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LEGAL ASPECTS OF VALUATION OF DAMAGES IN INVESTMENT ARBITRATION

SENIOR PROJECT

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Abstract

The on-going practice of investment arbitration is now facing serious challenges. The parties of investment disputes together with scholars and commentators have started to question the legitimacy of awards based on a number of grounds that are discussed in this project. Such problems as financial and economic incompetence of arbitrators, shifted role of experts involved in the process, problems of double counting and non-inclusion of political risks in calculation of damages, are creating inconsistent arbitral practice for similar cases, legal uncertainty, and undermining confidence of investors and states in the future decisions. Moreover, it creates threats of losing trust in the system of investor-state dispute settlement by investors and states, as the problems may potentially harm both sides of dispute. The senior project is aimed at identifying risks in the process of valuation of damages in investment arbitration and providing recommendations for the most effective resolution of the existing problems.

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List of Abbreviations

DCF – Discounted Cash Flow

IBA – International Bar Association

ICC – International Chamber of Commerce

ICSID - International Centre for Settlement of Investment Disputes

ILC - International Law Commission

LCIA - London Court of International Arbitration

PCIJ - Permanent Court of International Justice

PICC - Principles of International Commercial Contracts

UNCITRAL - United Nations Commission on International Trade Law

UNCTAD - United Nations Conference on Trade and Development

UNIDROIT - International Institute for the Unification of Private Law

Introduction

Each year there is a growing number of cases in international investment arbitration. The key factor for such trend is a global increase of cross-border economic activity in the world in the last 25 years.[1] According to the United Nations Conference on Trade and Development (UNCTAD) World Investment Report of 2014, the comparison of volumes of foreign direct investment (FDI) in the period between 1990 and 2013 demonstrated that the world has experienced a considerable growth of global volume of FDI from US$3.6 trillion in 1990 to US$25.5 trillion in 2013.[2] This growth in volumes of FDI led to a significant rise in the number of arbitration filings in the world.[3] The majority of FDI is being directed to the developing and transition economies with highly profitable natural resource industries.[4] In such countries, as demonstrated by the examples of Venezuela, Ecuador, Argentina and others, there is an amplified risk of "governmental opportunism," which is expressed in breach of obligations on protection of investment, arbitrary regulatory measures, expropriation and unfair treatment of investors.[5] According to the recent statistics of the International Centre for Settlement of Investment Disputes (*hereinafter* ICSID), if in 1987 there were only four cases registered by the ICSID, ten years later in 1997, the number of cases had reached ten cases for the calendar year, and in the year 2014, there were 38 cases registered.[6] International investment arbitration has become the most widespread investor-state dispute settlement

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[1] Mark Bezant, James Nicholson, and Howard Rosen, "Trends in International Arbitration in the New World Order," *The European, Middle Eastern and African Arbitration Review* (2015), accessed April 25, 2015, http://globalarbitrationreview.com/reviews/67/sections/232/chapters/2683/trends-international-arbitration-new-world-order/.
[2] Ibid.
[3] Ibid.
[4] Ibid.
[5] Herfried Woss et al., *Damages in International Arbitration under Complex Long-term Contracts*, (Oxford: Oxford University Press, 2014), 248.
[6] "The ICSID Caseload–Statistics," *International Centre for Settlement of Investment Disputes*, no. 1 (2015), accessed April 25, 2015, https://icsid.worldbank.org/apps/ICSIDWEB/resources/Documents/ICSID%20Web%20Stats%202015-1%20(English)%20(2)_Redacted.pdf.

mechanism for the reasons of impartiality, competence of arbitrators, reasonable freedom presented to the parties of disputes and enforceability in virtually any country in the world.[7]

With this increase in the number of cases presented before investment tribunals each year, the statistics demonstrate that the world is also experiencing a significant increase in the amounts of damages awarded to claimants against host states. For example, in 2012 the largest amount of damages awarded to the investor was $2.3 billion with interest applied.[8] In 2014, this record was beaten by $50 billion awarded to investor.[9] Even though such cases are infrequent, there is statistical background, which supports the view that there is a general growth in average volumes claimed and consequently awarded to investors at dispute.[10] In line with the growth in the volumes of damages awarded, more and more states as well as experts and scholars are demonstrating concerns on the legitimacy of awards, which endangers the whole system of investment arbitration.[11] Such threats may have serious potential implications, starting from a general lack of certainty in the process of arbitration, lack of trust of investors and states in the financial and economic competence of arbitrators, absence of consistency in arbitral practice and finishing with the overall decline of trust in the legitimacy of awards in the system of investor-state dispute settlement.[12]

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[7] Joshua B. Simmons, "Valuation in Investor-State Arbitration: Toward A More Exact Science," *Berkeley Journal of International Law* 30,no. 1, (2012): 204.
[8] "Ecuador ordered to pay Occidental $1.77 billion in damages," *Reuters*, accessed April 3, 2015, http://www.reuters.com/article/2012/10/06/us-ecuador-occidental-ruling-idUSBRE89500O20121006
[9] "Court orders Russia to pay $50 billion for seizing Yukos assets", *Reuters*, accessed April 7, 2015, http://www.reuters.com/article/2014/07/28/us-russia-yukos-idUSKBN0FW0TP20140728
[10] Mark Bezant, James Nicholson, and Howard Rosen, "Trends in International Arbitration in the New World Order," *The European, Middle Eastern and African Arbitration Review* (2015), accessed April 25, 2015, http://globalarbitrationreview.com/reviews/67/sections/232/chapters/2683/trends-international-arbitration-new-world-order/
[11] Joshua B. Simmons, "Valuation in Investor-State Arbitration: Toward A More Exact Science," *Berkeley Journal of International Law* 30,no. 1, (2012): 204.
[12] Ibid., 198.

The project focuses on the challenges faced by arbitrators, investors and states during the process of valuation of damages in the current arbitral practice. The methodology of research is based on a case study method, since the issues of this project are mostly connected to the practices used in modern investor-state arbitration. This work analyzes the most recent cases in order to make the analysis up-to-date and concentrates on problems, which are discussed in the scholarly community. Even though there are scholarly articles, books and other publications on the topic of damages, there are no works, at least known to the author, that would contain a comprehensive and up-to-date analysis of all the problems discussed in this project and provide recommendation for their resolution. In this regard, the project uses a method of synthesis by combining the findings of the published works and providing analysis and deeper elaboration on the problems discussed in the body of the work.

The senior project is dedicated to answering the question on whether the process of valuation of damages in the current arbitral practice results in legitimate awards. The proposed thesis statement is that the current practice of valuation of damages demonstrates the necessity of introduction of substance-based and procedural changes aimed at elimination of legal uncertainty and establishing consistency in arbitral practice to ensure legitimacy of arbitral awards.

The first chapter of the project is aimed at analyzing the existing legal and theoretical framework of the question of damages in modern international jurisprudence. The chapter describes the historical development of standards of compensation, starting from the landmark cases of *Lusitania* and *Factory at Chorzow*, which created the fundamental bases for determination of damages in international law, and finishing with modern international instruments. The chapter considers the standards of compensation,

which are applicable in investment arbitration, and demonstrates the essential differences between the standards of compensation that are used in investment and commercial arbitration. The chapter focuses on the key international instruments in the area of damages in investment arbitration, including the International Law Comission (ILC) Draft Articles on Responsibility of States, International Institute for the Unification of Private Law (UNIDROIT) Principles of International Commercial Contracts, and also 2012 U.S. Model Bilateral Investment Treaty (BIT) as an example of bilateral regulation of investments, including the question of damages. In the next subsection the project introduces the reader to the valuation methods used in arbitral practice. In its conclusion, the chapter answers the question whether the current regulation is sufficient for the legitimate determination of awards.

In the second chapter of the project the focus is on the most significant, controversial and currently discussed problems, which present challenges the current arbitral practices in the world. The problems are divided into two directions (procedure-based and substance-based). The project identifies such problems as lack of financial competence of arbitrators, which casts doubts on legitimacy of valuation and also lack of explanation of damages. Moreover, the project discusses the role of experts in international arbitration with a special emphasis on the occurring shift of the role of party-appointed experts and loss of their independence. In the next subsections, the project analyses the problem of double counting of losses, which creates erroneous practice of over-compensating the investors, and the problem of political risks in valuation of damages, which has become one of the most discussed problems for having inconsistent application in the current arbitral cases.

For each problem discussed, the project proposes recommendations for their resolution, such as the use of tribunal-appointed experts, expert-teaming, creation of consistent practice of inclusion of political risks in valuation and elimination of practice of double counting. The chapter analyzes the advantages and disadvantages of the proposed solutions and provides recommendations regarding which solution is more beneficial to fix the discussed problems. The author hopes that the provided recommendations will positively affect the shortcomings of the existing arbitral practice by bringing legal certainty, creating consistent practice and increasing the trust of investors and states to the legitimacy of future arbitral awards.

Chapter I. Theoretical and Legal Background of Compensation of Damages in International Investment Arbitration

The aim of this chapter is to introduce the reader to the conceptual framework of damages in international investment arbitration. The chapter provides a brief history of the development of the concept of damages from the earliest international public law disputes until its modern state in arbitral decisions. The chapter analyzes the effective international legal framework, which exists in the instruments of various national and international institutions, including UNIDROIT, ICC, model Bilateral Investment Treaties and others. The chapter concludes with the analysis of the existing state of legal framework, and applicability of historical developments in the modern world.

1. Conceptual Framework of Damages in International Law

The concept of damages in international law is a legal remedy available in the cases of a wrongful act.[13] The concept enshrines a "duty to pay for the detrimental consequences that the victim of an unlawful act has suffered."[14] Before the emergence of ILC Draft articles on State responsibility, there was a clear distinction between the concepts of damages and compensation, as it required establishing the legality of an act of responsible party to decide whether it has a duty to pay damages or to pay compensation.[15] This practice happened as the term of compensation was used in the limited scope of cases, which involved only the lawful actions of the state (for example, lawful expropriation).[16] However, with the creation of ILC articles, this distinction have lost its significance, and in the modern practice, these two terms are used

[13] Sergey Ripinsky and Kevin Williams, *Damages in International Investment Law*, (London: British Institute of International and Comparative Law, 2008), 4.
[14] Thomas W. Wälde and Borzu Sabahi, "Compensation, Damages and Valuation in International Investment Law", *Transnational Dispute Management*, no.6 (2008): 2.
[15] Sergey Ripinsky and Kevin Williams, *Damages in International Investment Law*, (London: British Institute of International and Comparative Law, 2008), 4.
[16] Ibid.

interchangeably in both lawful and unlawful behavior of the responsible party as they entail the same conceptual meaning.[17]

2. History of Concept of Damages in the 20th Century

There is no clear answer on how the term of damages or reparation appeared in international law. According to Lauterpacht in *Private Law Sources*, at the beginning of the 20th century, with a sensible raise in international disputes, the concept of damages had to find its grounding bases in the domestic private law notions.[18] One of the first international cases to consider the question of damages is the *Lusitania case*. The case was filed a result of sinking of British ocean liner Lusitania during the World War I by German submarine on the south coast of Ireland.[19] Because of sinking, 128 out of 197 American citizens on the board were lost.[20] The case of *Lusitania* has become important for the issue of compensation of damages as it states that, "it is a general rule of both the civil and common law that every invasion of private right imports an injury and that for every such injury the law gives remedy…the remedy must be commensurate with injury received."[21] This statement created an obligation for the tribunals to find real value of damages suffered by the injured party, in order to be fully compensated for the actions of responsible state.[22]

[17] Sergey Ripinsky and Kevin Williams, *Damages in International Investment Law*, (London: British Institute of International and Comparative Law, 2008), 4.
[18] Hersch Lauterpacht., *Private Law Sources and Analogies of International Law: With Special Reference to International Arbitration* (London: Longmans, Green and Co. Ltd., 1927), 147.
[19] Opinion in the Lusitania cases, 1923 Mixed Claims Commission, U.S. and Germany (Nov.1), 17-32.
[20] Ibid.
[21] Ibid.
[22] Borzu Sabahi, *Compensation and Restitution in Investor-State Arbitration: Principles and Practice*, (Oxford: Oxford University Press, 2011), 134.

2.1. The *Factory at Chorzow* Case as a Landmark Decision for Determination Damages in International Law

The most landmark decision in international law concerning the question of damages is the famous *Factory at Chorzow* (1928). The case was filed in the Permanent Court of International Justice by Germany against Poland.[23] Even though it is a public international law case and the parties of dispute are the states (Germany and Poland), it sets the ground for determination of damages for the cases, where private entity (investor) is involved.[24] By the year 2015, the case is 87 years old, but the fact that it remains one of the most cited cases with regards to the question of reparations in international law, reasonably proves the significance of the case.[25]

The facts of the case are the following. During the times of World War I, on March 5 1915, the Chancellor of German Empire entered into contract with a Bavarian chemical industries company named Bayerische Stickstoffwerke A.G. in order to build and operate the chemical factory (production of nitrates) at Chorzow in Upper Silesia.[26] On 1 July 1922, the Polish court issued a decision to expropriate the Chorzow factory by referring to a liquidation law of 1920.[27] It took the control of the factory and appointed its own manager.[28] In 1922-1925, Bayerische Stickstoffwerke A.G. and Oberschlesische Stickstoffwerke A.G. filed several claims to the German-Polish Mixed Arbitral Tribunal in Paris established under the

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[23] Borzu Sabahi, *Compensation and Restitution in Investor-State Arbitration: Principles and Practice*, (Oxford: Oxford University Press, 2011), 47.
[24] Ibid.
[25] Ibid.
[26] Case Concerning Factory at Chorzow (Germany v. Poland), 1928 P.C.I.J. Ser. A No. 17 (Sept. 13).
[27] Ibid.
[28] Ibid.

Treaty of Versailles and to the local Polish courts, but these claims were not successful. [29] In 1927, the German government filed a case in PCIJ, claiming the violations of Versailles treaty and Geneva Convention on Upper Silesia and that actions of Poland constituted illegal expropriation.[30] The Court found expropriation; however, in the end, the parties settled the case and withdrew it from PCIJ.[31]

The most important conclusion of the Court is not the merits of the case, but its findings on the issue of compensation. In its analysis, the Court concluded that reparation should "wipe-out all the consequences of the illegal act and reestablish the situation which would, in all probability, have existed if that act had not been committed."[32] This concept has become important as the Court ruled that the aggrieved party should be put in the position as if the illegal act would not have happened.[33] It is clear that this principle is "equivalent to compensation for specific performance under a standard synallagmatic contract."[34] Nevertheless, in the cases of breach of investor's rights, specific performance requirement may not be applicable. As it was analyzed by H.Woss in *Damages in International Arbitration under Complex Long-term Contracts,* the tribunals have no power to order for specific performance (*i.e.* to oblige the host state to return the expropriated property), or for the reason that "the tribunal cannot fully

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[29] Doak R. Bishop, James R. Crawford, W. Michael Reisman, *Foreign Investment Disputes: Cases, Materials and Commentary* (Hague: Kluwer Law International, 2005), 1278.
[30] Case Concerning Factory at Chorzow (Germany v. Poland), 1928 P.C.I.J. Ser. A No. 17 (Sept. 13).
[31] Borzu Sabahi, *Compensation and Restitution in Investor-State Arbitration: Principles and Practice*, (Oxford: Oxford University Press, 2011), 53.
[32] Case Concerning Factory at Chorzow (Germany v. Poland), 1928 P.C.I.J. Ser. A No. 17 (Sept. 13).
[33] Ibid.
[34] Herfried Woss et al., *Damages in International Arbitration under Complex Long-term Contracts*, (Oxford: Oxford University Press, 2014), 255.

replicate specific performance over time.[35] Therefore, in order to compensate the investor for the breach of the host State, the Chorzow formula should be applied.

The formula may be logically divided into three elements, and the relevant tribunal has to consider each of them in order to reach the amount compensation that will be in conformity with the Chorzow standard.[36] By stating that the award should "wipe out all the consequences," the tribunal refers to completeness of the compensation and causality.[37] The award should compensate all the consequences, which arose from the particular breach, but not the ones, which does not have or may have some indirect connection to the breach.[38] When the tribunal says that the compensations should "reestablish the situation which would … have existed if that act had not been committed," the Court refers to economic compensation (reestablishment) of the situation to some particular moment in time. There is a question, though, to which moment the award should compensate the situation – to the time of breach, time of award or some other moment in time?[39] Finally, "in all probability" means that the there has to be certain extent of certainty for correct valuation of the award.[40]

Chorzow factory case eliminated the question, which arose after *Lusitania case*.[41] There were doubts in scholarly views on whether the full compensation principle elaborated in that case should put the aggrieved party in a factual position before the illegal act of the State (*status quo ante*) or in the hypothetical position, imagining as if

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[35] Herfried Woss et al., *Damages in International Arbitration under Complex Long-term Contracts*, (Oxford: Oxford University Press, 2014), 255.
[36] Ibid.
[37] Ibid.
[38] Ibid.
[39] Ibid.
[40] Ibid.
[41] Borzu Sabahi, *Compensation and Restitution in Investor-State Arbitration: Principles and Practice*, (Oxford: Oxford University Press, 2011), 48.

the act have not taken place.[42] The Court in *Chorzow* ruled that hypothetical position should be considered in determining the reparation.[43] This concept is parallel to the "*but-for* premise," which is often used in commercial arbitration "to place the injured party in the situation it would be in had the breach not occurred."[44] Therefore, granting the compensation put the aggrieved party to the position of "indifference" in choice between monetary compensation and specific performance.[45] As mentioned by Woss, this has become "gold standard of compensation for breach," used both in commercial and investment disputes.[46]

2.2. Difference of Valuation of Damages in Investment v. Commercial Disputes

Even though both commercial and investment disputes are based on the same principles of compensation, there is a fundamental difference between them as to the issue of valuation of damages.[47] The standard established by *Factory at Chorzow* contains two fundamental elements, which cannot be applied for commercial disputes: use of “fair market value” standard instead of “market value,” and distribution of windfalls to the aggrieved party.[48] In commercial disputes, losses are determined by the "market value", whereas in investment arbitration, the tribunals have to determine the "fair market value" of losses occurred as a result of breach.[49] Such divergence is mainly justified by the fact that in common commercial contracts the parties are more likely to be balanced in their

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[42] Borzu Sabahi, *Compensation and Restitution in Investor-State Arbitration: Principles and Practice*, (Oxford: Oxford University Press, 2011), 50.
[43] Case Concerning Factory at Chorzow (Germany v. Poland), 1928 P.C.I.J. Ser. A No. 17 (Sept. 13).
[44] Herfried Woss et al., *Damages in International Arbitration under Complex Long-term Contracts*, (Oxford: Oxford University Press, 2014), 256.
[45] Ibid.
[46] Ibid.
[47] Ibid., 259.
[48] Ibid., 254.
[49] Ibid., 259.

rights and obligations, as they possess same leverage in the case of disputes.[50] The possibility of breach is an integral part of any commercial contract; thus, the parties have power to design the contract in such way, that it would not grant any of the party the "excessive leverage."[51] In contrast, investor-state relationships, by their inherent nature cannot be balanced and the states as a general practice have more power and "excessive leverage," as they have resource to unilaterally introduce regulatory provisions that would affect the investor, whereas investors are very limited in such forces.[52] Such excessive powers of host states leads to unrestrained governmental opportunism, and use of the market value standard may lead to under-compensating the investor. In order to compensate this leverage, the *Chorzow* uses the standard of "fair market value" instead of "market value" of losses suffered by the injured party.[53] Moreover, as it was underlined by several authors, for example *Ripinsky*, the "fair market value" standard is almost universally recognized as the appropriate standard of compensation in modern arbitral practice.[54]

The concept of fair market value is not defined in investment treaties; yet, it is not controversial and is ubiquitously used in investment arbitration.[55] The definition of fair market value of enterprise is provided in *Black's Law Dictionary*, which refers to it as "amount at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts."[56] Since *Chorzow,* the tribunals have used various

[50] Herfried Woss et al., *Damages in International Arbitration under Complex Long-term Contracts*, (Oxford: Oxford University Press, 2014), 259.
[51] Ibid.
[52] Ibid.
[53] Ibid.
[54] Sergey Ripinsky and Kevin Williams, *Damages in International Investment Law*, (London: British Institute of International and Comparative Law, 2008), 183.
[55] Ibid.
[56] *Black's Law Dictionary*, 6th ed. (Eagan: West Publishing, 1990), 597.

definitions of fair market value.[57] Nevertheless, in all the definitions there is a common willing buyer/willing seller framework, where the value is represented as a price that would be paid in normal conditions. In several cases (such as *Sempra v. Argentina*, *Azurix v. Argentina*, *CMS v. Argentina*) the tribunal referred to the definition of the American Society of Appraisers:

> [The fair market value is] the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.[58]

Moreover, tribunals often refer to the definition provided by the World Bank Guidelines on the Treatment of Foreign Direct Investment (1992), where it is defined as:

> an amount that a willing buyer would normally pay to a willing seller after taking into account the nature of the investment, the circumstances in which it would operate in the future and its specific characteristics, including the period in which it has been in existence, the proportion of tangible assets in the total investment and other relevant factors pertinent to the specific circumstances of each case.[59]

The definitions of fair market value provided by different sources complement each other, though each of them covers different characteristics.[60] The common feature of all these definitions is that determination of fair market value requires projecting the hypothetical framework of transaction between a willing buyer and a willing seller, who act free of compulsion and possess adequate knowledge of facts.

Another important element of the *Chorzow factory case* is the question of valuation of damages. The formula found by the court does not give a clear explanation

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[57] Sergey Ripinsky and Kevin Williams, *Damages in International Investment Law*, (London: British Institute of International and Comparative Law, 2008), 184.
[58] "ASA Business Valuation Standards," *American Society of Appraisers* (2009), 27, http://www.appraisers.org/docs/default-source/discipline_bv/bv-standards.pdf?sfvrsn=0.
[59] "World Bank Guidelines on the Treatment of Foreign Direct Investment," *World Bank* (1992). art. IV.5, available at http://www.italaw.com/documents/WorldBank.pdf
[60] Sergey Ripinsky and Kevin Williams, *Damages in International Investment Law*, (London: British Institute of International and Comparative Law, 2008), 185.

of how to calculate the damages.[61] However, the valuation methodology can be found in the case, as the Court decided to appoint independent experts.[62] In order to determine the amount of damages, the experts were ordered to answer three questions. Question I-A is the following:

> I-A. What was the value, on July 3rd, 1922, expressed in Reichsmarks current at the present time, of the undertaking for the manufacture of nitrate products of which the factory was situated at Chorzow in Polish Upper Silesia, in the state in which that undertaking (including the lands, buildings, equipment, stocks and processes at its disposal, supply and delivery contracts, goodwill and future prospects) was, on the date indicated, in the hands of the Bayerische and Oberschlesische Stickstoffwerke ?[63]

By this, the Court asked to determine the fair market value of the investment at the moment when expropriation had taken place with updating the value as of the time of award based on the actual value of factory.[64] In question I-B the Court assigned expert to calculate the lost profit (*lucrum cessans*) for the period between the moment of expropriation and date of award:

> I-B. What would have been the financial results, expressed in Reichsmarks current at the present time (profits or losses), which would probably have been given by the undertaking thus constituted from July 3rd, 1922, to the date of the present judgment, if it had been in the hands of the said Companies?[65]

Lastly, the Court asked to calculate the amount of damages as to the date of award (indemnification):

> II. What would be the value at the date of the present judgment , expressed in Reichsmarks current at the present time, of the same undertaking (Chorzow) if that undertaking (including lands, buildings, equipment, stocks, available processes, supply and delivery contracts, goodwill and future prospects) had remained in the hands of the Bayerische and Oberschlesische Stickstoffwerke, and had either remained substantially as it was in 1922 or had been developed proportionately on lines similar to those applied in the case of other undertakings of the same kind, controlled by the Bayerische, for instance, the undertaking of which the factory is situated at Piesteritz ?[66]

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[61] Herfried Woss et al., *Damages in International Arbitration under Complex Long-term Contracts*, (Oxford: Oxford University Press, 2014), 270.
[62] Ibid.
[63] Case Concerning Factory at Chorzow (Germany v. Poland), 1928 P.C.I.J. Ser. A No. 17, 51 (Sept. 13).
[64] Herfried Woss et al., *Damages in International Arbitration under Complex Long-term Contracts*, (Oxford: Oxford University Press, 2014), 270.
[65] Case Concerning Factory at Chorzow (Germany v. Poland), 1928 P.C.I.J. Ser. A No. 17, 51 (Sept. 13).
[66] Ibid.

From these questions, one can reason that PCIJ requires considering the factual state of the factory before the expropriation, and the hypothetical situation as if the factory was in the hands of German companies and was reasonably developing during the years before the date of judgment. These three values (value at the time of expropriation, value of lost profits, and current value) created a standard which has become consistent in case law.[67] The main interpretation of this standard is to use the higher of value of question I-A and sum of values of I-B and II, which will result in the amount of damages equal to the fair market value of the investment.[68] This position was supported by several cases, for example in *ADC v. Hungary* the Tribunal found that the value of the investment substantively raised in the period between the date of expropriation and the date of valuation (period of five years).[69] In this case, using the value of property as to the date of expropriation would result in under-compensation of the investor.[70] Therefore, using the "higher of" standard, the tribunal found that the investor should be awarded the value of investment as of the date of the award.[71] This shows that *Chorzow factory case,* even after almost 90 years, is still used as a standard for determining damages.

2.3. Developments after *Factory at Chorzow*

In 1961, the Harvard Law School published Draft Convention on Responsibility of States for Injuries to Aliens, which was later cited by the International Law Commission,

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[67] Richard A. Walck, "Quatum Quarterly, the Damages Newsletter," *King & Spalding's International Arbitration Group* (2010), 11, accessed December 25, 2014, http://www.kslaw.com/imageserver/KSPublic/Library/publication/Quantum-Quarterly-May-2010.pdf.
[68] Ibid.
[69] ADC Affiliate Limited and ADC & ADMC Management Limited v. the Republic of Hungary, ICSID Case No. ARB/03/16, Award, 97-98 (2006).
[70] Herfried Woss et al., *Damages in International Arbitration under Complex Long-term Contracts*, (Oxford: Oxford University Press, 2014), 272-73.
[71] P. Bienvenu, M.J. Valasek, "Compensation for Unlawful Expropriation and Other Recent Manifestations of the Principle of Full Reparation in International Investment Law," in *50 Years of the New York Convention*, ed. Albert Jan Van Den Berg, (Dublin: Kluwer Law International, 2009), 248-250.

where it observed the question of reparation for injury inflicted on aliens. In the article 27 it says that damages are awarded to put the alien "in as good a position, in financial terms, as that in which the alien would not have been if the act or omission for which the State is responsible had not taken place" and to restore to the alien which the responsible state received as a result of the act or omission.[72] Moreover, the responsible state should provide "appropriate satisfaction" to the injured alien.[73] The Convention limits the amount of reparations by subtraction of those remedies received by local and international remedies.

For breaches of contract or concession, the Draft Convention provides the damages of compensation of losses and lost profit (as "gains denied as the result of such wrongful act or omission").[74] Alternatively, it provides a possibility of simple compensation, which will restore the position of an injured party to the moment before the wrongful act had taken place.[75]

3. Modern International Instruments Regulating Damages

In this section the project analyzes some of the modern instruments of international law, which regulate the question of damages in investment arbitration, including Draft Articles on Responsibility of States, UNIDROIT Principles of International Commercial Contracts and U.S. Model Bilateral Investment Treaty (BIT) as an example of bilateral regulation of investment, including the issue of damages.

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[72] "Draft Convention on Responsibility of States for Injuries to Aliens," *Harvard Law School* (1961), http://legal.un.org/ilc/documentation/english/a_cn4_217.pdf.
[73] Ibid.
[74] Ibid.
[75] Ibid.

3.1. Draft Articles on Responsibility of States

The question of damages are regulated in the Draft Articles on Responsibility of States for internationally wrongful acts, which was adopted by the International Law Commission in 2001. Even though they have no legal force in the strict sense, they have already achieved recognition and are commonly cited in international jurisprudence.[76] According to the Draft Articles, there are three legal consequences of an internationally wrongful act. The first one is a continued duty of performance, which means that the commission of a wrongful does not allow the responsible state to cease the performance of its obligations. The second consequence is cessation and non-repetition. By this, the ILC tries to prevent future breaches of obligation and immediately stop the breach in question itself, if it has a continuing character.

The next obligation provided by the Draft Articles is the obligation of reparation. The Draft Articles follow the concept proposed by the Chorzow factory case. Article 31 imposes an obligation for the state "to make a full reparation for the injury caused by the internationally wrongful act."[77] According to the Draft Articles, there are three forms of reparation, namely restitution, compensation and satisfaction. These forms may be applied in combination or separately.[78] Restitution in this sense means that the responsible state has to reestablish the situation before the commission of wrongful act, if it is materially possible and if it does not entail disproportionate burden to the state.[79] The second form of reparation is compensation, which means that the responsible state is

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[76] Borzu Sabahi, *Compensation and Restitution in Investor-State Arbitration: Principles and Practice*, (Oxford: Oxford University Press, 2011), 53.

[77] "Draft Articles on Responsibility of States for Internationally Wrongful Acts", *International Law Commission* (2001), chp.IV.E.1, accessed December 8, 2014, http://www.refworld.org/docid/3ddb8f804.html.

[78] Ibid.

[79] "Draft Articles on Responsibility of States for Internationally Wrongful Acts", *International Law Commission* (2001), chp.IV.E.1, accessed December 8, 2014, http://www.refworld.org/docid/3ddb8f804.html.

obliged to compensate the damages, which are not covered by restitution.[80] This includes any "financially assessable damage" including the established loss of profit.[81]

The final form of reparation, as provided by ILC, is satisfaction, which works if the damages are not or cannot be covered by restitution and compensation.[82] This form may include the non-material obligations as acknowledgement of breach, regret, apology, etc., which have to be proportionate to the wrongful act, and not humiliate the responsible state.[83]

The question of interest is provided in the article 38, where it says that an interest shall be paid "in order to ensure full reparation."[84] The main result or goal of the rate and method of calculation is to reach the effect of full reparation.[85] The second part of the same article provides an obligation of the responsible state to pay interest, which runs until its obligations are fulfilled.[86]

3.2. UNIDROIT Principles of International Commercial Contracts

The question of damages is observed in Section 4 of UNIDROIT Principles of International Commercial Contracts. In the Principles, by stating that "any non-performance gives the aggrieved party a right to damages…", it establishes general principle of international law by granting the right to damages for any party which suffered from non-performance of other party.[87] The establishment of right to damages is

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[80] "Draft Articles on Responsibility of States for Internationally Wrongful Acts", *International Law Commission* (2001), chp.IV.E.1, accessed December 8, 2014, http://www.refworld.org/docid/3ddb8f804.html.
[81] Ibid.
[82] Ibid.
[83] Ibid.
[84] Ibid.
[85] Ibid.
[86] Ibid.
[87] "UNIDROIT Principles of International Commercial Contracts," *UNIDROIT* (2010) art. 7.4.1., accessed December 8, 2014, http://www.unidroit.org/publications/513-unidroit-principles-of-international-commercial-contracts.

a direct consequence of non-performance.[88] Therefore, according to the comment to this article, in order to be granted this right it is sufficient for the party to prove that the other party did not perform the contract.[89]

According to the Principles, aggrieved party is subject to full compensation, including
"any gain of which it was deprived."[90] This article provides an important right for party of contract, which is highly relevant and applicable to the topic of this thesis. However, in the commentary to this particular article of PICC, it is also mentioned that damages granted to the aggrieved party must not enrich it.[91] By this, the PICC emphasizes the equality of parties of conflict and the compensatory aim of the law. Such provisions can be found in the domestic legislations as well. The awarded damages cannot be higher that the factual loss and lost profit.

In order to prevent abuses of right to damages, PICC created limitations that have to be followed in order to establish the damages. One of them is the requirement of certainty of damages. The aggrieved party has a right to claim damages that are "established with a reasonable degree of certainty."[92] This means that it is impossible to seek damages if there was no harm inflicted to the aggrieved party of conflict. In the same article, there is also a provision for possibility to seek compensation for the loss of opportunity (loss of chance), which became quite controversial during past years. The

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[88] "Comment to UNIDROIT Principles of International Commercial Contracts," *UNIDROIT,* accessed December 8, 2014, http://www.unidroit.org/instruments/commercial-contracts/unidroit-principles-2010/406-chapter-7-nonperformance-section-4-damages/1037-article-7-4-1-right-to-damages.
[89] Ibid.
[90] "UNIDROIT Principles of International Commercial Contracts," *UNIDROIT* (2010), art. 7.4.2, accessed December 8, 2014, http://www.unidroit.org/publications/513-unidroit-principles-of-international-commercial-contracts.
[91] "Comment to UNIDROIT Principles of International Commercial Contracts," *UNIDROIT,* accessed December 8, 2014, http://www.unidroit.org/instruments/commercial-contracts/unidroit-principles-2010/406-chapter-7-nonperformance-section-4-damages/1036-article-7-4-2-full-compensation
[92] "UNIDROIT Principles of International Commercial Contracts," *UNIDROIT* (2010), accessed December 8, 2014, http://www.unidroit.org/publications/513-unidroit-principles-of-international-commercial-contracts.

problem of loss of chance, and speculations around this question, will be observed in depth in the second chapter of project.

3.3. 2012 U.S. Model BIT

2012 U.S. Model BIT provides obligation for the state, which breaches the contract by expropriation or destruction of investor's property, to provide restitution, compensation, or combination of both depending on the situation.[93] The requirements for compensation are that it has to be prompt, adequate and effective.[94]

Article 34 of the BIT grants the possibility to arbitrators to awards separately or in combination, the monetary damages plus interest, and restitution of property, with possibility of the responsible party to choose whether to provide restitution or to pay monetary damages with applicable interest. In the third part of the same article, the BIT provides that the tribunal "may not award punitive damages."[95] The important note on US model BIT is that in thearticle 32, it grants the tribunal a right to use experts in report in sphere of "environmental, health, safety, or other scientific matters" by request of one of the parties or by its own initiative. However, as to the question of valuation of damages, it has no provision on the appointment of expert in the field of financial matters.[96]

4. Valuation Methods in International Investment Arbitration

There are several methods of valuation of damages in international arbitration. They can be divided into three categories- market-based approach, asset-based approach and

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[93] "2012 U.S. Model Bilateral Investment Treaty," *U.S. Department of State* (2012), accessed December 8, 2014, http://www.state.gov/documents/organization/188371.pdf.
[94] Ibid.
[95] Ibid.
[96] Ibid.

income-based approach.[97] Market based approach is also referred to as "comparable transactions" method.[98] It calculates the value of a company by the amount money a person is willing to pay for it.[99] The value is firstly derived by the transactions of the company, which can show the value of the company itself.[100] In addition to the company's own transactions, the experts evaluate the company in comparison with other similar company, within the same business sector, with similar size, turnover, number of employees, financial structure, stability of company (its maturity), geography and other comparable factors.[101]

Asset-based approach is the valuation method based on the actual assets of the company. This includes "net book value" method, which is the difference between assets of the company in the business books and liabilities of the company.[102] Another asset-based approach is calculation of total money invested in the company.[103]

The most widely used income based method is the discounted cash flow method.[104] This method evaluates the company by future projected profits discounted by the time value of money and level of uncertainty.[105] The quality of the result produced

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[97] Kathryn Khamsi, "Compensation for Non-expropriatory Investment Treaty Breaches in the Argentine Gas Sector Cases: Issues and Implications," in *The Backlash against Investment Arbitration: Perceptions and Reality*, ed. Michael Waibel et al. (Alphen aan den Rijn: Kluwer Law International, 2010), 172.
[98] Ibid.
[99] Anthony Charlton, "Valuation approaches and the financial crisis. Part 1 – Market Methods," *Kluwer Arbitration Blog*, last modified November 29, 2011, accessed December 25, 2014, http://kluwerarbitrationblog.com/blog/2011/11/29/valuation-approaches-and-the-financial-crisis-part-1-%E2%80%93-market-methods/.
[100] Ibid.
[101] Ibid.
[102] Kathryn Khamsi, "Compensation for Non-expropriatory Investment Treaty Breaches in the Argentine Gas Sector Cases: Issues and Implications," in *The Backlash against Investment Arbitration: Perceptions and Reality*, ed. Michael Waibel et al. (Alphen aan den Rijn: Kluwer Law International, 2010), 172.
[103] Ibid.
[104] Ibid.
[105] Anthony Charlton, " Discounted cash flows – Part 2, Valuation and the Financial Crisis," *Kluwer Arbitration Blog*, last modified January 26, 2012, accessed December 25, 2014, http://kluwerarbitrationblog.com/blog/2012/01/26/discounted-cash-flows-%E2%80%93-part-2-valuation-andthe-financial-crisis/.

by this method highly depends on the quality of inputs, such as assumptions of growth and discount rate.[106] Such measurements may be subjective and based on certain judgment, not objective numbers. Therefore, the experts may come to extremely different results, depending on the future predictions. The problems which arise as a result of the use of DCF method and case study on this issue will be presented in the next chapter.

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The chapter discussed the conceptual and legal framework of the concept of damages in international investment law. The concept has gone through massive development; however, the underlying bases, which came from the very early cases, such as *Chorzow*, are still used today, which raises a question on their effectiveness and applicability in the modern practice. The modern instruments of international law does not provide enough regulation of the process of valuation of damages and creates difficulties in arbitral practice. These problems are analyzed in the next chapter.

[106] Anthony Charlton, " Discounted cash flows – Part 2, Valuation and the Financial Crisis," *Kluwer Arbitration Blog*, last modified January 26, 2012, accessed December 25, 2014, http://kluwerarbitrationblog.com/blog/2012/01/26/discounted-cash-flows-%E2%80%93-part-2-valuation-andthe-financial-crisis/.

Chapter II. Existing Problematic Issues of Valuation of Damages in Investment Arbitration

In the modern arbitral practice the question of valuation of damages became one of the most controversial. As it was concluded in the previous chapter, modern international instruments related to protection of investments, such as BITs, regional treaties, instruments of international organizations are mostly silent about the controversies of the question of valuation of damages. These instruments have vast importance for setting standards of protection of investments against unlawful actions of the states and creating grounds and requirements for prompt, adequate and effective compensation. However, they are not able to answer the key controversial questions, which arise in the valuation procedure, creating uncertainty in investment arbitration and furthermore establishing heterogeneous arbitral practice. In this chapter, the author analyses the main controversies, which arise in the process of determining the damages in investor-state arbitration.

1. Procedure-based Problems of Valuation

1.1. Financial Competence of Arbitrators in Investment Arbitration

One of the main challenges concerning the legitimacy of awarded damages is the question of financial competence of arbitrators. It is common practice that most arbitrators are not specialists in the areas of finance and economics.[107] They are mostly experts with legal background who are trained to deliver judgments on the merits of the case or the question of jurisdiction.[108] In investment arbitration, the arbitrators, in general, have enough knowledge to determine the standards that were breached by the host state and the standard of compensation to be applied. However, when the process of

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[107] Joshua B. Simmons, "Valuation in Investor-State Arbitration: Toward A More Exact Science," *Berkeley Journal of International Law* 30, no. 1, (2012): 208.
[108] Ibid.

arbitration reaches the phase of valuation of damages, it is submitted by several authors, they do not have enough competence to make decision based on economic and financial data, which is far "beyond the traditional legal training of arbitrators."[109] As pointed by one of the authors,

> Whether or not modern arbitrators are good at assessing damages is not, I suggest, the point. The question is whether parties can have confidence that the person assessing damages is properly qualified to do so, and I suggest that in general, with the very greatest respect to all my friends, the modern legal arbitrator is not so qualified for self-evident reasons. Legal and economic reasoning are different.[110]

Such attitude to the arbitrators is dangerous for the system of arbitration as a whole, since it decreases the level of confidence of both investors and host states to the persons who are to adjudicate their case.[111] One of the vivid examples of insufficient competence of arbitrators results in the practice of "*splitting the baby*" in investment arbitration.[112] This practice, as stated by scholars, is "perceived as the reality in international arbitration."[113] The concept can be explained by the following situation. For example, if the investor in arbitration claims damages for expropriation of property in the amount of 1 million dollars. The respondent party (host state) counters this claim by presenting the expert opinion with a value of 500 000 dollars. It is common practice that tribunal takes average of this two numbers and results in the arbitrary amount of 750 000 dollars. The following chart shows the percentage of awarded damages as compared to the claimed damages awarded to investors.

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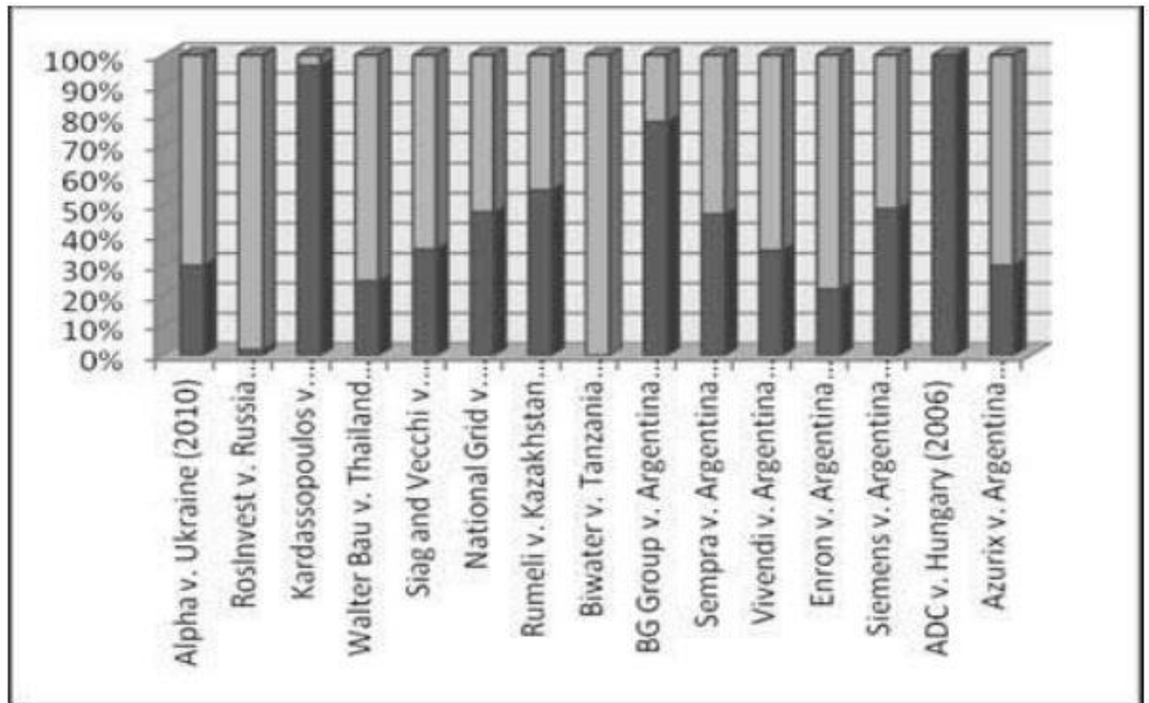
[109] Joshua B. Simmons, "Valuation in Investor-State Arbitration: Toward A More Exact Science," *Berkeley Journal of International Law* 30, no. 1, (2012): 208.
[110] Geoffrey B. Hartwell et al., "Assessing Damages - Are Arbitrators Good At It? Should They Be Assisted by Experts? Should They Be Entitled to Decide ex aequo et bono? Some War Stories," *J. World Inv. & Trade* 6, no. 7 (2005): 8.
[111] Joshua B. Simmons, "Valuation in Investor-State Arbitration: Toward A More Exact Science," *Berkeley Journal of International Law* 30,no. 1, (2012): 204.
[112] Ibid., 210.
[113] Sergey Ripinsky and Kevin Williams, *Damages in International Investment Law*, (London: British Institute of International and Comparative Law, 2008), 122.



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Joshua Simmons, after analyzing a number of recent cases (as of 2012), came to the conclusion that arbitrators, when determining the amount of damages to be awarded to the injured party, still have tendency to use the principle of "splitting the baby", and states that it "is difficult to refute without published decision that reveal a rigorous quantification of fair market value."[115] This principle, as results in arbitrary amounts, which does not have solid background, and, therefore, raise certain criticism from both sides of the disputes. Such decision may have impact on both sides of the dispute, by undercompensating the investor and putting the host state in a better position, or alternatively, overcompensating, thus putting an additional burden on the respondent state.

[114] Joshua B. Simmons, "Valuation in Investor-State Arbitration: Toward A More Exact Science," *Berkeley Journal of International Law* 30,no. 1, (2012): 212-213.
[115] Ibid.

1.2. Lack of Explanation of Damages

The problem of unexplained damages is a natural consequence of the previously discussed problem of inadequate competence of arbitrators in the spheres of economics and finance. The need of thoroughly explained calculation of damages has significant outcomes. It is not only a question of further possibilities of analysis by scholars, but it has implication for the parties of the concrete dispute, as well as arbitrators themselves, because well-explained damages can benefit their reputation and improve their position in highly competitive market of arbitrators.[116] For the respondent states, unexplained damages may become an incentive to be reluctant to the voluntary implementation of award.

The main instrument that the parties of investor-state dispute may use to challenge the legitimacy of award is the procedure of annulment of damages. Even though the arbitration awards are final and binding upon the parties, the ICSID Convention provides certain grounds which allow the losing party to annul the decision of the tribunal.[117] Such grounds are presented in Art. 52 of the ICSID Convention, which states that:

> (1) Either party may request annulment of the award by an application
> in writing addressed to the Secretary-General on one or more of
> the following grounds:
> (a) that the Tribunal was not properly constituted;
> (b) that the Tribunal has manifestly exceeded its powers;
> (c) that there was corruption on the part of a member of the Tribunal;
> (d) that there has been a serious departure from a fundamental rule of procedure; or
> (e) that the award has failed to state the reasons on which it is based.[118]

According to Lise Johnson in *Annulment of ICSID Awards: Recent developments*, the analysis of several cases shows that there is a variety of factors, which may

[116] Joshua B. Simmons, "Valuation in Investor-State Arbitration: Toward A More Exact Science," *Berkeley Journal of International Law* 30,no. 1, (2012): 214.
[117] Convention on the Settlement of Investment Disputes between States and Nationals of Other States, art. 52, Oct. 14, 1966, 575 UNTS 159.
[118] Ibid.

potentially be challenged by the parties of disputes.[119] This includes, but not limited to "tribunals' acceptance of jurisdiction, their findings regarding applicable law and application of that law, their admission and evaluation of evidence, their handing of discovery requests, calculations of damages, and matters relating to arbitrator independence and impartiality."[120]

The requirement to state reasons for awards naturally follows from Art. 48 of the ICSID Convention, which states the general requirements for the awards, which are:

> (1) The Tribunal shall decide questions by a majority of the votes of all its members.
> (2) The award of the Tribunal shall be in writing and shall be signed by the members of the Tribunal who voted for it.
> (3) The award shall deal with every question submitted to the Tribunal, and shall state the reasons upon which it is based.
> (4) Any member of the Tribunal may attach his individual opinion to the award, whether he dissents from the majority or not, or a statement of his dissent.
> (5) The Centre shall not publish the award without the consent of the parties.[121]

One of the early examples of annulment based on the lack of explanation of damages is the case of *Mar. Int'l Nominees Establishment (MINE) v. Guinea*. In that case, the claimant offered two theories for calculating lost profits.[122] The tribunal, however, rejected the theories proposed by the claimant, saying that they were too speculative in nature. As a result, the tribunal came to conclusion by using its own theory for calculation of lost profit of the aggrieved investor.[123] The annulment committee in this case decided to put the approach used by the tribunal under strong critique and found that "[h]aving concluded that theories 'Y' and 'Z' were unusable because of their speculative character, the Tribunal could not, without contradicting

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[119] Lise Johnson, "Annulment of ICSID Awards: Recent developments," *IV Annual Forum for Developing Country Investment Negotiators* (2010): 3, available at http://www.iisd.org/pdf/2011/dci_2010_annulment_icsid_awards.pdf.
[120] Lise Johnson, "Annulment of ICSID Awards: Recent developments," *IV Annual Forum for Developing Country Investment Negotiators* (2010): 3, available at http://www.iisd.org/pdf/2011/dci_2010_annulment_icsid_awards.pdf.
[121] Convention on the Settlement of Investment Disputes between States and Nationals of Other States, art. 48, Oct. 14, 1966, 575 UNTS 159.
[122] Maritime International Nominees Establishment v. Government of Guinea, ICSID Case No. ARB/84/4, Decision on Annulment, 125 (Dec. 14, 1989), https://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC674_En&caseId=C136.
[123] Ibid., 105.

itself, adopt a 'damages theory' which disregarded the real situation and relied on hypotheses which the Tribunal itself had rejected as a basis for the calculation of damages."[124] As stated in case of *MINE v. Guinea*, "the requirement to state reasons is satisfied as long as the award enables one to follow how the tribunal proceeded from Point A to Point B, and eventually to its conclusion, even if it made an error of fact or of law." [125] This statement became test which is now constantly cited as a test for challenging the explanation of damages by the tribunal. [126] However, the practice of annulment of ICSID awards based only on poor explanation of damages is rare, and it is commented by Simmons that *MINE v. Guinea* is an exception because it is the only decision which passed annulment for the lack of explanation of damages and "failure to state reasons" standard has not been used in any other case to overturn a decision based on an inadequate explanation of valuation."[127] One of the reasons of such scarcity of annulment cases is in the fact that the parties, when applying for annulment, are usually likely to include not one but several grounds for annulment, in order to make their claims more persuasive. [128] The question of inadequate explanation of damages was also challenged in annulment proceedings in such cases, as *Duke Energy v. Peru*, *Azurix Corp. v. Argentina*, *MTD Equity Sdn. Bhd. v. Chile*, *Wena Hotels Ltd. v. Egypt*, etc.[129]

In *Azurix Corp. v. Argentina*, after losing the case, Argentina decided to file the annulment proceedings. Among other grounds for annulment, Argentina challenged the

[124] Maritime International Nominees Establishment v. Government of Guinea, ICSID Case No. ARB/84/4, Decision on Annulment, 125 (Dec. 14, 1989), https://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC674_En&caseId=C136.
[125] Ibid., 105.
[126] Rumeli Telekom A.S. and Telsim Mobil Telekomunikasyon Hizmetleri A.S. v. Republic of Kazakhstan, ICSID Case No. ARB/05/16, Annulment, 32 (Mar. 25, 2010), http://www.italaw.com/documents/RumeliAnnulment.pdf
[127] Joshua B. Simmons, "Valuation in Investor-State Arbitration: Toward A More Exact Science," *Berkeley Journal of International Law* 30,no. 1, (2012): 216.
[128] Joshua B. Simmons, "Valuation in Investor-State Arbitration: Toward A More Exact Science," *Berkeley Journal of International Law* 30,no. 1, (2012): 216.
[129] Ibid., 216-17.

explanation of damages awarded to the aggrieved investor. It states that "in its analysis of the calculation of damages in the Award, the Tribunal's reasoning is contradictory."[130] Moreover, Argentina submits that the tribunal "failed to provide any formulae or principles in the Award as to how that figure was calculated or otherwise obtained."[131] This leads to the conclusion that the tribunal in *Azurix Corp. v. Argentina* did not pay sufficient attention to the question of damages, and did not provide the host state with enough explanation on how it reached the indicated amount of damages awarded to investor. However, due to several reasons, the annulment procedure was not successful for the host state.

One of the recent examples, where the state requested annulment on the ground of lack of explanation of damages is the case of *Rumeli Telecom v. Kazakhstan.*[132] In the annulment proceedings of this case, the applicant, which is the Republic of Kazakhstan, submitted that "the Tribunal's decision to award damages of $125 million was inexplicable, being based on inconsistent, illogical or nonexistent reasons."[133] The applicant stated that the explanation of damages in the tribunal's awards does not follow requirement of Art. 52 (1) (e) of the ICSID Convention by failing to state reasons for such award. In argumentation for its claim, the applicant referred to *MINE v. Guinea*, and stated that "it was impossible to follow the progression of the Tribunal's reasoning "from Point A to Point B and eventually" to its figure of $125 million."[134] Even though in both of these cases the applications for annulment were dismissed, the existence of annulment claims concerning explanation of damages in *Azurix Corp. v. Argentina* and

[130] Azurix Corp. v. The Argentine Republic, ICSID Case No. ARB/01/12, Annulment, 147 (Sep. 1, 2009), http://www.italaw.com/documents/Azurix-Annulment.pdf.
[131] Ibid.
[132] Rumeli Telekom A.S. and Telsim Mobil Telekomunikasyon Hizmetleri A.S. v. Republic of Kazakhstan, ICSID Case No. ARB/05/16, Annulment, 4 (Mar. 25, 2010), http://www.italaw.com/documents/RumeliAnnulment.pdf.
[133] Ibid., 32.
[134] Ibid.

Rumeli Telecom v. Kazakhstan in modern arbitration practice raises complex questions on legitimacy of unexplained or poorly explained awards. It challenges the existing attitude of arbitrators towards explanation of damages and demonstrates the importance of tribunals' explanation of how they reach the final quantum of damages. Therefore, it is recommended for future arbitration tribunals to pay more attention to the question of explanation of damages in order to comply with requirements of ICSID Convention. This practice will in fact increase confidence of parties and prevent future challenges submitted as annulment proceedings.

1.3. Use of Experts in Investment Arbitration

The role of experts in the process of determination of damages in investment arbitration is decisive, as the process of valuation of damages, as found by Ripinsky, is "a very complex exercise, requiring special knowledge, particularly where there is a need to value business interests which make the involvement of valuation experts in arbitral proceedings practically inevitable."[135] Both parties of dispute, investors and host states, have to use experts in order to substantiate their legal claims in a certain numerical outcome. As stated by H. Woss in *Damages in International Arbitration under Complex Long-term Contracts,* "[o]ften, the injured party has only certainty of the breach and an idea of the loss but is not able to define the loss in a sufficiently precise way in order to avoid the reproach of 'speculation'."[136] To eliminate this issue, the parties recourse to the use of experts in order to support their claims by evidentiary help of experts. Moreover, the use of expert is helpful for the arbtirators, as they serve to explain complex economic and financial terms to the arbitrators, who have no specific knowledge in these topics, by "translating signs, meaning from the language of economics to a language/discourse that

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[135] Sergey Ripinsky and Kevin Williams, *Damages in International Investment Law*, (London: British Institute of International and Comparative Law, 2008), 174.
[136] Herfried Woss et al., *Damages in International Arbitration under Complex Long-term Contracts*, (Oxford: Oxford University Press, 2014), 229.

is understandable by the judge and/or the jury, in other words "common (shared sense)." "[137]

However, modern arbitral practice of use of expert is now faces the problem of experts acting as advocates of the party they are presented by in the dispute. This problem is named as "one of the main problems of the adversarial system of expertise."[138] There is a strong division between common law and civil law approaches as to the role of expert in the proceedings.[139] According to Martin Hunter, the role of experts from both civil law and common law jurisdictions historically "tended to mirror the procedures and techniques adopted by the national court systems into which they were originally educated as litigation practitioners."[140] Civil law practitioners are more comfortable with tribunal-appointed experts.[141] In contrast, the representatives from common law jurisdictions, with its high level of development of adversarial system, as a general rule, are more likely to use party-appointed experts.[142] However, in modern arbitral practice, there is an extensive trend of using party-appointed experts.[143]

As to the civil law and common law split in practices, each side has its own disadvantages. The main disadvantage of common law approach is in the fact that experts are deviating from their traditional role in the dispute by losing impartiality and

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[137] Ioannis Lianos, "'Judging' Economists: Economic Experts in Competition Law Litigation: A European View," *The Reform of EC Competition Law: New Challenges* (2010), 189-92.
[138] Herfried Woss et al., *Damages in International Arbitration under Complex Long-term Contracts*, (Oxford: Oxford University Press, 2014), 230.
[139] Klaus Sachs, "Experts: Neutrals or Advocates," *ICCA Arbitration Advocacy in Changing Times* (2010): 2, http://www.josemigueljudice-arbitration.com/xms/files/02_TEXTOS_ARBITRAGEM/01_Doutrina_ScolarsTexts/evidence/experts__icca_2010_sachs.pdf.
[140] Martin Hunter, "Expert Conferencing and New Methods," *ICCA Congress* (2006): 1, http://www.arbitration-icca.org/media/0/12232940146050/jmh-techniques-for-eliciting-expert-testimony.pdf
[141] Ibid., 2.
[142] Ibid., 1.
[143] Klaus Sachs, "Experts: Neutrals or Advocates," *ICCA Arbitration Advocacy in Changing Times* (2010): 1, http://www.josemigueljudice-arbitration.com/xms/files/02_TEXTOS_ARBITRAGEM/01_Doutrina_ScolarsTexts/evidence/experts__icca_2010_sachs.pdf.

becoming an advocate for the position at which he is hired, by being ""bought" by the party presenting it."[144] The financial dependence of expert determines his views on the case, and, as reported by scholars, party-appointed expert tend to follow the argument used by legal advisor by being controlled by the appointing party in their findings.[145] They are instructed by the party of dispute to support and push for the interest of the hiring party of dispute in order to maximize the awards if they are appointed by investor, and minimize them, if the expert is hired by the respondent state.[146] The disadvantage of civil law practice is in the fact that parties are likely to believe that the outcome of the dispute will be decided not by the tribunal itself but by the expert appointed by the tribunal.[147] The parties have no or lack of trust in such expert as "they feel that their ability to control the manner in which what may be the most critical element in their case will be presented has been take away from them."[148]

The shift in the mission of expert in modern investment arbitration leads to the practice, where experts became not independent individuals who are designed to be "'educator' or 'translator' for the tribunal", but being additional advocates for one or another party, with one difference of having training in economics and finance, rather than law.[149] The main outcome of the existing shift of experts' mission in arbitral proceedings is demonstrated by the fact of enormous differences between experts' opinions in arbitration. For example in the recent case of *Tidewater v. Venezuela,* where

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[144] Martin Hunter, "Expert Conferencing and New Methods," *ICCA Congress* (2006): 1, http://www.arbitration-icca.org/media/0/12232940146050/jmh-techniques-for-eliciting-expert-testimony.pdf.
[145] Klaus Sachs, "Experts: Neutrals or Advocates," *ICCA Arbitration Advocacy in Changing Times* (2010): 6, http://www.josemigueljudice-arbitration.com/xms/files/02_TEXTOS_ARBITRAGEM/01_Doutrina_ScolarsTexts/evidence/experts__icca_2010_sachs.pdf.
[146] Ibid.
[147] Martin Hunter, "Expert Conferencing and New Methods*," ICCA Congress* (2006): 2, http://www.arbitration-icca.org/media/0/12232940146050/jmh-techniques-for-eliciting-expert-testimony.pdf.
[148] Ibid.
[149] Herfried Woss et al., *Damages in International Arbitration under Complex Long-term Contracts*, (Oxford: Oxford University Press, 2014), 230.

the tribunal relied on party-appointed expert's estimates on damages, the claimant's experts presented the value of US$48,443 million.[150] At the same moment, the respondent's expert counted the value of US$27,407 million.[151] If the experts are to provide independent and impartial valuation of damages, such differences in number, ideally, should not have happened. However, this became accepted practice in investment arbitration. In the case of *Exxon-Mobil v. Venezuela*, the difference in party-appointed experts' opinions is even more preposterous. While the respondent is presenting the value of compensation of US$ 190,403,200 for Cerro Negro project and US$75 million for La Ceiba Project (expropriation of two oil projects was involved in the dispute), the investor, at the same moment, is claiming in respect of the Cerro Negro Project approximately US$14.5 billion and US$179 million for La Ceiba Project.[152] Such enormous difference in results of valuation is a clear example of partiality of experts, which creates difficulties for arbitrators in the process of determination of damages.

The problem of partiality of party-appointed experts is not the only disadvantage of the existing practice. There is also a problem of understanding or clarity of reports presented by party-appointed experts.[153] The party-appointed experts' report may be too

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[150] Tidewater Investment SRL, Tidewater Caribe, C.A. v. the Bolivarian Republic of Venezuela, ICSID Case No. ARB/10/5, 65 (Mar. 13, 2015), http://www.italaw.com/sites/default/files/case-documents/italaw4206_0.pdf.
[151] Ibid.
[152] Mobil Corporation, Venezuela Holdings, B.V., Mobil Cerro Negro Holding, Ltd., Mobil Venezolana de Petróleos Holdings, Inc., Mobil Cerro Negro, Ltd., and Mobil Venezolana de Petróleos, Inc. v. Bolivarian Republic of Venezuela, ICSID Case No. ARB/07/27, Award, 57 (Oct. 9, 2014).
[153] Klaus Sachs, "Experts: Neutrals or Advocates," *ICCA Arbitration Advocacy in Changing Times* (2010): 6, http://www.josemigueljudice-arbitration.com/xms/files/02_TEXTOS_ARBITRAGEM/01_Doutrina_ScolarsTexts/evidence/experts__icca_2010_sachs.pdf.

long and complicated.[154] Moreover, as these experts are not instructed by the tribunal, "the reports tend to have a different focus than the tribunal has."[155]

Another problem is the absence of coordination of experts. Their reports may be "based on different facts, different scientific approaches and different assumptions, and they address different issues."[156] Such methodological differences create additional difficulty for arbitrators, who have to weigh findings of each side of the argument, and it requires more time and effort to consider two different valuation reports on the same case.

1.4. Recommendations

1.4.1. Use of Tribunal-Appointed Experts

In order to solve the procedure-based problem of inadequate financial and economic competence of arbitrators, lack of explanation of damages and compensate the existing practice of expert being not neutrals but advocates, it is recommended to use practice of tribunal-appointed experts. UNCITRAL Model Law on International Commercial Arbitration (1985, amended in 2006) provides the possibility of use of tribunal-appointed experts by stating in its art. 26, that "[u]nless otherwise agreed by the parties, the arbitral tribunal … may appoint one or more experts to report to it on specific issues to be determined by the arbitral tribunal."[157] The tribunal, in this case, is given discretion, if otherwise is not agreed by the parties, to appoint its own expert. Such discretion is also provided in institutional rules of arbitration such as ICC Rules of Arbitration, which

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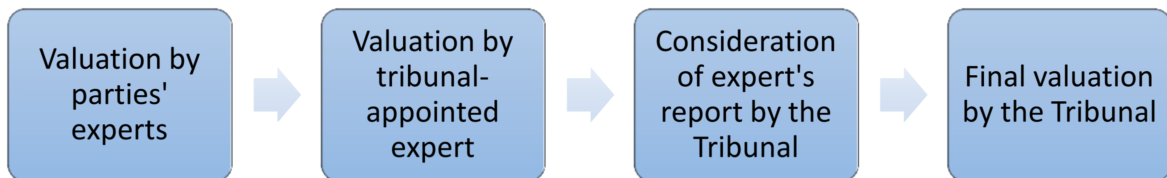
[154] Klaus Sachs, "Experts: Neutrals or Advocates," *ICCA Arbitration Advocacy in Changing Times* (2010): 6, http://www.josemigueljudice-arbitration.com/xms/files/02_TEXTOS_ARBITRAGEM/01_Doutrina_ScolarsTexts/evidence/experts__icca_2010_sachs.pdf.
[155] Ibid.
[156] Ibid.
[157] "UNCITRAL Model Law on International Commercial Arbitration," *UNCITRAL* (1985 with amendments as adopted in 2006), available at http://www.uncitral.org/pdf/english/texts/arbitration/ml-arb/07-86998_Ebook.pdf

states in Art. 25.4 that "[t]he arbitral tribunal, after having consulted the parties, may appoint one or more experts, define their terms of reference and receive their reports. At the request of a party, the parties shall be given the opportunity to question at a hearing any such expert."[158] The similar discretion of arbitrators to appoint experts is provided by AAA International Dispute Resolution Procedures, and LCIA Rules of Arbitration. The LCIA Rules, in Art 21.2. provide additional requirement that "[a]ny such expert shall be and remain impartial and independent of the parties; and he or she shall sign a written declaration to such effect, delivered to the Arbitral Tribunal and copied to all parties."[159]

As it was analyzed, the current arbitration rules and practices allow the use of such practice and large discretion is granted to the arbitrators, who have powers to appoint one or more experts to the case. However, even though this method is able to solve several crucial problems, it cannot be free of any disadvantages. There is potentially a risk that parties of dispute may distrust the person whom they did not choose and "fear" that they will not be able "explain to the expert their view and position." [160] Another critique faced by this method is the fact that parties of dispute may be reluctant to use such expert, as they may fear that the expert would start to play decisive role in determination of damages.[161] The parties tend to think that the decision will be rendered not by the tribunal, which was deliberately elected by the parties, but by the person, whom they cannot elect.[162] This challenge puts in danger the whole system of

[158] "ICC Rules of Arbitration," *International Chamber of Commerce* (2012), available at http://www.iccwbo.org/products-and-services/arbitration-and-adr/arbitration/icc-rules-of-arbitration//
[159] "LCIA Arbitration Rules," *London Court of International Arbitration* (2014), available at http://www.lcia.org/Dispute_Resolution_Services/lcia-arbitration-rules-2014.aspx/
[160] Klaus Sachs, "Experts: Neutrals or Advocates," *ICCA Arbitration Advocacy in Changing Times* (2010): 7, http://www.josemigueljudice-arbitration.com/xms/files/02_TEXTOS_ARBITRAGEM/01_Doutrina_ScolarsTexts/evidence/experts__icca_2010_sachs.pdf/
[161] Ibid.
[162] Ibid.

arbitration, which is based on the parties' will and the fundamental concept that the parties of arbitral proceedings should able to choose their arbitrator, as opposed to the mechanism of traditional court litigation provided by domestic legislation.[163] The following chart demonstrates the proposed proderure of valuation:



In the proposed procedure of separate valuation by the tribunal-appointed expert, it is important to notice that final valuation is not granted to the tribunal's own expert, but it should be made by the tribunal itself. The expert in this case shall not provide the final decision on the amount of damages to be applied, but should serve as an impartial and independent consultant to the arbitrators, who are, in the end, the ones to decide. The expert should provide unbiased recommendation based on existing data, in order to clearly explain the calculation to the relevant tribunal. The standard mechanism of valuation in investment arbitration is usually conducted on the basis of findings of parties' experts. Tribunal-appointed experts are being used only in exceptional cases. By now, there are four known cases where the tribunals referred to experts appointed by themselves in order to eliminate uncertainty: *CMS v. Argentina*, *Sempra Energy v. Argentina*, *Enron v. Argentina*, and *National Grid P.L.C. v. Argentina*.[164] In all these

[163] Klaus Sachs, "Experts: Neutrals or Advocates," *ICCA Arbitration Advocacy in Changing Times* (2010): 9, http://www.josemigueljudice-arbitration.com/xms/files/02_TEXTOS_ARBITRAGEM/01_Doutrina_ScolarsTexts/evidence/experts__icca_2010_sachs.pdf/

[164] CMS Gas Transmission Co. v. Argentine Republic, ICSID Case No. ARB/01/8, Award, ¶ 416 (May 12, 2005). Sempra Energy Int'l v. Argentine Republic, ICSID Case No. ARB/02/16, Award (Sept. 18, 2007).

casesы, tribunal-appointed experts demonstrated their effectiveness.[165] In the case of Enron, for example, the tribunal-appointed expert helped to manage the divergent valuations of experts. The tribunal found the position of expert as "more balanced and realistic" because he provided the consultations in impartial and independent position.[166] Ripinsky, for example, uses *Enron* case as example of proper application of DCF method in investment arbitration.[167] This experience demonstrates that the use of tribunal-appointed experts may positively affect the on-going practice.

1.4.2. Pre-Hearing meetings

Apart from tribunal-appointed experts, there are other methods of countering the existing problems in the procedure of valuation. One of them is explained in Art. 5.4 of IBA Rules on the Taking of Evidence in International Arbitration, which provide the following opportunity.

> The Arbitral Tribunal in its discretion may order that any Party-Appointed Experts who will submit or who have submitted Expert Reports on the same or related issues meet and confer on such issues. At such meeting, the Party-Appointed Experts shall attempt to reach agreement on the issues within the scope of their Expert Reports, and they shall record in writing any such issues on which they reach agreement, any remaining areas of disagreement and the reasons therefore.[168]

This opportunity may be useful to solve the existing problems; however, this method is challenged by the potential situation in which experts, being hired by the parties, will be reluctant to come to certain concessions, as it would contradict their interests. In such case, the possibility of agreement remains low.

Enron Corp. v. Argentine Republic, ICSID Case No. ARB/01/3, Award (May 22, 2007). National Grid P.L.C. v. Argentina Republic, UNCITRAL, Award (Nov. 3, 2008).

[165] Joshua B. Simmons, “Valuation in Investor-State Arbitration: Toward A More Exact Science,” *Berkeley Journal of International Law* 30,no. 1, (2012): 240-41.

[166] Enron Corporation and Ponderosa Assets, L.P. v. Argentine Republic, ICSID Case No. ARB/01/3, Award, 408-410 (May 22, 2007).

[167] Sergey Ripinsky and Kevin Williams, *Damages in International Investment Law*, (London: British Institute of International and Comparative Law, 2008), 203-04.

[168] “IBA Rules on the Taking of Evidence in International Arbitration,” *International Bar Association* (2010), art 5.4, available at http://www.ibanet.org/Document/Default.aspx?DocumentUid=68336C49-4106-46BF-A1C6-A8F0880444DC.

1.4.3. Witness Conferencing

This instrument can follow the results of pre-hearing meetings.[169] According to Wolfgang Peter, it is "the simultaneous joint hearing of all fact witnesses, expert witnesses, and other experts involved in the arbitration."[170] Such technique is, for example, used in national litigation in England in Australia, where it is known as "hot tubbing."[171] In the opinion of commentators, this method has shown its effectiveness where party-appointed experts are involved.[172]

The instruments of "pre-hearing meetings" and witness "conferencing", according to Sachs, can serve as an effective technique to

(i) clarify technical and factual issues,
(ii) outline areas of agreement and disagreement,
(iii) focus on relevant points,
(iv) diminish the differences between expert reports,
(v) encourage scientific debate and, as a consequence,
(vi) render the taking of expert evidence more time and cost efficient.[173]

1.4.4. Expert Teaming

One of the new methods of countering the problem of partiality and dependence of party-appointed experts is a method of "expert teaming".[174] It is considered to be a

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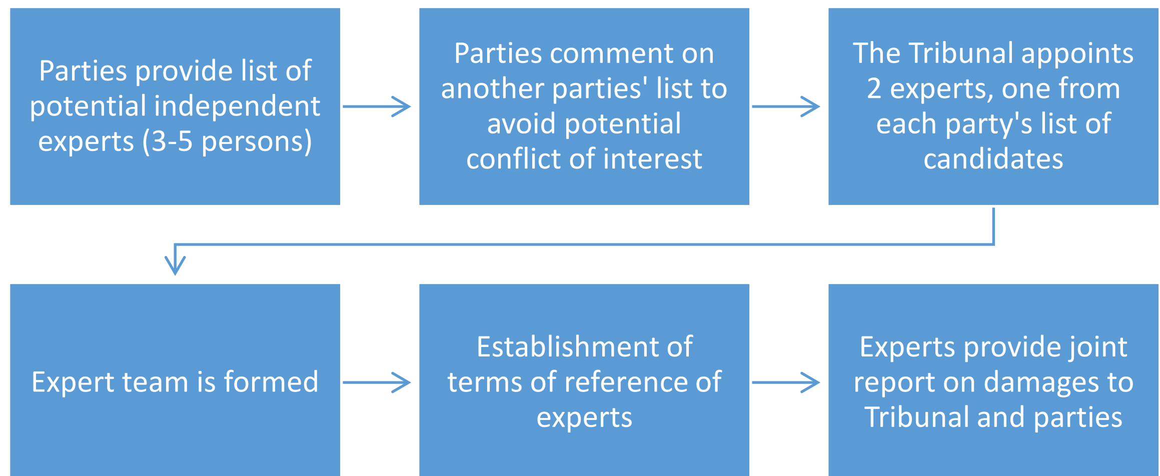
[169] Klaus Sachs, "Experts: Neutrals or Advocates," *ICCA Arbitration Advocacy in Changing Times* (2010): 9, http://www.josemigueljudice-arbitration.com/xms/files/02_TEXTOS_ARBITRAGEM/01_Doutrina_ScolarsTexts/evidence/experts__icca_2010_sachs.pdf.
[170] Peter Wolfgang, "Witness 'Conferencing'," *Arbitration International* 18, no. 1, (2002): 47.
[171] Klaus Sachs, "Experts: Neutrals or Advocates," *ICCA Arbitration Advocacy in Changing Times* (2010): 9, http://www.josemigueljudice-arbitration.com/xms/files/02_TEXTOS_ARBITRAGEM/01_Doutrina_ScolarsTexts/evidence/experts__icca_2010_sachs.pdf.
[172] Peter Wolfgang, "Witness 'Conferencing'," *Arbitration International* 18, no. 1, (2002): 49.
[173] Klaus Sachs, "Experts: Neutrals or Advocates," *ICCA Arbitration Advocacy in Changing Times* (2010): 13, http://www.josemigueljudice-arbitration.com/xms/files/02_TEXTOS_ARBITRAGEM/01_Doutrina_ScolarsTexts/evidence/experts__icca_2010_sachs.pdf.
[174] Herfried Woss et al., *Damages in International Arbitration under Complex Long-term Contracts*, (Oxford: Oxford University Press, 2014), 231.

synthesis of methods, which manages in "combining the advantages of party-appointed and tribunal-appointed experts", and compensating disadvantages of both approaches.[175] The method is presented in the following scheme.



According to this scheme, each party provides the tribunal with a list of experts.[176] Then, the parties are granted a chance to comment on the list presented by the opposing party in order to exclude candidates with possible conflict of interest.[177] After that, from the short list of candidates, the tribunal appoints two experts to participate in the dispute.[178] The tribunal should choose one expert form each list presented by the party in order to build confidence of parties in the experts and provide equal representation of parties will in the composition of expert team.[179] The experts, even though they are elected from the list submitted by the parties, do not serve as representatives of the party, which included them in the list, and act independently and

[175] Herfried Woss et al., *Damages in International Arbitration under Complex Long-term Contracts*, (Oxford: Oxford University Press, 2014), 231.
[176] Ibid.
[177] Ibid.
[178] Ibid.
[179] Ibid.

impartially.[180] They work in cooperation with each other, and as a result of their work, present a joint report on damages, which is circulated to tribunal and parties to make comments.[181] In the process of mutual work, the expert team should not base their findings on the parties' experts' conclusions but should "rely only on its own expertise," but it is allowed to consult with the parties.[182] After hearings on damages, where expert team is examined by the tribunal and parties, the final decision on quantum of damages is delivered by the tribunal.[183]

The use of this practice can overcome several disadvantages of using tribunal-appointed experts. Firstly, by this scheme, the parties are actively involved in the process of election of the expert team, which builds trust to the outcome of their mutual work. Another benefit is that the experts are allowed to mutually control each other during the process, which creates a system of checks and balances.[184]

The method also compensates the main disadvantage of party-appointed experts, who tend to be dependent and partial. As the expert team is not represented by any side of dispute and financially independent, they have no interest in providing one-sided, impartial or biased valuation of damages. This will result in a more legitimate and fair determination of damages. The fact that the expert team provides joint report will

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[180] Klaus Sachs, "Experts: Neutrals or Advocates," *ICCA Arbitration Advocacy in Changing Times* (2010): 15, http://www.josemigueljudice-arbitration.com/xms/files/02_TEXTOS_ARBITRAGEM/01_Doutrina_ScolarsTexts/evidence/experts__icca_2010_sachs.pdf.

[181] Herfried Woss et al., *Damages in International Arbitration under Complex Long-term Contracts*, (Oxford: Oxford University Press, 2014), 231.

[182] Klaus Sachs, "Experts: Neutrals or Advocates," *ICCA Arbitration Advocacy in Changing Times* (2010): 15, http://www.josemigueljudice-arbitration.com/xms/files/02_TEXTOS_ARBITRAGEM/01_Doutrina_ScolarsTexts/evidence/experts__icca_2010_sachs.pdf.

[183] Herfried Woss et al., *Damages in International Arbitration under Complex Long-term Contracts*, (Oxford: Oxford University Press, 2014), 231.

[184] Klaus Sachs, "Experts: Neutrals or Advocates," *ICCA Arbitration Advocacy in Changing Times* (2010): 17, http://www.josemigueljudice-arbitration.com/xms/files/02_TEXTOS_ARBITRAGEM/01_Doutrina_ScolarsTexts/evidence/experts__icca_2010_sachs.pdf.

eliminate the problem of highly contradictory valuations submitted by party-appointed experts. Another advantage is in fact that the expert team should work in consultation with tribunal and parties, who will be provided chances to comment on specific points and stress the attention of expert on issues that, by their view, should be analyzed further.[185]

The main disadvantage of using additional tribunal-appointed experts is in potential increase of costs of arbitral proceedings.[186] In the case of expert teaming, the parties may refrain from hiring their own expert and use only the expert team.[187] Bearing in mind the amounts of damages that are usually under question in international investment arbitration, and importance of in-depth analysis and clear and sufficient explanation of damages, the use of this method in highly controversial cases will be helpful to increase legitimacy of awarded damages.

2. Substance-Based Problems of Valuation

2.1. The Problem of Double Counting in Investment Arbitration

One of the problems concerning the question of damages in investor-state arbitration is the problem of double counting. It is a common understanding arising from domestic legislation of many jurisdictions that any violation of rights create an obligation for the creditor to compensate the suffering party with losses it suffered (*damnum emergens*) and future lost profits (*lucrum cessans*).[188] Such method of establishing damages is generally used as a consequence of breach of commercial contracts. This point can be

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[185] Klaus Sachs, "Experts: Neutrals or Advocates," *ICCA Arbitration Advocacy in Changing Times* (2010): 17, http://www.josemigueljudice-arbitration.com/xms/files/02_TEXTOS_ARBITRAGEM/01_Doutrina_ScolarsTexts/evidence/experts__icca_2010_sachs.pdf.

[186] Herfried Woss et al., *Damages in International Arbitration under Complex Long-term Contracts*, (Oxford: Oxford University Press, 2014), 231.

[187] Ibid., 17.

[188] Michael Pryles, "Lost Profit and Capital Investment," *World Arbitration and Mediation Revie*w 1, no. 1 (2007):2-4.

found, for example in the Civil Code of the Kyrgyz Republic. In art. 358, the Civil Code establishes obligation for the person who committed a wrongful act to compensate all the losses incurred because of violation.[189] The notion of losses is described in art.14 of the Civil Code, and include both losses suffered as a direct consequence of breach and profits lost as a result of such breach.[190] The same position can be found in art. 15 of Civil Code of the Russian Federation and art. 9.4 of the Civil Code of the Republic of Kazakhstan.[191]

This approach of establishing the damages can be found in arbitral practice as well. For instance, in the case of Sapphire International Petroleums Ltd. v. National Iranian Oil Co., the tribunal explains the notion of damages as following.

> According to the generally held view, the object of damages is to place the party to whom they are awarded in the same pecuniary position that they would have been in if the contract had been performed in the manner provided for by the parties at the time of its conclusion. They should be the natural consequence of the breach. This rule is simply a direct deduction from the principle pacta sunt servanda, since its effect is to substitute a pecuniary obligation for the obligation which was promised but not performed. It is therefore natural that the creditor should thereby be given full compensation. This compensation includes the loss suffered (damnum emergens), for example the expenses incurred in performing the contract, and the profit lost (lucrum cessans), for example the net profit which the contract would have produced.[192]

In the case of Karaha Bodas, the tribunal states the following:

> Indonesian Law, like numerous other legal systems, provides for the recovery of lost profits ("lucrum cessans") as a component of the damages to which the innocent party is entitled in case of inexcusable breach of contract, in addition to the other damages component, the "damnum emergens."[193]

According to this notion, it may create understanding that the method of determination of damages should be as follows:

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[189] Grazhdaskii Kodeks Kyrgyzskoi Respubliki chast I [GK KR] [Civil Code of the Kyrgyz Republic part I], 1996, № 15, art. 358. Grazhdaskii Kodeks Respubliki Kazakhstan [GK RK] [Civil Code of the Republic of Kazakhstan], 1994, № 269-XII, art. 9.4.
[190] Ibid., art. 14.
[191] Grazhdaskii Kodeks Rossiskoi Federatsii [GK RF] [Civil Code of the Russian Federation], 1994, № 51, art. 15.
[192] Sapphire International Petroleums Ltd. v. National Iranian Oil Co., 35 I.L.R. 136 (1967).
[193] Karaha Bodas Co v. Perusahaan Pertambangan Minyak Das Gas Bumi Negara, 364 F.3d 274 (2004).

1. Calculate losses suffered as a result of breach of obligations.[194]
2. Calculate the profits, which the aggrieved party would receive if the violation of contract had not taken place.[195]
3. Use the sum of the previous two values as a final amount of damages to be awarded for the party, which suffered because of the breach.[196]

However, such mode of calculation is not applicable for the investment arbitration. In order to understand why, it would be helpful to use examples for more clear understanding of the problem. For instance, there is a hypothetical contract of sale of goods concluded between a producer of goods and a merchant who is willing to gain profit after reselling the goods to the third party. In the case of non-delivery of goods by the seller, it is natural that the buyer should be able to claim the paid price of the goods, confirmed losses incurred to fulfill the contract and additionally the profits lost as a result of non-delivery of goods. According to this logic, the Civil Code provision is effective and reasonable measure of compensation of losses suffered by the aggrieved party.

However, in the situation with investment contracts, the situation entails a different approach. The investment itself (the money the investor contributed to the project) should not be considered as a separate form of damages. This position can be found in the case of Himpurna:

> [W]hen awarding compensation for expropriated business ventures], there is generally no basis to apply the contractual reliance damages (damnum emergens), but only the expectancy damages (lucrum cessans). An undertaking has been expropriated; the prejudice suffered by its former owner is simply the worth of the venture as a going concern. That worth is crystallised in an analysis which discounts the future revenue stream of the enterprise to establish its present value.[197]

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[194] Michael Pryles, “Lost Profit and Capital Investment,” *World Arbitration and Mediation Revie*w 1, no. 1 (2007):2-4.
[195] Ibid.
[196] Ibid.
[197] Himpurna California Energy Ltd v. PT. (Persero) Perusahaan Listruik Negara (Indonesia), UNCITRAL Ad Hoc, Award (May 4, 1999).

In *Damages in International Arbitration under Complex Long-term Contracts* the authors also mention this problem as highly controversial.[198] Ripinsky and Williams in their *Damages in International Investment Law* also analyze this problem. They manage to demonstrate the essential difference between general commercial contracts, as for example contract of sales of goods, services, lease contracts, etc., and investment contracts by the following example.[199]

> Consider the case of a bond with a market price today of $100 and which matures in five years. The market price today ($100) is by definition equal to the net present value of future interest and capital repayments, as no buyer will pay more than this amount. If a buyer made the investment today and it was instantly expropriated, compensating the investor for the wasted costs as damnum emergens, i.e., the amount invested in the bond ($100), and lucrum cessans, i.e.., the loss of the discounted future cash flows involving interest and capital repayments ($100), would mean compensating the investor for $200…As a result, the purchaser of the bond would be in a better position than just before the expropriation happened.[200]

According to Wells, "the arbitrators in the case double counted in determining the amounts owed by Pertamina and PLN by awarding the amount of the investment (with no adjustment…) plus the NPV [Net Present Value] of expected cash flows."[201] Another example, where the investor's claim for damages consisted double counting error is the case of *RDC v. Guatemala*. In this case, the claimant requested the sunk costs of the investment and for the lost profits in future cash flows.[202] However, the tribunal found an

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[198] Herfried Woss et al., *Damages in International Arbitration under Complex Long-term Contracts*, (Oxford: Oxford University Press, 2014), 274.
[199] Sergey Ripinsky and Kevin Williams, *Damages in International Investment Law*, (London: British Institute of International and Comparative Law, 2008), 176. *See also* Herfried Woss et al., *Damages in International Arbitration under Complex Long-term Contracts*, (Oxford: Oxford University Press, 2014), 274.
[200] Ibid.
[201] Louis T. Wells, "Double Dipping in Arbitration Awards? An Economist Questions Damages Awarded Karaha Bodas Company in Indonesia," *Arbitration International*, no.4 (2003).
[202] Railroad Development Corporation v. Republic of Guatemala, ICSID Case No. ARB/07/23, Award (June 29, 2012).

error in claimant's request of both *damnum emergens* and *lucrum cessans* and managed to award only lost profits.[203]

Recommendations

It is important to differentiate between the processes of determining the damages for investment projects and other commercial disputes. There is a significant difference between concepts and practices traditionally used in domestic legislations for determination of damages for commercial contracts compared to the nature of investment disputes, which creates requirement of deviation from approaches used in domestic commercial disputes. In the process of determination of damages, the investor who suffered from the actions of the host state should be awarded *damnum emergens* to compensate the direct losses as a result of expropriation or any other breach of obligations or, alternatively, *lucrum cessans*, that is lost profit that the aggrieved party of dispute would receive if the expropriation had not taken place. As an alternative, the clear deduction has to be made for the value of the sunk costs of the investment when considering the future profits of an enterprise. The awarding both of these sums without any deduction would result in double counting and unfair enrichment of the aggrieved party, which is investor, who suffered by the actions of the host state. Such practice contradicts the *Chorzow* standard of compensation of damages, and puts the investor in a better position than if the breach had not taken place.

As a conclusion, the practice of double counting of damages in investment arbitration leads to unfair and unjustified enrichment of the investors, by granting both profits lost as a result of breach, and the value of property itself, as a separate element of damages. Such practice is not admissible, and has to be eliminated in future arbitral

[203] Railroad Development Corporation v. Republic of Guatemala, ICSID Case No. ARB/07/23, Award (June 29, 2012).

proceedings. In practice, the elimination of such approach should be explained to the arbitrators by creation of general guidelines which would help them to result in legitimate awards. As the investors are highly interested in finding methods to increase the awards, they are likely to include the double counting schemes in their calculation of damages. Accordingly, it is of a great importance and responsibility to increase awareness of arbitrators concerning this problem with aims to prevent further attempts of claimants to use the double counting calculations in investment arbitration.

2.2. Problems of Discounted Cash Flow Method

The DCF method, which has became one of the most popular methods nowadays, raises much controversy in the opinion of scholars and arbitrators. The mechanism of valuation according to this method was discussed in the previous chapter. The core of this method is using the projected net cash flows of the company for the period of life of the investment and finding correct discount rate for the cash flow, which will result in the final amount of damages to be awarded to the investor.[204]

The key feature of legitimacy of awards is how the arbitrators manage to consider all relevant information presented by the parties and reach the amount of damages, which would be fair for aggrieved party and put it in the same pecuniary position as if the violation had not taken place.[205] Even though "it is for the claimants to prove that they have suffered some damage in order to be awarded compensation, it is for the Tribunal itself to determine the amount of compensation."[206] This should result in the clear and understandable calculation of damages and correct amount of awards. The

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[204] Anthony Charlton, " Discounted cash flows – Part 2, Valuation and the Financial Crisis," *Kluwer Arbitration Blog,* last modified January 26, 2012, accessed December 25, 2014, http://kluwerarbitrationblog.com/blog/2012/01/26/discounted-cash-flows-%E2%80%93-part-2-valuation-andthe-financial-crisis/.

[205] Case Concerning Factory at Chorzow (Germany v. Poland), 1928 P.C.I.J. Ser. A No. 17 (Sept. 13).

[206] Tidewater Investment SRL, Tidewater Caribe, C.A. v. the Bolivarian Republic of Venezuela, ICSID Case No. ARB/10/5, 54 (Mar. 13, 2015), http://www.italaw.com/sites/default/files/case-documents/italaw4206_0.pdf.

question of whether the DCF method results in 100 percent correct awards is of great difficulty. The question is quite overwhelming and for the clear analysis should be divided into several directions, each of them to be discussed consecutively.

2.2.1. Applicability of Discounted Cash Flow Method

The first point to mention is applicability of method. The main problem is in the fact that DCF, even though is one of the most popular methods in arbitral practice, it cannot be used in the cases of new businesses.[207] The main requirement for use of DCF is the presence of track records of the company.[208] According to those records, the expert will be able to create model and count projected cash flow of the company.[209] This requirement of the method makes it inapplicable for any case, therefore, the consistency of arbitral practice on this question is not achievable.[210] However, this disadvantage should not be the ground for rejection of this method, because with correct exploitation by qualified expert, it may result in correct and legitimate awards.[211]

2.2.2. The Controversy on Discount Rate in Discounted Cash Flow

The second and by far most controversial element of this method is determination of discount rate to be used for calculation. In fact, the use of this discount rate gives strong grounds for the awards to be speculative, as it is difficult, or may be impossible to formalize the element, which would affect the lifespan of investment into precise number.[212] In the recent ICSID award of *Tidewater v. Venezuela*, the arbitrators challenged and analyzed the elements or variables of the DCF method. Firstly, it is important to mention that long history of the investment and availability of proven track

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[207] Joshua B. Simmons, "Valuation in Investor-State Arbitration: Toward A More Exact Science," *Berkeley Journal of International Law* 30, no. 1, (2012): 204.
[208] Ibid.
[209] Ibid.
[210] Ibid.
[211] Joshua B. Simmons, "Valuation in Investor-State Arbitration: Toward A More Exact Science," *Berkeley Journal of International Law* 30, no. 1, (2012): 233.
[212] Ibid., 232.

record of profitability were determining factors for the use of DCF as the most effective tool of valuation the fair market price of the investment. Historically, it was fortunate for arbitrators that Tidewater had some fifty years of successful operation and success in profitability during the last 5 years of operation.[213] All these factors gave grounds for use of DCF method to determine the damages, which resulted in 46.4 million USD awarded to Tidewater.[214] However, what is of particular importance in this case, is that the tribunal formulated criteria, which affect the determination of discount rate when considering the damages using this method.

2.2.3. Variables in Determination of Damages in DCF

The tribunal in Tidewater found the following six criteria. The first criterion is the scope of business. The tribunal found that it is important to determine the scope of business which activities shall play role in determination of damages.[215] The tribunal found that the enterprise had not only worked in Lake Maracaibo, but also had some offshore business, which should play role in valuation of damages.[216]

The second criterion is accounts receivable by business. The parties were disputing were the receivable accounts of the company shall be considered in the cash flow. The respondent was arguing that receivable money shall not considered in the cash flow, because the enterprise still exists as a company and can collect its debts.[217] The tribunal, however, found that the company's receivables should be considered as part of its investment for the reason that after expropriation it lost control over its assets and could not effectively collect its debts from other companies.

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[213] Tidewater Investment SRL, Tidewater Caribe, C.A. v. the Bolivarian Republic of Venezuela, ICSID Case No. ARB/10/5, 55 (Mar. 13, 2015), http://www.italaw.com/sites/default/files/case-documents/italaw4206_0.pdf.
[214] Ibid., 66.
[215] Tidewater Investment SRL, Tidewater Caribe, C.A. v. the Bolivarian Republic of Venezuela, ICSID Case No. ARB/10/5, 56 (Mar. 13, 2015), http://www.italaw.com/sites/default/files/case-documents/italaw4206_0.pdf.
[216] Ibid.
[217] Ibid., 58.

The third factor is the determination of the cash flow itself. The problem in the case considered the fact that financial year 2009 was of particular profitability for the company.[218] Such high gains were an exceptional situation for the company, and the problem was whether the inclusion of the results of this year would distort the valuation. In this case, the tribunal decided that even years of exceptional profitability shall be included, because for potential hypothetical buyer, such information would be have decisive effect.[219]

Another variable that should be considered is equity risk premium. The tribunal in this case used several reports and considered 6.5% risk as appropriate in this case.[220]

The most important variable which Tidewater case brings out is the situation with country risk. This question raises a heated debate whether the cash flow should be discounted as a result of political risk. The tribunal decided to include the political risk for determination of discount rate.[221] For more detailed analysis, see next subchapter with discussion of political risk.

The final risk to be considered is the general business risk. The question is whether the tribunal should consider the risk of reduction of business over time. According to the respondent's expert, the Tidewater's business was likely to have high business risks because its activities was concentrated on one single customer, and therefore, the risk of reduction of business was 25% per year.[222] The tribunal analyzed the presented facts and came to conclusion that even though the connection only with one customer can be a potential risk for any other business, particularly in this case, considering the fact that oil industry was nationalized by Venezuela in 1975 and

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[218] Tidewater Investment SRL, Tidewater Caribe, C.A. v. the Bolivarian Republic of Venezuela, ICSID Case No. ARB/10/5, 58 (Mar. 13, 2015), http://www.italaw.com/sites/default/files/case-documents/italaw4206_0.pdf.
[219] Ibid.
[220] Ibid., 60.
[221] Ibid., 61.
[222] Ibid., 63.

Tidewater's business was to provide transporting for the huge national company which had large control over oil industry, the potential buyer would not apply such high risk of 25% per annum.[223]

2.3. Problem of Country Risk in Valuation of Damages

2.3.1. Country Risk as a Ground for Discounting the Cash Flow

Damages in investor-state arbitration can be claimed in the cases of violation of international legal standard or breach of contract concluded between investor and a hosting state, containing the umbrella clause which grants the investor a right to claim for damages. However, the main difference that investment project are not general projects. FDIs with high amounts of investments are usually project of high importance and in most cases are unique, considering the country's specific geography and other factors, and also the specific peculiarities of the project itself. Another difference raises from the fact the disputes in investment arbitration have high connection with political course of the give host state. Such political issue may have implications not only for determination of liability of the country, but also it has connection to the valuation process.

One of the controversial problems faced by tribunals in investment arbitration nowadays is the question of inclusion of country risks in determination of discount rate applicable to the valuation of enterprise by its discounted cash flow.[224] There is a heated debate on the question of whether the political risk (as part of country risk) shall be

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[223] Tidewater Investment SRL, Tidewater Caribe, C.A. v. the Bolivarian Republic of Venezuela, ICSID Case No. ARB/10/5, 63 (Mar. 13, 2015), http://www.italaw.com/sites/default/files/case-documents/italaw4206_0.pdf.
[224] Herfried Woss et al., *Damages in International Arbitration under Complex Long-term Contracts*, (Oxford: Oxford University Press, 2014), 279.

considered in calculation of the discount rate.[225] The inclusion of the political risk premium can play a huge role in the final result of the award. For example in the case of Tidewater, the claimant's expert used a country risk premium of 1.5% in order to increase the amount of damages to be paid for expropriation.[226] At the same time, the respondent's expert used a premium of 14.75%, which would massively alter the amount of damages to be paid.[227] This became a trending problem in the modern arbitral practice. Even though for common reader, the difference between 1.5 or 15% of risk may seem not constitute a serious and problematic difference in numbers, the situation is far more difficult. As stated by the damages expert Brent Kaczmarek, who was engaged in both *Tidewater* and *Gold Reserve* cases, mentions in his interview to *Investment Arbitration Reporter* that "a country risk premium of 1.5% can reduce the value of an enterprise by approximately 20% while a country risk premium of 14.75 percent can reduce the value of an enterprise by approximately 70%."[228] This proves that the problem has a massive economic background and minor changes in risks may lead to gigantic outcome in the process of determination of market value of the property in question, thus raising significant challenge for both arbitrators and parties involved in dispute.

The arbitral practice for this question is not homogenous. There are several decision, including the aforementioned *Tidewater v. Venezuela*, *Himpurna v. PT*

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[225] "In-Depth: As $3 Billion of ICSID Arbitral Debt Piles Up on Venezuela, Arbitrators are Seen to Disagree on Key Factors Affecting Compensation," *Investment Arbitration Reporter* accessed March 19, 2015, http://www.iareporter.com/articles/20150316_2.
[226] Tidewater Investment SRL, Tidewater Caribe, C.A. v. the Bolivarian Republic of Venezuela, ICSID Case No. ARB/10/5, 60 (Mar. 13, 2015), http://www.italaw.com/sites/default/files/case-documents/italaw4206_0.pdf.
[227] Ibid.
[228] "In-Depth: As $3 Billion of ICSID Arbitral Debt Piles Up on Venezuela, Arbitrators are Seen to Disagree on Key Factors Affecting Compensation," *Investment Arbitration Reporter* (2015), accessed March 19, 2015, http://www.iareporter.com/articles/20150316_2.

(country risk of 21%), *Lemire v. Ukraine* (18.5%).[229] However, there are also decision where political risk was not included in DCF calculation, such as *Gold Reserve Inc. v. Venezuela*. In that case, the tribunal accepted DCF method, but there was again an argument regarding the inclusion of political risk to the discount rate. The claimant proposed a discount rate of 8.22%, whereas Venezuela argued for rate between 15% and 23%.[230] Mainly because of Venezuela's harsh political climate with regards to foreign investment, and its trending policy of expropriation of FDI. However, the tribunal found it inappropriate to include such high political risk of expropriation.[231] According to Jarrod Hepburn's opinion for *Investment Arbitration Reporter*, "this finding is likely based on the view that states could otherwise minimize compensation by creating a hostile political environment, thereby increasing country risk and decreasing the DCF value of investments in the state."[232] Such policy can lead to unfair enrichment of the host States, which are involved in the policy of expropriation of FDIs.[233] Such opinion is also supported by James Searby in *The Country Risk Premium in International Arbitration* for *Global Arbitration Review*, who states that "[a]n appropriate assessment of damages should not reward the state for the consequences of its own bad actions."[234]

2.3.2. BIT as a Guarantee against Political Risks

Each party of the political risk debate has its own arguments intended to promote their position. One of the argument for exclusion of political risk can be demonstrated in the

[229] Tidewater Investment SRL, Tidewater Caribe, C.A. v. the Bolivarian Republic of Venezuela, ICSID Case No. ARB/10/5, (Mar. 13, 2015), http://www.italaw.com/sites/default/files/case-documents/italaw4206_0.pdf. Himpurna California Energy Ltd v. PT. (Persero) Perusahaan Listruik Negara (Indonesia), UNCITRAL Ad Hoc, Award (May 4, 1999). Joseph Charles Lemire v. Ukraine, ICSID Case No. Arb/06/18, Award (Mar. 28, 2011).
[230] Gold Reserve Inc. v. the Bolivarian Republic of Venezuela, ICSID Case No. ARB(AF)/09/1 (Sep. 22, 2014).
[231] Ibid.
[232] "In Gold Reserve Case, Weight Placed on Hugo Chavez's Statements; Venezuela's Heightened Political Risk Premium should not Reduce Damages," *Investment Arbitration Reporter* (2015), accessed March 20, 2015, http://www.iareporter.com/articles/20140929?
[233] Ibid.
[234] James Searby, "The Country Risk Premium in International Arbitration," *The European and Middle Eastern Arbitration Review* (2011): 24.

position of claimant's expert in *Tidewater*, who argues that "the risk ought to be excluded…based upon a view about the legal implications of the existence of the investment protections contained in the Venezuela-Barbados BIT."[235] This, he says, gave bases to exclude the "real risks of the Government acting in a very negative way towards any private investment."[236] The argument is that the inclusion of political risk in the discount rate would result in unfair enrichment of the State which gains not only as a result of expropriation or any other illegal actions against the private property of the investor, but it is granted even more benefits as a result of discounting of the damages to be paid for investor, thus significantly decreasing the amount of damages to be paid for its own actions.[237] The expert says,

> If the State can create these risks that it controls, threaten businesses, […] lower the value of the business, and then they expropriate, if we're going to take all that risk into account, then they get to purchase the company at a very steep discount because of their own risks that they have created hostile towards those companies.[238]

The counter-argument for inclusion of the political risk as a variable of discount rate can be analysed in the position of tribunal in *Tidewater*, which supported the claims of respondent. It rejected the arguments of the claimant, stating that BITs is "not an insurance policy or guarantee against all political or other risks associated with such investment."[239] Rather, it is a mechanism by which the investor is granted a right to claim for compensation in the cases of expropriation or other.[240] The role of tribunal is to find the market value (or fair market value) of the investment, considering among others the existing situation in the host country, and finding the "amount a willing buyer would

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[235] Tidewater Investment SRL, Tidewater Caribe, C.A. v. the Bolivarian Republic of Venezuela, ICSID Case No. ARB/10/5, 60 (Mar. 13, 2015), http://www.italaw.com/sites/default/files/case-documents/italaw4206_0.pdf
[236] Ibid., 61.
[237] Ibid.
[238] Ibid.
[239] Ibid.
[240] Ibid.

pay to a willing seller of the investment immediately prior to the taking in question."[241] By this, the tribunal refers to the World Bank Guidelines on the Treatment of Foreign Direct Investment (1992, namely the definition of discounted cash flow, which should consider "the risk associated with such cash flow under realistic circumstances."[242] The political risk, as part of country risk, should also be considered when determining the appropriate discount rate for the DCF model.

The author of this paper supports the position of the tribunal in *Tidewater* and highly criticizes the position of claimant's expert. Even though there is some form of double enrichment of the state by its own actions, the due considerations should be given to the mind of potential buyer, whose main criterion to invest would be the potential risks of certain company, including political risks which would potentially affect the life of the investment in this particular country. The statistics shows that the majority of investor-state disputes are claimed against developing states (60% according to 2014 estimates; however, historical average of claims against developing and transitional economies was 28%).[243] As the developing states suffer from high political risks, this factor may become decisive from the view of potential buyer who would in any case consider political risks before investing in developing or transitional economy.

2.3.3. Time of Determination of Political Risks

Another argument for the position of exclusion of country risks is the time of determination of political risks. This problem was put under question in the case of *Exxon-Mobil v. Venezuela*. In this decision, the tribunal was answering the question whether the risk of confiscation should be counted in determination of discount rate

[241] "World Bank Guidelines on the Treatment of Foreign Direct Investment," *World Bank* (1992), accessed March 20, 2015, http://www.italaw.com/documents/WorldBank.pdf
[242] Ibid.
[243] "Recent Trends in IIAs and ISDS", *UNCTAD*, no. 1, (2015), available at http://unctad.org/en/PublicationsLibrary/webdiaepcb2015d1_en.pdf

applicable. According to investor's opinion, "the discount rate can take into consideration country risks such as those resulting from a volatile economy or civil disorder, but not the confiscation risk."[244] Venezuela criticizes this by stating that "elements such as the risk of taxation,regulation and expropriation are essential to the country risk and must be taken into consideration in the determination of the discount rate."[245] According to Art. 6 of the Venezuela BIT, the aggrieved investor shall be compensated by the market value at the moment before the breach had taken place or became publicly known.[246] In this case, the Tribunal found, which is supported by author, that risks of confiscation existed precisely before the factual confiscation had taken place and therefore, should be included in calculation.[247] Therefore, the argument of time of valuation, does not have impact on the risks which existed before the illegal act, and thus cannot be used by investors to increase amount to be paid.

Recommendations

Inclusion of political risks in consideration of discount rate is in line with the standard of fair market value. The absence of homogenous practice with regards to the question of inclusion or exclusion of political risks into consideration of discount rate applicable to DCF model create challenges for legitimacy of the system of investment arbitration. The practice of exclusion should be prevented in future in order to avoid inconsistency of awards and create certainty for parties of current and future disputes.

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[244] Mobil Corporation, Venezuela Holdings, B.V., Mobil Cerro Negro Holding, Ltd., Mobil Venezolana de Petróleos Holdings, Inc., Mobil Cerro Negro, Ltd., and Mobil Venezolana de Petróleos, Inc. v. Bolivarian Republic of Venezuela, ICSID Case No. ARB/07/27, Award, 121 (Oct. 9, 2014).
[245] Ibid.
[246] Agreement on encouragement and reciprocal protection of investments between the Kingdom of the Netherlands and the Republic of Venezuela (Netherlands-Venezuela BIT), art. 6, available at http://arbitration.org/sites/default/files/bit/netherlands_venezuela_english.pdf
[247] Mobil Corporation, Venezuela Holdings, B.V., Mobil Cerro Negro Holding, Ltd., Mobil Venezolana de Petróleos Holdings, Inc., Mobil Cerro Negro, Ltd., and Mobil Venezolana de Petróleos, Inc. v. Bolivarian Republic of Venezuela, ICSID Case No. ARB/07/27, Award, 121 (Oct. 9,2014).

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The chapter analyzed the existing problems, which occur during the process of valuation of damages in international investment arbitration. For procedure-based problems, such as financial incompetence of experts, lack of explanation of damages and shifted role of experts in international arbitration, the project proposes a number of options for resolving the problems. The most effective ways of resolution are use of tribunal-appointed experts and the technique of expert teaming. For substance-based problems, the chapter recommends to prevent the practice of double-counting and include the political risks in determination of damages, creating a consistent practice on these issues.

Conclusion

The senior project had an objective to answer the question on whether the process of valuation of damages in the current arbitral practice results in legitimate awards. Via analysis of cases, international instruments and scholarly publications, the research objective has been achieved and the project has demonstrated the necessity of introduction of substance-based and procedural changes aimed at elimination of legal uncertainty and establishing consistency in arbitral practice to ensure legitimacy of arbitral awards.

The existing instruments of international law pay no or little attention to the question of damages in investment arbitration. The current arbitral practice is based on the standards which were determined in the beginning of the 20th century. These standards are not prescribed by international law instruments, but were constructed by case practice, which had gradually transformed into customary international law. When considering the amount of damages to be awarded to the investor, the tribunals should reach the fair market value of the investment. Even though the standard itself is not controversial, the current arbitral practice demonstrates serious threats for legitimacy of awards. The main threat is imperfection of the procedure of valuation of damages. The project has shown that parties of disputes as well as scholars and commentators have reasons to cast doubts on financial competence of arbitrators for the reason that the questions they have to determine are out of traditional legal expertise. Valuation experts, whose functions are designed to compensate this lack of competence of arbitrators in finance and economics are not fulfilling their inherent obligations to be independent and impartial. The existing controversies between the claimants' and respondents' experts have shown that in modern investment arbitration the role of experts experienced a

critical shift as now they are serving as representatives (or advocates) of the party that invites them, by being financially dependent and possessing interest in reaching the outcome that would be positive for the hiring party. In order to solve this issue, the project has made several proposals and discussed advantages and disadvantages of each of them. The project has demonstrated that the most effective ways of improvement of the shortcomings are the use of tribunal-appointed experts and, alternatively, the scheme of expert-teaming. For the problem of double counting of damages, the project expresses its critique to this scheme of over-compensation of investors and proposes to prevent such practice in future decisions. In the problem of inclusion or non-inclusion of political risks in the process of valuation, the project supports the position of inclusion of political risks, since it is in line with the fair market value standard of compensation.

The project concludes with a recommendation to pay more attention to the question of damages in international investment arbitration, and take measures to fix the existing problems in order to eliminate uncertainty in the process and improve trust of parties to the whole system of investor-state dispute settlement.

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