

**Case summary**

## CMS Gas Transmission Company v Argentina

**Year of the award:** 2005

**Forum:** ICSID

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

<p><b>Arbitrators</b>                  Mr. Francisco Orrego Vicuña,                  President                  Mr. Marc LaLonde                  Mr. Francisco Rezek</p> <p><b>Annulment Committee</b>                  Judge Gilbert Guillaume, President                  Judge Nabil Elaraby                  Professor James R. Crawford</p>	<p><b>Timeline of the dispute</b>                  26 July 2001 – request for arbitration                  11 January 2002 – arbitral tribunal                  constituted                  17 July 2003 – Decision on Objections to                  Jurisdiction                  12 May 2005 – Final Award                  25 September 2007 – Decision of the Ad Hoc                  Annulment Committee</p>
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## **I. Executive Summary**

CMS, a US corporation, owned a 30% share of TGN, an Argentinean gas transportation company. At the time of making the investment, Argentina granted TGN the right to calculate tariffs in US dollars and then convert them to pesos at the prevailing exchange rate, and to adjust tariffs every six months to reflect changes in inflation. These rights were enshrined in the Argentinean law and in the License granted to TNG for the period of 35 years (until 2027).

At the time of a serious economic crisis in Argentina in late 1990-s, Argentina first temporarily suspended and then permanently terminated both TGN's right to calculate tariffs in US dollars and its right to make inflation adjustments. The peso was devalued with the effective rate being 3.6 peso for one dollar, whereas respective tariffs were redenominated at a rate of one peso to the dollar. This led to a great decrease in TGN's profits and to the loss of value of the TGN as a company.

CMS claimed that the measures at issue were in violation of several of Argentina's obligations under the Argentina-US BIT and requested compensation of US\$ 261 million (the decreased value of its shares in TGN plus interest and costs).

The Tribunal found violations of the fair and equitable treatment provision and the umbrella clause of the BIT. Despite the fact that no violation of the expropriation clause was established, the Tribunal applied the "fair market value" standard to make good the long-term losses caused to the investor by the measures at issue. In application of this standard and in order to estimate the lost value of CMS's shares in TGN, the Tribunal applied the discounted cash flow (DCF) valuation method. The Tribunal awarded US\$ 133 million plus interest.

In the annulment proceedings, the Tribunal's findings relating to the umbrella clause were annulled. Other findings were upheld, even though errors of law detected in relation to the Tribunal's findings on necessity. The award of damages was not affected.

## **II. Factual Background and Claims of the Investor**

CMS, a US corporation, acquired in 1995 – the course of privatisation of the gas sector in Argentina – a 30% share of TGN, an Argentinean gas transportation company. As part of its energy privatisation incentives, Argentina granted TGN the right to calculate tariffs in US dollars and then convert them to pesos at the prevailing exchange rate, and to adjust tariffs every six months to reflect changes in inflation. These rights were enshrined in the Argentinean law and in the License granted to TNG for the period of 35 years (until 2027).

Against the background of a serious economic crisis that began to unfold in Argentina in late 1990-s, in December 1999 Argentina and the gas companies entered into a 6-month agreement for the temporary suspension of the inflation adjustments, with the

understanding that this suspension would not be permanent. However, in August 2000, it became apparent that the temporary suspension would not be lifted.

Furthermore, in January 2002, under the so-called Emergency Law, Argentina unilaterally terminated both TGN's right to calculate tariffs in US dollars and its right to make inflation adjustments. The peso was devalued with the effective rate being 3.6 peso for one dollar, whereas respective tariffs were redenominated at a rate of one peso to the dollar. What started as a temporary suspension under the 1999 agreement, later became a permanent measure.

CMS brought a dispute before the ICSID Tribunal claiming that the measure at issue was in violation of several of Argentina's obligations under the Argentina-US BIT:

- 1) Expropriation without compensation;
- 2) Fair and equitable treatment
- 3) Arbitrary and discriminatory measures;
- 4) Umbrella clause (a provision obliging each BIT party to respect "any obligation it may have entered into with regard to investments").

CMS requested compensation in the amount of US\$ 261 million which represented the decreased value of its shares in TGN plus interest and costs. Argentina rejected all claims.

### **III. Findings on Merits**

#### **A. Applicable law**

Neither the parties, nor the BIT had chosen a particular law applicable to the resolution of the dispute (in addition to the rules of the BIT itself). Under the ICSID Convention, in such situations "the Tribunal shall apply the law of the Contracting State party to the dispute [...] and such rules of international law as may be applicable" (Article 42(1) of the Convention).

In its interpretation of this provision, the Tribunal followed the approach of the Annulment Committee in *Wena v. Egypt*, which did not give prevalence neither to international law, nor to domestic law, but established instead that both had a role to play. (para. 116)<sup>1</sup> The Tribunal decided that both Argentinean law (Constitution, Civil Code, gas legislation and regulations) and international law were applicable; it did not identify the hierarchy between the two. (para.122)

#### **A. Expropriation**

The Tribunal found that there was no expropriation in this case, as the investor had not been deprived of enjoyment of its property and retained full control and ownership of the investment. Thus, no BIT violation was found.

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<sup>1</sup> Throughout the summary, references are made to paragraph numbers in the Final Award.

## **B. Fair and Equitable Treatment**

The Tribunal found that the measure at issue, and specifically the effective dismantling of the dollar standard in tariffs and of the inflation adjustment mechanism, entirely transformed the legal and business environment under which the investment had been made and which was crucial for the investment decision. Therefore, the Tribunal held that the FET standard, “inseparable from stability and predictability”, was breached.

## **C. Arbitrary/Discriminatory Treatment**

The Tribunal did not find violation of the BIT provision prohibiting arbitrary/discriminatory treatment of foreign investors.

## **D. Umbrella Clause**

CMS claimed violation of the BIT “umbrella clause” – a provision obliging each country to respect “any obligation it may have entered into with regard to investments” – on the grounds that Argentina had breached its legislation and contractual commitments made at the time of investment. The Tribunal accepted the claim and held that, in particular, two clauses of the TGN’s License were breached by Argentina:

- 1) the obligation not to freeze the tariff regime or subject it to price controls;
- 2) the obligation not to alter the basic rules governing the License without TGN’s written consent.

Breaches of these License terms entailed the violation of the BIT umbrella clause.

The Annulment Committee had “major difficulties” with the “broad interpretation” of the umbrella clause implicit in the Tribunal’s award. Specifically, the Committee emphasized that the umbrella clause did not change *parties* to the obligation, and it was “quite unclear” how the Tribunal had arrived at its conclusion that CMS could enforce the obligations of Argentina to TGN. This finding of the Tribunal was annulled for the failure to give reasons. (Annulment Decision, paras.94-97.)

## **E. Necessity Defence**

Argentina relied on Article 25 of the ILC Articles on State Responsibility in arguing that its measures were adopted to safeguard essential economic interests. Argentina further invoked Article XI of the BIT (“Emergency Clause”) that allowed measures “necessary for the maintenance of public order, the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.” The Tribunal found that Argentina’s defences could not be justified.

Also importantly, the Tribunal noted that even if it accepted Argentina’s necessity defence, this would not exclude the duty to compensate the investor (with reference to Article 27 of the Articles on State Responsibility). The Tribunal noted that under international law and the principles governing most domestic legal systems, one party should not bear entirely the cost of the plea of the essential interest of the other party. (paras.388, 390)

The Tribunal's findings under Article XI were subsequently severely criticized (although not annulled) by the Annulment Committee. It stated that Article XI and rules of customary international law on necessity (reflected in ILC Article 25) were "substantially different" in their "operation and content". The Annulment Committee held, therefore, that the Tribunal had made a manifest error of law by assimilating the two articles. (Annulment Decision, paras.128-131)

The Annulment Committee concluded that the Tribunal also made a manifest error of law by conflating the *consequences* of successful invocation of the necessity defence under customary international law and the BIT. In Committee's view, such consequences would have been different depending on the law applied. The Committee suggested that Article XI, if successfully invoked, necessarily absolved the respondent from an obligation to pay compensation: "Article XI, if and for so long as it applied, excluded the operation of the substantive provisions of the BIT. That being so, there could be no possibility of compensation being payable during that period". (Annulment Decision, paras.144-147)

## **IV. Findings on Damages**

### ***A. Applicable law***

As already said above, the Tribunal decided that both Argentinean law (Constitution, Civil Code, gas legislation and regulations) and international law were applicable and did not identify hierarchy between the two. However, in its analysis on damages, the Tribunal referred only to international sources.

### ***B. Restitution vs. Compensation***

The Tribunal suggested that restitution was by far the most reliable choice to make the injured party whole as it aimed at the reestablishment of the situation existing prior to the wrongful act. (para.406) Where, as in this case, restitution is not possible, compensation is the appropriate form of reparation.

### ***C. Standard of Compensation***

With reference to the Draft Articles on State Responsibility and to other sources, the Tribunal stated that compensation should be commensurate with the loss suffered by the claimant and should cover any financially assessable damage including capital value, loss of profits and expenses. (paras.401-402)

In this non-expropriatory case, the Tribunal faced the difficulty of finding an appropriate standard of compensation, as no guidance was offered by the BIT. Exercising its discretion, the Tribunal decided to apply the standard of fair market value, established by the BIT for cases of expropriation. In support of its decision, the Tribunal referred to the cumulative nature of the breaches of the BIT and to the fact that the breaches resulted in important long-term losses. (para.410)

The Tribunal had to estimate the loss of value suffered by CMS on its TGN's shares.

### ***D. Burden of Proof***

The Tribunal did not discuss the burden of proof issue and appeared to imply that it was for the Claimant to prove the damages it had sustained. At the same time, the Tribunal seemed unsatisfied with the fact that Argentina did not provide an alternative valuation, although the Tribunal had specifically requested it. (para.83) In the end, the Tribunal based its valuation of damages on the estimate produced by the CMS's expert, although the Tribunal modified a number of assumptions used in that estimate.

### ***E. Valuation Method***

The Tribunal referred to the following "internationally recognized definition" of the fair market value standard:

"the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy and when both have reasonable knowledge of the relevant facts." [Footnote reference: International Glossary of Business Valuation Terms, American Society of Appraisers, ASA website, June 6, 2001, p.4 ] (para.402)

This definition also prompts the first method of establishing fair market value – when assets are publicly traded, the market price of this asset would be its fair market value.

For non-publicly traded assets, the Tribunal enumerated four other methods that had "generally been relied upon" to arrive at the fair market value:

- (1) The "asset value" or the "replacement cost" approach which evaluates the assets on the basis of their "break-up" or their replacement cost;
- (2) the "comparable transaction" approach which reviews comparable transactions in similar circumstances;
- (3) the "option" approach which studies the alternative uses which could be made of the assets in question, and their costs and benefits;
- (4) the "discounted cash flow" (DCF) approach under which the valuation of the assets is arrived at by determining the present value of future predicted cash flows, discounted at a rate which reflects various categories of risk and uncertainty.<sup>2</sup> (para.403)

Out of the four, the Tribunal selected the DCF method as the most appropriate in this case because:

- TGN was a going concern;
- DCF techniques had been universally adopted, including by numerous tribunals, as an appropriate method for valuating business assets;
- there was adequate data to make a rational DCF valuation of TGN;

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<sup>2</sup> With footnote reference to: Damodaran, "Investment Valuation", John Wiley & Sons, New York, 2002, pp.946-949.

- losses had extended through a prolonged period of time;
- experts from both sides agreed that the DCF method was proper. (paras.416-417)

The Tribunal acknowledged the challenges associated with the DCF analysis in this case because some of the relevant factors included a large degree of uncertainty.<sup>3</sup> The Tribunal had to evaluate what the years 2000 to 2027 (till the expiry of the TGN’s license) would have been like had TGN’s license and regulatory environment remained unchanged, as well as to foresee what the future held for TGN under the new (and not completely known) regulatory environment. (para.419) Despite this, the Tribunal decided that it was still possible to arrive at “rationally justified” figures that would not be “arbitrary or analogous to a shot in the dark”. (para.420)

The Tribunal specifically noted that in determining compensation, it could not ignore the reality of the Argentinean economic crisis. The Claimant cannot be entirely beyond the reach of the abnormal conditions prompted by the crisis, but at the same time, it would be wholly unjustifiable that to put all the costs of the crisis on the Claimant. (para.244) In Tribunal’s view, CMS had borne a certain business risk when investing in Argentina and some of the negative impacts should be attributed to this business risk. The Tribunal said that both parties should be “sharing some of the costs of the crisis in a reasonable manner”, otherwise the arbitral award could “amount to an insurance policy against business risk”. (para.249) For example, the crisis was taken into account during the DCF analysis when projecting the gas demand trends. (paras.443-446)

At the same time, the Tribunal noted that Argentina did not withdraw the measures at issue even after the economic crisis was largely over (paras.250-251), so that the Tribunal had to treat them as permanent and not temporary (para.107), which ultimately increased the measure of Argentinean liability.

## ***F. Valuation***

The Tribunal used the following approach to value TGN and its shares:

- 1) compute the cash flows to equity (cash flows from operations, minus interest and debt repayments);
- 2) discount the cash flows to equity at the cost of equity;
- 3) add the discounted cash flows to equity to the cash flows to equity to establish the value of equity (“the direct equity value”);
- 4) add the value of debt to establish the value of the firm.

(paras.430, 433)

However, the Tribunal did not proceed to discuss each of these valuation stages. Instead, the Tribunal said that it based its findings on the estimate presented by the CMS’s expert (Argentina did not provide an alternative calculation), who had used the forecast figures prepared by TGN for internal use in 2000. The Tribunal stated that the use of a company’s internal forecast prepared in the normal course of business was

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<sup>3</sup> For example, Argentina’s future economic health; peso rate with the US dollar; the evolution of production costs; required future investments for the maintenance of the pipeline system’s efficiency and security. (para.419)

quite acceptable as a starting point. (para.422) However, the Tribunal (assisted by two of its own experts) reassessed and modified some of the more crucial assumptions contained in the estimate of the CMS's expert, including the following:

- duration of the contract;
- demand for gas and revenues;
- exchange rate;
- equity discount rate;
- tariff adjustments;
- operations and maintenance expenditures.

(paras.439-462)

The Tribunal did not address and modify a number of other factors used by the CMS's expert (in particular, US\$ export sales, tax rate, depreciation, interest tax rate, target debt ratio and additional capital expenditures).

After all modifications, the Tribunal arrived at a DCF loss valuation of US\$ 133.2 million, which represented the compensation owed by Argentina to CMS. The very consequence of mathematical operations that lead to this figure did not feature in the award.

### ***G. Interest***

The Tribunal awarded interest using the following scheme:

- 1) from August 2000 to 60 days after the Award – simple interest at the US Treasury Bills rate (2.51% for that period);
- 2) thereafter – compounded (semi-annually) interest at the US Treasury Bills rate.

(para.471)

### ***E. Legal Costs***

Without offering an explanation, the Tribunal held that each party should bear its own legal costs and that arbitration costs should be borne in equal shares.

## **V. Implications / Initial Analysis**

- When rejecting Argentina's arguments on **necessity**, the Tribunal noted that although this defence would justify the wrongfulness, it would not exclude compensation (with reference to Article 27(b) of the Articles on State Responsibility). At the same time, the Tribunal seemed to imply that the amount of compensation in this case could have been less than under "normal" circumstances. The **Annulment Committee** decided that consequences of the necessity defence under the BIT are different from those under customary international law. In Committee's view, had Article XI of the BIT been successfully invoked, it would exclude the operation of the substantive provisions of the BIT and absolve the respondent from the obligation to pay compensation.

- In the event of an **economic crisis**, both parties should be “sharing some of the costs of the crisis in a reasonable manner”. Some negative impacts should be attributed to the **business risk** borne by the investor at the time of making the investment. The BIT should not be an insurance instrument against all business risks of foreign investors. When assessing the damages, the Tribunal took the crisis into account.
- The Tribunal applied the **‘fair market value’ standard** to award compensation in this non-expropriation case (in particular, because the effects of the breach resulted in “important long-term losses”).
- The Tribunal seemed to be dissatisfied with the fact that Argentina had not submitted its own **alternative valuation of damages** (Argentina did so on the premise that it was for the claimant to prove the quantum of damages).
- When an investor is a shareholder in the investment and the damages are caused to the investment, a tribunal can evaluate the damages by assessing the **loss in the value of the shares** owned by the investor.
- For publicly traded assets, a **price quoted on a public market** will normally be an indication of the FMV. In the absence of a stock price, **DCF method** can be applied to assess the lost value of shares. This method will be particularly relevant where the investment is a going concern; where there is adequate data to make a rational DCF valuation; and where losses extend through a prolonged period of time.
- An **internal business forecast** of a firm prepared in the normal course of business can be acceptable as a basis of the DCF analysis.