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Case summary

Sempra Energy International
v
Argentine Republic

Year of the award: 2007
Forum: ICSID (Case No. ARB/02/16)
Applicable investment treaty: Argentina-US BIT (1991)

Arbitrators	**Timeline of the dispute**
Professor Francisco Orrego Vicuña, President The Honorable Marc Lalonde Dr Sandra Morelli Rico	11 September 2002 – Request for arbitration 5 May 2003 – Arbitral tribunal constituted 11 May 2005 – Decision on the Objections Jurisdiction 28 September 2007 – Award

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I. Executive Summary

Sempra, a US investor, held an equity interest in two Argentinean gas distribution companies, CGS and CGP, which had been created during the privatization campaign in early 1990s. At that time, in order to attract foreign investors, Argentina enacted legislation which guaranteed that tariffs for gas distribution would be calculated in US dollars (paid in pesos at the prevailing exchange rate) and that automatic semi-annual adjustments of tariffs would be based on the US Producer Price Index (US PPI). The Government also undertook to reimburse to CGS and CGP the subsidies set for residential customers of Patagonia. Relevant obligations were replicated in the Licenses granted to CGS and CGP until 2027.

In the circumstances of the economic crisis that developed in Argentina in early 2000s, the Government abrogated the guarantees provided at the time of privatization, which led to a very substantial reduction in the profitability of the gas distribution business and, accordingly, returns on Sempra's investment. The Government also stopped reimbursing the subsidies. To avoid the default of CGS and CGP, in December 2001 Sempra lent them US$56 million.

In 2002, Sempra initiated ICSID arbitral proceedings claiming multiple violations of the 1991 Argentina-US BIT and requesting damages. The Tribunal found that Argentina's measures breached fair and equitable treatment standard and the umbrella clause. Other claims were dismissed. The Tribunal also rejected Argentina's plea of a state of necessity but took the circumstances of the economic crisis into account when assessing damages.

The Tribunal based its award of damages on the loss in fair market value of Sempra's equity. This loss was estimated by calculating the difference in the DCF valuations of the CGS and CGP under the "no breach" scenario and the "breach" scenario. When performing the valuation under the "no breach" scenario, the Tribunal reduced the value (and consequently compensation) on account of Argentinean economic crisis. The principal head of damages was supplemented by three others: (1) the amount of the lost loan; (2) historical damage suffered due to the suspension of US PPI adjustments (up to the date of valuation); and (3) subsidies unpaid by the Government. The Tribunal awarded interest at the LIBOR rate plus 2%, compounded semi-annually, from the date of valuation to the date of the Award. Post-Award interest was not awarded because it had not been requested in time.

II. Factual Background and Claims

Sempra Energy International ("Sempra"), a US company, invested an alleged total of US$350 million in its equity interest in two Argentinean gas distribution companies Camuzzi Gas Pampeana ("CGP") (37.10%) and Camuzzi Gas del Sur ("CGS") (38.78%). During the privatization of Argentina's national gas transport and distribution monopoly in the early 1990s, CGP and CGS had been granted Licenses for gas distribution in seven Argentine provinces for a term of 35 years (until 2027), with a possible 10-year extension.

In order to attract foreign investment, at the time of privatization Argentina introduced a regulatory framework that included several advantageous features including: the calculation of tariffs for gas distribution in US dollars and their conversion into pesos at the prevailing exchange rate at the time of billing; semi-annual adjustments of tariffs according to the changes in the US Producer Price Index ("PPI"); the commitment that there would be no price freeze applicable to the tariff system without compensation. The Government also undertook to reimburse the subsidies set for residential customers of Patagonia. These obligations were set out in the Argentine legislation and in the Licenses. The Government, acting through its natural gas regulator ENARGAS, honoured these obligations during 1993-1999.

In view of the economic crisis that started developing in Argentina in the late 1990s, the Government and the Licensees first agreed to a one-off six-month postponement of the tariff adjustments due in January 2000. A second agreement postponed the tariff adjustments until 30 June 2002. These agreements were approved by Decree 669/00 of 17 July 2000, which also provided for the subsequent compensation for the deferred tariff increase. However, on 18 August 2000, a judicial injunction was granted at the request of the Argentine Ombudsman, with the result that PPI adjustments became indefinitely suspended.

The Government also stopped reimbursing the subsidies (in the Subsidies Agreement of 12 December 2001, the amount owed through 31 October 2001 was established at approx. AR$108 million). Finally, on 2 January 2002, the Government enacted the "Emergency Law", which abrogated the right to calculate tariffs in US dollars ("pesification of tariffs"). The substantial devaluation of peso led to a severe decrease in Licensees profits. The Law also definitively abolished PPI adjustments. To avoid default of CGS and CGP, Sempra lent them US$56 million at the end of 2001.

In December 2001, Sempra initiated ICSID arbitral proceedings under the 1991 Argentina-US BIT. It argued that by failing to respect the regulatory framework, Argentina had expropriated the Claimant's investment, breached the fair and equitable treatment obligation, taken arbitrary and discriminatory measures and violated the "umbrella clause". Sempra requested US$ 209.3 million damages, consisting of damage to equity value, debt, unpaid subsidies and historical PPI damage.

In April 2007, Argentina signed Memoranda of Understanding with the Licensees, CGS and CGP, agreeing to a 25% tariff adjustment from 1 January 2008 for one company and from 1 July 2007 for the other. The Claimant expressly disavowed its acceptance of these agreements.

III Findings on Merits

A. Applicable Law

In the absence of a choice of law by the parties, the Tribunal applied Article 42(1) of the ICSID Convention. The Tribunal held that under this clause, both Argentine law and international law had "a role to perform in the resolution of the dispute". The Tribunal concluded that "there is generally no inconsistency between the Argentine law and international law insofar as the basic principles governing the matter are concerned" but added that "[t]o the extent that there is any inconsistency between Argentine law and the treaties in force, however, international law will prevail". (paras.231-240)

Before proceeding to the Treaty claims, the Tribunal considered the claims under Argentine law and found that "in considering the claims solely from the point of view of the Argentine legislation […], the obligations and commitments which the Argentine Republic owed in relation to the License were not observed." (para.268)

B. Treaty Violations Found

1. Fair and Equitable Treatment (FET)

The Tribunal found that the "measures in question in this case have beyond any doubt substantially changed the legal and business framework under which the investment was decided and implemented" and that, therefore, the Respondent committed "an objective breach of the fair and equitable treatment due under the Treaty … to the detriment of the Claimant's rights". (paras.290-304)

2. Umbrella Clause

The Tribunal stated that "ordinary commercial breaches of a contract are not the same as Treaty breaches" and that "such a distinction is necessary so as to avoid an indefinite and unjustified extension of the umbrella clause". Regarding the measures at issue, the Tribunal found that they were far from "ordinary" contractual breaches; instead they were "the outcome of major legal and regulatory changes introduced by the State" and gave expression to a sweeping "change of policy" that could be performed only by the State, "and not an ordinary contract party". The Tribunal further found that the License, which was "the ultimate expression of a series of complex investment arrangements made with the specific intention of channeling the influx of capital into newly privatized companies", included obligations "with respect to a specific investment". Having breached the obligations included in the License, the Respondent was found to breach the umbrella clause of the Treaty. (paras.305-314)

C. Rejected Claims

1. Expropriation

The Claimant argued that the measured at issue had expropriated without compensation its investment in equity in CGS and CGP, and also the specific contractual rights arising from the License regime. The Tribunal decided that there had been no direct expropriation because the title to Claimant's property had not been affected and there had been no intention to expropriate. (paras.280-282) The Tribunal also rejected the claim of indirect expropriation because such a finding "would require that the investor no longer be in control of its business operation, or that the value of the business have been virtually annihilated", which was not the case in the present dispute. (paras.283-285)

2. Arbitrariness and Discrimination

The Tribunal rejected the claim that the measures at issue had been arbitrary because "a finding of arbitrariness requires that some important measure of impropriety be manifest", while the measures at issue "responded to what the Government believed and understood to be the best response to the unfolding crisis" and had been "not entirely surprising" in the context, in which they had taken place. (para.318)

The claim of discrimination was rejected because the Tribunal found that none of the affected sectors had been "particularly singled out either to have applied to it measures harsher than in respect of others, or conversely to be provided with a more beneficial remedy to the detriment of another". The Tribunal did not find "any capricious, irrational or absurd differentiation in the treatment accorded to the Claimant as compared to other entities or sectors." (para.319)

3. Full Protection and Security

The claim concerning the Respondent's failure to afford full protection and security to the Claimant's investment was rejected because there had been "no allegation of a failure to give full protection and security to officials, employees or installations", while the "general argument made about a possible lack of protection and security in the broader ambit of the legal and political system" had not been proven or adequately developed. (para.324)

D. Respondent's Plea of Necessity

The Respondent pleaded to be exempt from liability in the light of national emergency or state of necessity under (1) domestic law; (2) customary international law, and (3) the Treaty.

1. Domestic Law

The Tribunal rejected the plea of emergency under domestic law on the grounds that "the constitutional order was not on the verge of collapse" and that "[e]ven if emergency legislation became necessary in this context, legitimately acquired rights could still have been accommodated by means of temporary measures and renegotiation." (paras.328-332)

2. Customary International Law

The Tribunal relied on Article 25 of the ILC Articles on State Responsibility "as reflecting the state of customary international law on the matter". The Tribunal viewed this Article as establishing a state of necessity as "a most exceptional remedy" that was "subject to very strict conditions" and went on to examine whether all of these conditions were cumulatively met. The Tribunal rejected the Respondent's argument that the crisis had "compromised the very existence of the State and its independence, and thereby qualified as one involving an essential State interest" and that the measures taken under the Emergency Law had been the only ones available. The Tribunal found further that there had been "a substantial contribution of [Argentina] to the situation giving rise to the state of necessity". In light of these findings, the Tribunal concluded that the conditions of ILC Article 25 were not cumulatively met. (paras.333-354)

3. Treaty

Article IV(3)

The Tribunal first addressed the Respondent's arguments under Article IV(3) of the Treaty.[1] While the Tribunal accepted that that Article covered "economic emergency measures taken in circumstances of particular gravity", the Article did not allow "derogation from Treaty", nor could it be read "as a general escape clause from treaty obligations" and did not result "in the exclusion of wrongfulness, liability and eventual compensation". The Tribunal thus concluded that a state of necessity could not be justified under that Article. (paras.356-363)

Article XI

Article XI of the BIT provided: "*This Treaty shall not preclude the application by either party of measures necessary for the maintenance of public order, the fulfilment 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 adopted a "restrictive interpretation" of this provision in light of the Treaty's general object and purpose to protect rights of investors "in situations of economic difficulty and hardship". (para.373) The Tribunal further found that Article XI covered economic emergency but that the provision was not self-judging.

[1] Article IV(3) of the Treaty provided:

> Nationals or companies of either Party whose investments suffer losses in the territory of the other Party owing to war or other armed conflict, revolution, state of national emergency, insurrection, civil disturbance or other similar events shall he accorded treatment by such other Party no less favorable than that accorded to its own nationals or companies or to nationals or companies of any third country, whichever is the more favorable treatment, as regards any measures it adopts in relation to such losses.

The Tribunal also held that because Article XI did not determine the precise conditions of its application, rules of customary law (ILC Article 25) had to be applied in a subsidiary manner. The Tribunal therefore concluded that, in light of its earlier rejection of the plea of necessity under ILC Article 25, there was "no need to undertake a further judicial review of Article XI given that this Article [did] not set out conditions different from customary international law in this regard." (paras.364-391)

4. Compensation

The Tribunal considered ILC Article 27, which provides that successful invocation of the necessity defence is "without prejudice [..] to the question of compensation for any material loss caused by the act in question." The Tribunal stated that Article 27 did not "exclude the possibility of an eventual compensation for past events". In confirmation of this interpretation, the Tribunal noted that the 2007 agreements between the Respondent and the Licensees covered the period running from 6 January 2002 until the end of the License and therefore included past damages. (para.394)

IV. Findings on Damages

A. Law Applicable to the Determination of Damages

To award damages, the Tribunal referred to "principles governing compensation under international law" as established in the *Chorzów Factory* case and codified in the ILC Articles on State Responsibility (paras.400-401).

B. Heads of Damages Claimed

The Claimant made the following claims:

- Loss of equity value (US$143.49 million);
- Historical damage concerning the US PPI adjustments (US$9.86 million);
- Unpaid subsidies (US$38.63 million);
- Loss on a loan (US$17.4 million).

C. Approach to Compensation

The Tribunal noted that the Treaty contained rules on compensation for expropriation ("fair market value"). The Tribunal further stated that in cases where a non-expropriatory breach caused "significant disruption to the investment made", it "might be very difficult to distinguish the breach of fair and equitable treatment from indirect expropriation or other forms of taking and it is thus reasonable that the standard of reparation might be the same." (para.403)

The Tribunal referred to the fair market value as "a commonly accepted standard of valuation and compensation"[2] and decided that it would be the most appropriate standard "to establish the value of the losses […] by comparing the fair market value of the companies concerned with and without the measures adopted by Argentina in January 2002." (para.404)

The Tribunal also separately considered and allowed all three remaining heads of damages, although it reduced slightly the amounts claimed (see below).

D. Equity Value Loss

1. Method of establishing the equity value loss

The Respondent's expert proposed an original way of measuring compensation by establishing the present value of future cash flow (through DCF) from 2005 to 2027 under the actual conditions prevailing in Argentina (with pesification), adding this value to the compounded value of historical cash flows from 1992 to 2004, and deducting from the resultant figure the compounded value of the Claimant's investment. This approach effectively suggested that "in so far as the positive cash flows are equal or superior to the negative ones, or to the realized investments, there is no reason to award compensation since the investment is recoverable, even with the effects of the measures adopted by Argentina." (paras.407-410)

The Tribunal decided not to adopt this method ("without contesting its economic validity per se") because the task was not to decide whether the Claimant had been "fairly remunerated in the past". (para.413) Instead, the Tribunal opted for the more conventional approach suggested by the Claimant's expert, namely comparing the DCF values of the CGS and CGP with the impact of the Argentinean measures ("the pesification scenario") and without such impact ("the but-for scenario"). The difference between the two values constituted the main element of loss/compensation (supplemented by discrete heads of damages mentioned above). (paras.411-412)

In addition to parties' experts, the Tribunal was assisted by its own independent expert. (paras.49-50, 399)

2. Date of valuation

In the context of the valuation date, the Tribunal had to address the fact that the Claimant had increased its investment in CGS and CGP in October 2000, *after* the introduction of the first measure by Argentina (suspension of PPI adjustments on 17 August 2000). The Tribunal accepted the Claimant's explanation that at that time, the suspension of the PPI adjustment had been considered "a temporary deferral that would be fully compensated in the short-term" and determined that the investment decision had been made "in good faith".

[2] The Tribunal used the "internationally recognized" definition of the FMV given in the *International Glossary of Business Valuation Terms*.

The Tribunal adopted 31 December 2001 as the proper valuation date (immediately before the Emergency Law, which had had the most serious effect on the equity value) and treated the investments made in October 2000 "as part of the protected equity affected by the complained-of measures". (paras.203-210)

3. The impact of the economic crisis

The Tribunal emphasized on several occasions that despite its reluctance to accept the necessity defence raised by Argentina, it would consider effects of the crisis at the valuation stage:

> While these unfortunate events do not in themselves amount to a legal excuse, neither would it be reasonable for the Claimant to believe it remains wholly unaffected by them. The economic balance of the License was clearly affected by the crisis, and just as it is unreasonable for the licensees to bear the entire burden of such a changed reality, neither would it be reasonable for them to believe that nothing has happened in Argentina since the License was approved. (para.269)

Accounting for the crisis circumstances was "a measure of justice the Tribunal [was] bound to respect". (para.397)

4. Valuation in the but-for scenario

In light of its decision to take account of the crisis circumstances, the Tribunal adjusted a number of factors in the Claimant's "but-for scenario" valuation, which resulted in a lower value. The said factors included:

- The asset base;
- The discount rate;
- The tariff increases that would have been approved;
- The consumption effect.

The Tribunal stated in particular:

> [U]nder the but-for scenario, CGP and CGS would [not] have merrily sailed through the major economic crisis which Argentina suffered and brought home large returns on equity, as if nothing had ever happened. In particular, the Tribunal is of the view that CGP and CGS would have been called upon to shoulder some of the burden of the general economic crisis and might have been faced with the need to reduce some of the increases to which they might otherwise have felt they were entitled to; moreover, and in a significant way under the but-for scenario, gas consumption and tariff rates would have been significantly impacted, with the consequent results on the value of the firm. (para.436)

The Tribunal determined that, under the but-for scenario, the equity value of CGP was US$168,240,220, and that of CGS was US$33,434,238. (The relevant fact-specific findings of the Tribunal can be found at paras.416-450.)

5. Valuation in the pesification scenario

This valuation was performed on the basis of actual conditions that prevailed in Argentina after the valuation date, i.e. taking into account the measures at issue in this dispute. The Tribunal had to correct the analysis offered by the Claimant's expert to take account of the Memoranda of Understanding signed by Argentina with CGS and CGP in 2007.

Respective MOUs provided for a 25% increase in tariff for the transportation and distribution of natural gas and an additional 2% (subject to the implementation of certain investments). These increases were due to come into effect on 1 July 2007 for CGS and on 1 January 2008 for CGP. In addition, the MOUs contained an indexation formula for the future based on a mechanism of monitoring of costs in the Argentinean economy. The MOUs were subject to a number of restrictions and conditions, including the abandonment of all arbitral or judicial claims by the Licensees or their shareholders relating to the pre-2002 regime.

Sempra refused to accede to those MOUs and initiated proceedings against the shareholders of the companies that had approved and signed the MOUs. Despite this, the Tribunal decided that it should take the MOUs into account "in assessing the pesification (or "actual") scenario as it prompts objective consequences for the Licensees and consequently for the interests of the Claimant." The Tribunal therefore accepted the adjustments to the original pesification scenario. (paras.451-459)

The Tribunal estimated, under the pesification scenario, the equity value of CGP at US$21,510,284. CGS was determined to have the negative value of -US$58,030,252 ("in practice 0 for the shareholders and the rest affecting the creditors").

6. Equity value loss

The Tribunal established the equity value loss for 100% of equity of CGP and CGS (by calculating the difference in values under the two scenarios) and then estimated the Claimant's share in this loss (US$54,436,806 for CGP and US$12,965,797 for CGS, a total of US$67,402,603).

E. Other Heads of Damages

1. Loss on the loan

In December 2001, in order to avoid default, Sempra loaned US$56 million to the Licensees. The Claimant argued that this loan should be considered part of the investment and claimed compensation for it. The Tribunal reasoned that a loan qualified as an investment under the broad definition of the Treaty. The Tribunal determined that

in the circumstances, extending this loan had been "a normal business move by the investor in a situation where additional financing was necessary to keep a company out of default. To the extent that the loans were made in connection with a legitimate business purpose, as they in fact were, there is no reason to exclude them from the protected investment." (paras.211-216)

The Tribunal decided, however, that the claim was valid only in relation to CGS (with had negative equity value). According to the Tribunal, as CGP had positive equity value, "its debt will have been reimbursed in full during the duration of the License". The Tribunal calculated that the loss on the loan as a percentage on the negative equity value of CGS, in the fixed of US$15,949,540. (paras.462-466)

2. Historical damage concerning the US PPI adjustments

Since the valuation date was chosen as 31 December 2001, the Tribunal decided that the Claimant was entitled to compensation for the losses incurred due to the suspension of the US PPI adjustments from 17 August 2000 up to the valuation date. The relevant amount was estimated at US$8,652,140. (paras.467-469)

3. Non-payment of subsidies

As mentioned above, in the December 2001 Subsidies Agreement, the amount of subsidies owed through 31 October 2001 was established at approx. AR$108 million. The Tribunal decided that the claim for unpaid subsidies should cover the period finishing on 31 December 2001 only. The Tribunal also held that the subsidies which the Respondent had paid or committed to pay subsequently to that date must also be deducted. (paras.470-474)

Under this head of damages, the issue of **currency** arose. The Respondent argued that the amount owed should be in AR$ and not US$ and that most of that debt had already been repaid. The Claimant recognized that a certain amount had been received but that it was very far from covering the total amount of unpaid subsidies. The difference in the estimates was due to the fact that the Claimant considered that the amount owed by the Respondent should be calculated on the basis of parity between the two currencies in effect at the time the debt was incurred. The Tribunal accepted the Claimant's argument and decided that even though the subsidies were payable in Argentine pesos, they must be compensated in US dollars at the parity exchange value which the peso had in December 2001 "as otherwise the Claimant would be put at great disadvantage". (paras.184, 188, 475-477).

The subsidies were payable to CGS and CGP, not to the Claimant. The Tribunal estimated the amounts owed to CGS and CGP and awarded shares in these amounts corresponding to the Claimant's shares in those companies. The Tribunal added that if the Respondent were not to implement the commitments it made under the Fiduciary Fund[3] (respective amount was deducted from compensation), "such pending payments must be added to the amount awarded by the Tribunal". (paras.478-480)

[3] The Tribunal did not explain in detail the Fiduciary Fund scheme.

F. Total Amount of Compensation

The total amount of compensation (estimated by summing up the four heads of damages awarded) was fixed at US$128,250,462. (para.482)

G. Interest

The Tribunal ordered the Respondent to pay interest on the total amount of compensation, starting on 1 January 2002, at the successive 6-month LIBOR rates, plus a 2% annualized premium or portion thereof, compounded semi-annually. By majority, the Tribunal decided that since the Claimant requested to award interest to the date of Award (a separate request for post-Award interest was made only after the oral hearings), it would not award post-Award interest. (paras.483-486)

V. Implications / Initial Analysis

- A case with **multiple heads of damages**, where the main measure of compensation (difference in the FMV of equity with and without the breaches) was supplemented by three other discrete elements of damage established by the Claimant. This may be contrasted to a case of lawful expropriation where only the fair market value of the investment is recoverable.
- It is interesting to compare the tribunal's mode of compensating for the **loss in equity value** to the awards in similar cases. The *LG&E* Tribunal, to avoid the possibility of over-compensation, refused to award the loss of equity value when this value was not lost completely and equity could still rebound in value. The *CMS* Tribunal addressed this problem by giving the host State an option to buy out the equity at the current price. In the present case, however, this issue was neglected, which may lead to over-compensation if the Claimant's equity in the Argentinean companies rebounds.
- Even though the Tribunal rejected the **method of establishing losses** offered by the Respondent's expert, it did so "without contesting its economic validity per se", and thus the method might be retained in future cases. The idea underlying the method is to see whether the investor has received fair returns on its investment throughout the past and future life of the investment. Under this approach, compensation aims to ensure a fair return on investment, rather than to meet the higher (even though legitimate) expectations of the investor.
- Similarly to *CMS* and *Enron*, the Tribunal took **account of the economic crisis** in the process of the DCF valuation of the investment, thereby reducing the amount of compensation. In particular, the Tribunal had to "project" what the Government would reasonably have done in the crisis circumstances (for example, use the lower asset base, refuse to make the full tariff increases) as well as objective effects of the crisis (for example, reduction in gas consumption).

- Despite the fixed valuation date, the Tribunal also took into account ***ex post* information** (not only the crisis circumstances but also the 2007 agreements concluded by CGS and CGP with Argentina that envisaged tariff indexation). The Tribunal, however, did not take into account the fact that those agreements were conditioned upon the abandonment of all arbitral or judicial claims by the Licensees or their shareholders. Given that Sempra did not abandon its claim, the fate of these agreements is questionable.
- **Currency issue**: currency conversion should be done at the time when the payment is due. Creditor should not bear the risk of currency devaluation if it was not paid on time by reason of debtor's default.
- The Tribunal stated that it will consider the **regulated part** of the Licensees' business separately from the **non-regulated part** (paras.217-219) but, in contrast to *Enron*, it has not expressly done so in the quantum section of the award.
- **Flow of damage** from investment to investor: even though unpaid subsidies were owed to the companies, where the investor held shares, the relevant share of the unpaid subsidies was included in the compensation (loss of the subsidiary equated with the loss of the shareholder). Cf. the opposite treatment of unpaid invoices in *Azurix*.
- If a claimant wishes to obtain **post-Award interest**, it must make sure that such request is included in its submissions.