It’s quantum!
by
George Kahale, III

Remember James Carville’s famous “It’s the economy, stupid” from Bill Clinton’s 1992 campaign? Well, in today’s ISDS, “it’s quantum”.

Over the past 10 years, there has been much criticism of the investor-state dispute settlement (ISDS) mechanism. In general, the focus has been on the substantive provisions of investment treaties, who interprets them and the entire process through which they are interpreted. Equally important, though perhaps not as well appreciated, are the problems associated with quantum, i.e., the monetary amount of an award. It is there that ISDS has become most dangerous. It is one thing to have bad decisions on questions of jurisdiction or liability, and quite another to have those decisions lead to surreal awards that respondents could not afford to satisfy even if they were inclined to do so.

Many factors contribute to the proliferation of mega-claims in ISDS, including the following:

- There are few rules to curb the natural tendency to engage in strategic claim exaggeration, a practice that has been taken to a new level in ISDS.

- The economic expert profession has flourished, consisting of expert witnesses who provide complex, voluminous reports followed by testimony justifying the mega-claims, giving them a veneer of credibility.

- Lawyers, both counsel and arbitrators, are usually not as comfortable with issues of quantum as they are with purely legal issues, making them less equipped to recognize, expose and address claim exaggeration.

- Arbitrators and counsel alike are often called upon to deal with thousands of pages of analysis and exhibits relating to quantum in a few hours at the tail end of a one or two-week hearing devoted mainly to jurisdiction and liability—not the best way to explore and digest technical issues foreign to most lawyers.
And last, but not least, the structural bias in the system in favor of claimants and the system’s lack of adequate checks and balances (factors that plague the entire arbitral process) too often result in adventurous tribunals pushing the envelope on quantum, just as on issues of jurisdiction and liability.

While these problems permeate all aspects of quantum, it can be difficult to identify issues that are not case-specific. One recurring issue that deserves special attention is the use, or abuse, of the discounted cash flow methodology of valuation (DCF).

In 1992, the following warning appeared in the World Bank’s Report on the Legal Framework for the Treatment of Foreign Direct Investment: “[P]articular caution should be observed in applying this method as experience shows that investors tend to greatly exaggerate their claims of compensation for lost future profits.” The Guidelines accompanying the Report also warned that DCF should not be used to value a project that does not have a track record of profitability. That is because DCF analyses are inherently speculative, as they are based on long-term projections of cash flows that are virtually certain to turn out wrong, the only question being by how much. After constructing these cash flows, a discount rate is applied to derive a present value, requiring tribunals not only to delve into the assumptions underlying the cash flows, but also to assess the intricate analyses that the warring experts present on discount rate. The discount rate factor alone can make a difference of hundreds of millions, if not billions, of dollars.

Two relatively recent examples of the dramatic impact of such analyses are P&ID v. Nigeria and Tethyan v. Pakistan. In each of those cases, the project at issue had not even begun commercial operation, meaning that there was no track record at all. Yet, the tribunals not only proceeded to use DCF, but they also adopted a virtually risk-free discount rate that resulted in gargantuan awards: around US$6.6 billion in P&ID and US$4 billion in Tethyan, excluding interest. Had anything like a traditional discount rate analysis been applied in either case, the discount rate would have been many times higher and the value much lower, or non-existent. Of course, the result would also have been very different if the World Bank Guidelines’ admonition about using DCF for a project that never got off the ground had been heeded.

With cases like these, the question has to be asked, only half in jest, whether executives will be motivated to promote expropriation of their own projects because of the distinct possibility that the fortunes that await them in arbitration would far exceed what they could hope to obtain carrying out their conventional business plans. To say the least, that is not what the architects of ISDS had in mind in creating the system.

* George Kahale, III (gkahale@curtis.com) is Chair, Curtis, Mallet-Prevost, Colt & Mosle LLP. The author wishes to thank Charlie Garnjana-Goonchorn, Louis T. Wells and an anonymous peer reviewer for their helpful peer reviews.

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