA Cerro Negro, S.A. (Respondents)

Sector:
Hydrocarbon Production

Members of the Tribunal:
Karl-Heinz Böckstiegel (Chair), Henri C. Alvarez, and Jacques Salès

Background:
This dispute arose out of a joint venture between the Claimant, Mobil Cerro Negro ("Mobil"), and one of the Respondents, PDVSA Cerro Negro, to exploit heavy oil resources located in the Orinoco Belt in Venezuela. The joint venture had been set up as part of the *apertura petrolera*, a Venezuelan Government campaign to attract foreign investments in the 1990s. This policy came to an abrupt end when President Chávez moved to reassert control over the oil industry to capture a larger share of the petroleum rent. In April 2007, the Venezuelan Government seized the project's assets without offering any form of compensation.

Mobil took the claim to arbitration, seeking indemnification under the terms of its joint venture agreement with PDVSA Cerro Negro, as well as under Petróleos de Venezuela's parent guarantee (PDVSA Cerro Negro and Petróleos de Venezuela are hereinafter referred to collectively as "PDVSA"). The contracts required PDVSA to indemnify Mobil against the effects of any expropriation, seizure of assets, or discriminatory measure imposed by the Venezuelan Government causing a "Materially Adverse Impact" on Mobil's cash flows from the project.

The Tribunal found in favor of Mobil, determining that PDVSA owed damages as determined below.

Damages Claim:
As a preliminary matter, it should be emphasized that Mobil's claim arose out of a contractually agreed indemnity provision and did not constitute a claim for expropriation under international law. Venezuela's expropriation of the Cerro Negro project became relevant under the contract only because it was one of the conditions that triggered PDVSA's obligation to indemnify Mobil. From a quantum standpoint, Mobil obtained damages based on the indemnification formula attached to the joint-venture agreement, not on the standard of compensation for the expropriation of its investment under international law.

A threshold issue concerned the term of the indemnification period. Mobil argued that the Tribunal had jurisdiction to award damages covering the entire contractual term (up to 2035). PDVSA, in turn, held the view that the Tribunal had jurisdiction to award damages covering Mobil's prejudice only for the year 2007 — when the expropriation took place — but not thereafter because the expropriation had made it impossible to apply the indemnity formulas to the years 2008 through 2035.

Noting that the parties had indisputably negotiated the joint venture agreement keeping in mind the

> "From a quantum standpoint, Mobil obtained damages based on the indemnification formula attached to the joint-venture agreement, not on the standard of compensation for the expropriation of its investment under international law."

nationalization of the Venezuelan oil industry in 1975 and that the government's aim was to attract international oil companies back to the country, the Tribunal concluded that the parties clearly intended to provide indemnification when expropriation, partial or complete, had occurred. A good-faith interpretation of the joint-venture agreement thus required applying the indemnity provision to the entire period.

Absent the parties' agreement on the issue, the joint-venture agreement required the Tribunal to determine whether measures having a materially adverse impact on Mobil had occurred. The Tribunal held that such measures had effectively occurred, triggering PDVSA's obligation to help Mobil obtain compensation or to provide indemnification. In doing so, the Tribunal rejected PDVSA's argument that the joint-venture agreement's indemnity formula could not apply when the agreement had been terminated.

In addition to determining whether measures having a materially adverse impact had occurred and awarding damages, the joint-venture agreement also required the Tribunal to recommend amendments to that agreement that would restore Mobil to its contractual situation "but for" the harmful measures. However, the termination of the joint-venture agreement effectively meant that the Tribunal could not recommend amendments to the agreement.

Calculation of Indemnification:
The joint-venture agreement provided for a set of complex formulas based on crude oil prices and actual cash flow to calculate the indemnity on a year-by-year basis. The agreement then provided for limitations to the calculated indemnity. The Tribunal considered the opportunity of awarding general damages instead but ultimately decided to apply the formula and limitation provisions.

PDVSA argued that compensation for the years beyond 2007 could not be calculated because there were no actual cash flows after 2007. The Tribunal adopted the view that while this made it difficult to apply the formulas, it did not make it impossible. The Tribunal went on to use the 2007 budget to calculate the future indemnity, considering it would constitute the most accurate reflection of the parties' intent and expectations for the project's future production.

In the absence of provisions in the joint-venture agreement or the parties' agreement, the Tribunal

had to determine what discount rate should apply to calculate Mobil's indemnity for the remainder of the agreement (2008-2035).

The Tribunal underlined the differences between valuing future cash flows under an indemnity formula, and valuing the potential cash flows from the project, noting that there may be fewer risks to indemnity cash flows than to project cash flows. The discount rate, however, should not "add back the very risks that the indemnity protects against." The Tribunal further noted that the discount rate should reflect the risks to the indemnity cash flows, historical rates of return to ExxonMobil and other oil companies' shareholders, and WAAC or hurdle rates that such companies set for their investments.

The Tribunal was persuaded that the 18% rate proposed by PDVSA appropriately reflected the risks related to the indemnity cash flow analysis, whereas the "risk free" rate proposed by Mobil could not be accepted. This 18% discount rate is largely responsible for the dramatic difference between the amounts claimed and awarded.

Pursuant to this analysis, the Tribunal set the indemnity for 2007 at US$12.681 million, taking into account the limitations on liability contained in the joint-venture agreement. For the remaining life of the agreement (2008-2035), the Tribunal awarded an indemnity of US$894.9 million.

Additional Claims:
The Tribunal rejected Mobil's request for declarations that PDVSA had breached contractual obligations,

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and also rejected PDVSA's counterclaims for (i) compensation for the prior attachment of its assets in New York, and (ii) project financing.

But the Tribunal did accept PDVSA's counterclaim in the amount of US$6,073,622, which represented the value of 1.3 million barrels of oil delivered to Mobil after 26 June 2007, and which the parties agreed did not belong to Mobil. The value of that oil was offset against the amount awarded to Mobil.

Interest:
The Tribunal rejected Mobil's claim for pre-award interest because it held that the debt upon which interest was to be calculated was not, and would not become, certain, liquidated, and due until the time of the Award.

As to post-award interest, Mobil suggested a rate of 9% but did not indicate whether this was a matter of *loi de police*. The Tribunal considered that in any event it should not be bound by *loi de police*, in that international arbitration practice is generally to award a market rate or a reasonable commercial rate under similar circumstances. The Tribunal thus awarded compound interest at the New York Prime Rate calculated from the date of the Award until the date of payment in full.

Costs, Enforcement, and Taxation:
The Tribunal observed that the case was of exceptional volume and complexity and that while Mobil had prevailed on liability, it had lost in substantial part on the quantum it sought. Similarly, while PDVSA had failed on jurisdiction and liability, it had prevailed to a large extent on quantum. Considering the exceptional magnitude and complexity of the case and the respective strengths and weaknesses of the parties' cases, the Tribunal held that each party should bear its own costs and that the costs of the arbitration should be equally shared.

The Tribunal further mentioned that while it had no competence to rule on enforcement, the assets that Mobil had attached in New York valued at approximately US$315 million, plus accrued interest, should be used by Mobil to partially satisfy the amount of the Award.

Finally, in order to prevent unjust enrichment, ensure that Mobil would not be subject to double taxation, and comply with the framework of the joint-venture agreement, the Tribunal directed PDVSA to pay the amount of taxes deducted and retained in connection with the indemnity calculation and to indemnify Mobil against any attempt by the Venezuelan Government to impose liability on Mobil in connection with those taxes.

El Paso Energy International Company v. Argentine Republic[1]

Date of Award:
31 October 2011

The Parties:
El Paso Energy International Company (Claimant), Argentine Republic (Respondent)

Sector Involved:
Energy (electricity and hydrocarbons)

Applicable Treaty:
US - Argentina Bilateral Investment Treaty ("BIT")

Members of the Tribunal:
Lucius Caflisch (President), Piero Bernardini, and Brigitte Stern

Background:
El Paso is an international energy company that invested in the Argentine companies CAPSA, an oil

[1] King & Spalding represented the claimant.

producer, and CAPEX, an electric power generator (collectively, the "Companies"). El Paso alleged that from December 2001 onward, Argentina took measures that breached undertakings it had assumed when the investments were made, which rendered the investments largely worthless and prevented the Companies from functioning independently. In June 2003, El Paso sold its shares in the Companies, citing Argentina's ongoing measures and the dim prospects for a return to a stable investment environment.

El Paso subsequently initiated ICSID arbitration, alleging that the measures violated several provisions of the US - Argentina BIT. The Tribunal ultimately found Argentina liable for breach of the fair and equitable treatment standard under Article II(2)(a) of the BIT and rejected Argentina's defenses under Article XI of the BIT and customary international law. The damages were determined as set forth below with the help of an independent expert appointed by the Tribunal.

Calculation of Damages

Causation:

Before assessing the amount of damages due to El Paso for Argentina's breach of the fair and equitable treatment standard, the Tribunal considered the element of causation, which had been raised by the parties.

El Paso's Position:

Argentina had argued that El Paso's losses were due to macroeconomic conditions (i.e., that El Paso had "bought high" in 1997 and "sold low" in 2003), and therefore it should not be allowed to recover damages for the "business risk" inherent in such a divestiture. El Paso protested that this assertion was misplaced for two principal reasons. First, its claim was solely for the loss of value due to the government's measures in violation of El Paso's legal and contractual rights, which would have occurred whether El Paso sold or not. Second, the discounted cash flow ("DCF") analysis of El Paso's expert had removed any effect of macroeconomic conditions, such that damages comprised only effects resulting directly from the government's measures.

Argentina's Position:

Argentina stated that for a causal connection to exist, the government's measures had to be the proximate cause of the loss. El Paso did not deny this characterization. Argentina went on to say that, as determined by international tribunals, damages must be the natural and normal result of the act, as well as a reasonably foreseeable consequence of the act, or the intention of the perpetrator. Argentina contended that El Paso had not proved the causality link but rather confirmed causing the losses through its own acts (i.e., its decision to sell its assets during the financial crisis in Argentina).

Tribunal's Analysis

The Tribunal started its analysis by affirming that it shared the view of other tribunals that the test of causation was whether there was a sufficient link between the treaty violation and the alleged damage. The Tribunal held that the test was satisfied here.

The Tribunal went on to say that it could not be denied that general economic conditions were taken into account by El Paso when it decided to sell. Nonetheless, contrary to what Argentina asserted, the Tribunal held that "there is no contribution by the Claimant to a loss it suffered due to its own conduct, in the absence of a willful or negligent action by Claimant." The Tribunal had already concluded, in its analysis on liability, that the measures were the prevailing cause of El Paso's decision to sell. Additionally, the Tribunal was satisfied that El Paso's DCF analysis included only the effects of the government's measures; this had been confirmed by the Tribunal's appointed damages expert.

Compensation:

El Paso claimed for the loss in value of its Argentine assets as a result of the government's measures. El Paso's experts estimated the compensation owed using two valuation methodologies: the DCF method and

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> "...contrary to what Argentina asserted, the Tribunal held that 'there is no contribution by the Claimant to a loss it suffered due to its own conduct, in the absence of a willful or negligent action by Claimant.'"

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"…the Tribunal compared the "actual" and "but for" values of El Paso's stakes in the Companies, representing the fair market value of each Company with and without the effect of Argentina's measures."

"transactions" method. The former sought to measure damages as the difference between the value of El Paso's stakes in the Companies with and without the measures, while the latter sought to measure damages as the difference between the hypothetical "but for" sale price of El Paso's stakes in the Companies in the absence of the measures, as compared to the sale proceeds that El Paso actually obtained from its divestiture in 2003. The Tribunal chose the DCF.

The Tribunal first observed that the BIT did not articulate a standard to evaluate damages where there had been a breach of the fair and equitable treatment standard. In such a scenario, the appropriate standard of compensation was that found in the *Factory at Chorzów* case (i.e., that reparation must, as far as possible, wipe out all the consequences of the illegal act and reestablish the situation that would, in all probability, have existed if that act had not been committed). The Tribunal referred to other cases involving Argentina where treaty breaches other than expropriation had been found and in which tribunals had held that "damage should compensate for the difference in the 'fair market value' of the investment resulting from the breach of the BIT." The Tribunal adopted this approach as well.

As a result, the Tribunal compared the "actual" and "but for" values of El Paso's stakes in the Companies, which represented the fair market value of each Company with and without the effect of Argentina's measures. As to the valuation date, the Tribunal, in keeping with the reasoning of the *Chorzów Factory* case, concluded that it should take account of events up to the moment when compensation was paid.

The Tribunal had to address several additional issues before it could decide on the amount due to El Paso, to wit:

> The WAAC: The Parties' experts had arrived at "widely divergent" discount rates. Both rates were criticized by the independent expert appointed by the Tribunal, who calculated discount rates of 15.45% for electricity and 15.43% for hydrocarbons.
>
> Debt Discount: The Parties also had opposite views on whether a discount should be applied to the debt value of the Companies. El Paso argued that no discount should apply because the book value of the debt would remain the same before and after the measures. Conversely, Argentina argued that a discount fully attributable to the macroeconomic crisis should be adopted. The Tribunal's expert agreed with Argentina that a discount rate should be applied to the debt, but he disagreed on the attribution of the discount. He proposed two different discount rates for the actual and but-for scenarios — the former reflecting the negative and continuing impact of the measures and the macroeconomic crisis, and the latter reflecting the macroeconomic crisis only.
>
> Withholding Tax: The Tribunal had previously concluded that it had no jurisdiction over El Paso's claim for withholding taxes, as this claim fell within Article XII(2) of the BIT's exclusion (with a limited exception that the Tribunal found not applicable) of tax measures from the purview of the Treaty.
>
> Oil Prices: The Tribunal concluded that the valuation standard it adopted would allow it to consider information that became known after the date of the first measures in 2001, and so it relied on a valuation that included oil prices as of the date of El Paso's sale of the Companies in 2003.

[8] *Duke Energy Electroquil Partners and Electroquil S.A. v. Republic of Ecuador* (ICSID Case No. ARB/04/19), Award of August 18, 2008.

[9] *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile* (ICSID Case No. ARB/01/7), Award of May 25, 2004.

Benefits to El Paso from Pesification: The Tribunal was satisfied that any benefits to El Paso due to pesification (e.g., pesification of local obligations) had been fairly considered in the expert reports.

Value Collected by El Paso for the Sale of the Argentine Companies: This value was not deducted to determine the damages amount beacuse the DCF damages calculation assumed that El Paso had kept its shareholding in the Companies.

In the end, the Tribunal calculated El Paso's total damages to be US$43.03 million, exclusive of interest.

Interest:
El Paso had asked for interest to be awarded at the LIBOR rate plus 2% compounded quarterly. Argentina objected and argued that simple interest should be awarded. The Tribunal was persuaded that El Paso's proposal was reasonable. It also concurred with the holding in the series of available cases against Argentina that compound interest reflects economic reality and accordingly ordered that interest be compounded semi-annually. Finally, the Tribunal determined that interest would run from January 1, 2002, which was the date to which the amount of compensation was discounted in the Expert's Report, until the full payment of the amount due.

Costs:
The Tribunal noted that it had broad discretion in awarding costs and that some arbitral decisions had followed the principle "loser pays," while others had ordered each party to pay its own costs. In this case, the Tribunal observed that while El Paso had been successful on jurisdiction, it had been only partially successful on the merits and quantum. As such, it found it had good reasons to order the Parties to pay their own costs and legal expenses and bear equally the costs and expenses of the Tribunal and ICSID. ✦

[10] The Participation Agreements were an intra-group investment arrangement between Claimant and its parent company, the Elliott Group, by which Claimant was the nominal owner of the shares and the Elliott Group was the beneficial owner of the shares.

Our "Old But Still (Very) Useful" Section

Libyan American Oil Co. ("LIAMCO") v. Libya, 17 I.L.M. 3 (1978), 4 Y.B. COM. ARB. 177 (1979)

The LIAMCO case was one of a trio of arbitral decisions arising from Libya's nationalization of its oil sector in 1973. LIAMCO, a US company, had entered into a number of concessions with Libya in 1955. After the nationalizations imposed by the then-new Qaddafi regime, LIAMCO initiated arbitration proceedings under its Concession Agreements, requesting as its primary remedy the reinstatement of its concessions and as an alternative, damages in the amount of US$207,652,667 plus interest. That amount consisted of the following three components: (1) Physical Plant and Equipment — US$13,882,667; (2) Concession — 20 US$186,270,000 (lost profits); and (3) Concession 17 — US$ 7,500,000 (lost profits).

Initially, the sole arbitrator ruled that he could not award restitution, stating among other things that "it is impossible to compel a State to make restitution; this would constitute in fact an intolerable interference in the internal sovereignty of States." As to LIAMCO's alternate claim for damages, turning first to the physical property, the arbitrator said that "there is no difficulty also that the indemnity should include as a minimum the *damnum emergens*, e.g., the value of the nationalized corporeal property, including all assets, installations, and various expenses incurred." For these assets and expenses, the arbitrator awarded LIAMCO the full amount of its claim.

With respect to the two concessions, the arbitrator first undertook a full conceptual analysis of the recoverability of lost profits. He found that (1) most municipal law systems permit lost profits as part of the damages for breach of contract; (2) both Libyan law and Islamic law also allow the recovery of lost profits; and (3) classical international law allows the recovery of lost profits for both wrongful taking of property and lawful nationalizations. He noted, however, that the recent evolution of international law indicated there was no constant and uniform rule for the compensation of lost profits for nationalizations, at least not all future profits.

Turning next to the specific claims of quantum, as for Concession 20, the arbitrator considered that to award lost profits for all future concession reserves would be an "extreme" position. In lieu of this "extreme," the arbitrator held that "it would be reasonable and just to adopt the formula of 'equitable compensation' as a measure for the estimation of damages..." Relying on this compensation formula, the arbitrator awarded LIAMCO only US$66 million (out of its US$186 million claim) for its rights in Concession No. 20.

The situation for Concession 17 was different. Unlike Concession 20, no oil had ever been produced from that field, but LIAMCO argued that the increase in the price of oil would have rendered the field economic, such that LIAMCO should be compensated US$7.5 million for its lost opportunity. But the arbitrator awarded nothing on this claim, reasoning that such profits were not "certain and direct," were doubtful, and were probably not realizable.

As for interest, LIAMCO requested a 12% rate on all amounts claimed, although it recognized that setting the rate was a matter for the arbitrator's discretion. The arbitrator concluded that it was "just and equitable to consider the interest claimed not as usury (ribd), but as a compensatory equivalent consideration of the said discount rate ...." The arbitrator elected the 5% rate allowed by Libyan law for commercial cases but granted interest only from the date of the final assessment of damages on the theory that interest cannot be awarded on unliquidated damages before they are ascertained.

As for costs, the arbitrator awarded LIAMCO US$203,000, pointing to Libyan law and a clause in the contract that suggested costs could be allocated in an appropriate manner in light of LIAMCO's success in pursuing some but not all of its claims.

The LIAMCO case is an interesting one to read in light of more recent international jurisprudence on quantum. The arbitrator's decision conflicts with some recent cases on the power to award restitution, against a State as well as the "full" compensation standard. Nonetheless, the arbitrator's reasoning on awarding LIAMCO only about a third of its claimed damages mirrors to some extent the conservative approach to compensation taken by many modern tribunals, even those applying an ostensibly more robust standard. In addition, the arbitrator's general analysis on lost profits, as well as his decisions on interest and costs, are likewise reflective of much current jurisprudence on these issues, except that his decision to award interest only from the date of the award is inconsistent with the requirements of most modern bilateral investment treaties. ✦

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