

Case summary

Azurix Corp. v The Argentine Republic

Year of the award: 2006

Forum: ICSID

Applicable investment treaty: Argentina – United States BIT (1991)

Arbitrators

Dr. Andrés Rigo Sureda, President

The Hon. Marc Lalonde

Dr. Daniel H. Martins

Timeline of the dispute

19 September 2001 – request for arbitration

8 August 2002 – arbitral tribunal constituted

8 December 2003 – decision on jurisdiction

14 July 2006 – arbitral award

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I. Executive Summary

During the 1999 water privatization in Argentina, Azurix, a US corporation, won – through its Argentinean subsidiary (ABA) – the tender for a 30-year concession for the distribution of potable water and the treatment of sewerage in the Province of Buenos Aires. ABA paid a “Canon” of \$438.5 million for the Concession.

In the course of 1999-2001, the provincial authorities allowed political interests to interfere with the tariff regime applied by ABA to charge customers for the water services, precluding ABA from increasing its revenues. The Province also failed to fulfill obligations under the Concession agreement regarding completion of infrastructure repair works, which resulted in an algae outbreak. Following the incident, the government blamed the foreign investor and encouraged consumers to refuse to pay their water bills. At the end of 2001, Azurix gave notice and subsequently terminated the Concession, but the Province rejected the termination. However, after ABA filed for bankruptcy procedures in February 2002, the Province terminated the Concession alleging ABA’s failure to provide the service under the concession.

Azurix initiated ICSID arbitral proceedings under the 1991 Argentina-US BIT and claimed that Argentina’s actions constituted multiple violations of the said BIT, including expropriation, fair and equitable treatment, non-discrimination and full protection and security. Azurix requested approx. US\$ 665 million in damages plus interest.

The Tribunal found that the actions of the Province were arbitrary and constituted violations of the fair and equitable treatment and full protection and security obligations. The claim of expropriation and remaining claims were rejected. The Tribunal awarded what it considered to be the “fair market value” of the investment, i.e. of the Concession (despite its rejection of the expropriation claim). This value was established by the Tribunal on the basis of the “actual investment” approach. However, the Tribunal adjusted the amount of the Canon paid in 1999 by the investor significantly downwards (it awarded \$60 million as opposed to \$438.5 million paid by Azurix) on the grounds that Azurix had overpaid for the Concession and would not have been able to recoup its investment; therefore the loss was partly due to Azurix’s own ill-informed business decision.

The Tribunal also awarded compensation for additional investments (\$105 million) plus interest at the average rate applicable to US six-month certificates of deposit, compounded semi-annually. The Tribunal rejected the “unjust enrichment” approach as a basis of determining the amount of compensation.

II. Factual Background and Claims of the Investor

The Claimant, Azurix Corp. (“Azurix”), a US corporation, took part in the privatization of water services in the Argentinean Province of Buenos Aires. In July 1999, Azurix Buenos Aires S.A. (“ABA”), an Argentinean indirect subsidiary of Azurix, won a privatization tender and was granted a 30-year concession for the distribution of potable water, and the treatment and disposal of sewerage in the Province. ABA made a “canon payment” of 438.5 million Argentine pesos (its tender bid) for the Concession.¹ A new regulatory authority (“ORAB”) was established to oversee and regulate the Concession.

In August 1999 ORAB issued a resolution precluding ABA from billing amounts in excess of those billed prior to the granting of Concession. The Claimant alleged that this was contrary to the information provided to the bidders at the time of the tender and that this decision was politically motivated. In 2000, the Province also discontinued the valuation methodology to determine appropriate tariffs provided for in the Concession agreement, without establishing an alternative methodology. Furthermore, the Province did not fulfill ABA’s request to increase the tariff to account for the increase in the Retail Price Index. The Claimant alleged that the Respondent had effectively failed to honour the tariff regime under the concession agreement.

Under the Concession agreement, the Province was obliged to complete certain infrastructure repairs before Azurix would take over the water concession. However, the Province never completed the necessary repairs. As a result, in April 2000 an algae outbreak led provincial health authorities to warn customers that they should boil tap water. Azurix alleged that provincial authorities bore responsibility for failing to complete work on equipment and systems which would be critical to algae removal. The company further accused the government of inciting public panic and encouraging consumers to refuse to pay their water bills following the incident.

In July 2001 ABA requested the Province to cure the breaches of the Concession agreement, but the request was denied. ABA terminated the Concession in October 2001. However, the Province rejected the termination and demanded that ABA continue the provision of the water services. In February 2002, ABA filed for bankruptcy reorganization procedures, and in March 2002 the Province terminated the concession agreement alleging ABA’s failure to provide relevant services.

Azurix initiated ICSID arbitral proceedings under the 1991 Argentina-US BIT and claimed that Argentina’s actions amounted to expropriation of its investment, constituted a violation of obligations of fair and equitable treatment, non-discrimination and full protection and security. (para.43) Azurix claimed approx. US\$ 665 million in damages, including the canon payment, additional investments, consequential costs and amounts owed to it by consumers.

¹ At the time, the exchange rate of Argentinean peso was fixed at 1:1 in relation to US dollar.

III. Findings on Merits²

A. Applicable law

In accordance with Article 42(1) of the ICSID Conventions, the Tribunal held that the dispute was governed by the Argentina-US BIT and applicable international law. The Tribunal also noted that the law of Argentina should be helpful in the carrying out of the Tribunal's inquiry into the alleged breaches of the Concession Agreement, to which Argentinean law applied. (para.67)

B. Fair and Equitable Treatment (FET)

In light of previous jurisprudence, the Tribunal interpreted the FET standard not to require "bad faith" or "malicious intention" as a necessary element of its violation. It also linked the standard to the legitimate expectations of the investor. The Tribunal concluded that the FET obligation presupposed "a favorable disposition towards foreign investment, in fact, a pro-active behavior of the State to encourage and protect it." (para.372)

Applying the standard to the facts of the case, the Tribunal found several instances where Argentina acted inconsistently with the standard:

- Refusal of the Province to accept ABA's notice of termination of the Concession and its insistence on terminating it by itself on account of abandonment of the Concession (para.374);
- "Politicization of the tariff regime" because of concerns with forthcoming elections or because the Concession was awarded by the previous government (para.375);
- Repeated calls of the Provincial governor and other officials for non-payment of bills by customers (para.376).

The Tribunal concluded that "[c]onsidered together, these actions reflect a pervasive conduct of the Province in breach of the standard of fair and equitable treatment." (para.377)

C. Arbitrary Measures

The BIT prohibited to "impair by arbitrary or discriminatory measures the management, operation, maintenance, use, enjoyment, acquisition, expansion, or disposal of investments."

The Tribunal found that some of the provincial authorities' actions had been of an arbitrary nature and impaired the operation of Azurix's investment. These included:

² Prior to this award on merits, the Tribunal issued a decision on jurisdiction of 8 December 2003 which is not covered in this summary.

- calling for non-payment of bills even before the regulatory authority had made a decision;
 - threatening the members of the ORAB because it had allowed ABA to resume billing;
 - requiring ABA not to apply the new tariff.
- (para.393)

D. Full Protection and Security

The Tribunal held that the aforementioned breaches of the “fair and equitable treatment” standard also served to violate the obligation to provide “full protection and security”.

E. Expropriation and Other Claims - Rejected

The Tribunal rejected claims of expropriation as, in its view, Province’s actions did not amount to expropriation – Azurix at all times continued to control ABA and its ownership of 90% of the shares was not affected. (para.322)

The Tribunal rejected the claim under the BIT “umbrella clause” (i.e. a provision capable of transforming contractual breaches into breaches of the BIT) on the grounds that the contracts invoked by Azurix had not been entered into by the parties to the treaty arbitration – namely Azurix and the Argentine Republic – but rather were between Azurix subsidiaries and the Province of Buenos Aires. (para.384)

IV. Findings on Damages

A. Law Applicable to the Determination of Damages

The Tribunal applied the BIT and international law.

B. Standard of Compensation

The BIT determined the standard of compensation (“basis upon which the damages should be assessed”) only for cases of expropriation (“fair market value”). Since this case did not involve expropriation, the Tribunal had to determine the applicable standard of compensation. It reviewed existing jurisprudence in similar cases (in particular, *CMS v. Argentina*, *S.D.Myers*, *Pope & Talbot*, *Feldman* and *MTD v. Chile*) and noted in particular the discretion of tribunals to determine the appropriate standard. (paras.419-423)

The Tribunal decided that in this case the “fair market value” standard was appropriate in relation to the Concession. The reason given by the Tribunal was that the Concession was eventually taken over by the Province. (para.424)

The Tribunal used the following definition of the fair market value: “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.”³ (para.424)

C. Date for Establishing the Value

The Tribunal noted the difficulty in establishing an appropriate date for valuation purposes in cases, where there are several measures contributing to violations of BIT provisions on fair and equitable treatment, arbitrary treatment or full protection and security (as opposed to cases of direct expropriation where the date is usually ascertained without difficulty).

The Tribunal referred to the test of the Iran-US Claims Tribunal on creeping expropriation, according to which the date of expropriation is “the day when the interference has ripened into a more or less irreversible deprivation of the property rather than on the beginning date of the events”. Applying the said approach to the case at hand, the Tribunal chose 12 March 2002 – the date when the Province put and end to the Concession – as an appropriate date.

The Tribunal further noted that “in assessing fair market value, a tribunal would establish that value in a hypothetical context where the State would not have resorted to [illegal] maneuvers but would have fully respected the provisions of the treaty and the contract concerned.” (para.417)

D. Heads of Damages Claimed

Azurix claimed somewhat different heads of damages in its Post-Hearing Memorial, as compared with its initial Memorial. The Tribunal considered that the “Post-Hearing Memorial is not the place to change the submissions for compensation since the simultaneous timing of the memorials of the parties does not permit the other party to comment on the changes made.” (para.416) Therefore, the Tribunal ruled on Azurix’s original claims.

In its Memorial, the Claimant submitted two alternative claims for compensation (based on two different valuation methods):

- 1) Under the actual investment method, Azurix claimed to have invested \$449 million when it acquired the Concession, \$102.4 million in additional capital

³ *International Glossary of Business Valuation Terms*, American Society of Appraisers, ASA website, June 6, 2001, p. 4.

contributions to ABA, and \$15 million on consequential costs including corporate expenditures and legal costs related to negotiations with the Province.

- 2) Under the book value method, Azurix claimed the book value of the Concession, estimated between \$482.2 million and \$516.9 million depending on the date taken for valuation purposes.

Additionally (under both methods), Azurix claimed the amount owed by customers to ABA when the Concession was taken over by the Province and which the Province had publicly requested the customers not to pay to ABA (approx. AR\$120 million).

E. Damages and Valuation

Of the two methodologies offered by the Claimant, the Tribunal chose the actual investment method, agreeing with the Claimant that the investment was recent and highly ascertainable. However, the Tribunal decided that a significant adjustment was required to determine the real value of the Canon paid by the Claimant. (para.425)

1. Canon payment

In the Tribunal's view, no well-informed investor would have paid the price paid by Azurix in mid-1999 (\$438.5 million) for the Concession in March 2002, irrespective of the actions taken by the Province and of the economic situation of Argentina at that time. (para.426) According to the Respondent, during the 1999 tender other bidders' offers had been at least ten times lower than that submitted by the Claimant. (para.240) In these circumstances, the Tribunal had to determine "what an independent and well-informed third party would have been willing to pay for the Concession in March 2002, in a context where the Province would have honored its obligations." (para.427)

In determining this, the Tribunal concluded that under the tariff adjustment system enshrined in the Concession agreement the chances of recouping the canon payment were uncertain. (para.427) In support, the Tribunal referred to the fact that the Overseas Private Investment Corporation ("OPIC") refused to grant Azurix financial support for the project, on the grounds that, in OPIC's assessment, the tariffs system would not allow Azurix to generate sufficient revenues. (paras. 426, 162, 167)

Although the Tribunal also took into account that the Province, through its conduct, contributed to the loss in value of the Concession, it concluded that no more than a fraction of the Canon payment could realistically have been recuperated under the Concession agreement. (para.429) The Tribunal decided that Azurix had grossly overpaid for the Concession and established the value of the Canon on 12 March 2002 at US\$60 million, without explaining how it arrived at this figure. (para.429)

2. Additional investments

Azurix claimed compensation for additional investments (additional capital contributions) made to finance ABA. The Tribunal accepted the amount claimed (approx US\$113 million) but reduced it by US\$ 7.6 million to account for the damages which the Tribunal found to be related to contractual claims (dismissed by the Tribunal under the “umbrella clause”) and that should be borne by Azurix as part of its business risk. The Tribunal thus awarded approx. US\$ 105 million for additional investments. (para.430)

3. Unpaid bills

Azurix claimed AR\$120 million for unpaid bills to ABA for services rendered prior to the takeover of the Concession by the Province and which the Province had directed customers not to pay to ABA. The Tribunal rejected this claim on the grounds that the claimed amount was owed by the Province to ABA (not to Azurix) and therefore should not be part of the compensation awarded to Azurix. (para.431)

4. Consequential damages

Azurix claimed US\$ 15 million for (i) corporate expenditures for negotiations with the Province, termination of the Concession and transfer of the service (US\$ 7.1 million), and (ii) costs for the preparation, registration, and participation in the ICSID arbitral proceedings (US\$ 7.9million). The Tribunal considered the second component of this claim as part of its award on costs. As for the first one, the Tribunal found that it had not received sufficient evidence in support of such costs and that in any case, these costs related to the business risk taken by Azurix when it had decided to invest.

F. Unjust Enrichment

As an alternative to the fair market value of the investment, the Claimant proposed that compensation could be based on the theory of unjust enrichment (this would allow Azurix to recover the full amount of the Canon). The Tribunal observed that damages and unjust enrichment are conceptually distinct in terms of the principles of liability and the measure of restitution: “In the case of damages, liability rests on an unlawful act, which is not necessarily the case in unjust enrichment. As to compensation on account of an unlawful act, it is based on the loss suffered, while, in the case of unjust enrichment, it is based on restitution” (para.436)

The Tribunal furthermore referred to the jurisprudence of the Iran-US Claims Tribunal, which held that “there must be no contractual or other remedy available to the injured party whereby he might seek compensation from the party enriched.” The Tribunal reasoned that the Claimant had chosen the remedy provided for in the BIT (compensation for damages) and that the measure of compensation was not the restitution of the Claimant’s investment but its fair market value before the breach

occurred. For these reasons the Tribunal did not accept the approach based on unjust enrichment proposed by the Claimant. (para.438)

F. Interest

The Tribunal awarded compound interest at the average rate applicable to US six-month certificates of deposit, compounded semi-annually, from 12 March 2002 until the date of the award (if the awarded amount was not paid within 60 days, then until the date of payment). In its justification of compound (as opposed to simple) interest, the Tribunal stated that compound interest reflected the reality of financial transactions, and best approximated the value lost by the investor. (para.440, 442(6))

V. Implications/Initial Analysis

- In this non-expropriation case the Tribunal applied the expropriation **standard of compensation** (“fair market value”). Reason – the investment (Concession) was eventually lost (taken over by Argentina), that is, the effect of the violations was similar to an expropriation.
- In the context of the expropriation claim, the Tribunal seemed to consider the **subsidiary** (ABA) as Azurix’s **investment** (the expropriation claim was rejected because Azurix’s ownership of shares remained unaffected). By contract, when quantifying the damages, the Tribunal established the fair market value of the **Concession** (not Azurix’s shares in the subsidiary), i.e. it treated the Concession as the lost investment.
- In order to establish an appropriate **date of valuation**, the Tribunal adjusted the approach of the Iran-US Claims Tribunal for creeping expropriation (perhaps because the effect of the violations was deprivation of Concession, i.e. similar to an expropriation). Date of valuation is also important because interest starts running from this date.
- Although the Tribunal accepted the **actual investment method** as a basis for valuation, fair market value of the investment was determined to be much less than the actual investment made (due to the fact that the Claimant had overpaid for the Concession at the tender). This essentially means that some other method was applied by the Tribunal to determine the FMV (most likely, amounts offered by competing bidders).
- The Tribunal believed that the **value of the Concession** at the time of the original bid (and at the date of the breach) was only a fraction of what the investor had actually paid (the Canon) because, in its view, under the Concession agreement the investment could not realistically be recuperated. Consequently, the major part of the loss was not due to the breach by Argentina but to Azurix’s **ill-informed business judgment** at the time of the tender (in other words, the loss would have been suffered in any event).

- The ill-informed business judgment of Azurix at the time of the tender and the resulting loss could be considered a case of **contributory fault** on the investor's part (the Tribunal did not use this term).
- It is not clear in which cases **damages** of the investment can “**flow**” to the investor. For example, the “unpaid bills” claim was rejected by the Tribunal because this was a debt to Azurix's subsidiary that operated the Concession, and not to Azurix itself. This is controversial given that the subsidiary was owned by Azurix (90% shares), so at least some damage was ultimately also suffered by the foreign investor.
- The Tribunal did not accept the theory of **unjust enrichment**; it held that there were other remedies available under the BIT and the measure of compensation was the fair market value (not restitution as in cases of unjust enrichment). This reasoning makes it very difficult for investors to use the unjust-enrichment approach to quantify compensation.
- The Tribunal awarded **interest compounded** semi-annually, on the basis that it reflected the reality of financial transactions, and best approximated the value lost by the investor.