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[S Ripinsky with K Williams, Damages in International Investment Law \(BIICL, 2008\)](#)*

Case summary

The Government of the State of Kuwait v The American
Independent Oil Company
(‘Kuwait v Aminoil’)

Year of the award: 1982

Forum: *Ad hoc* Arbitral Tribunal

Applicable law: Kuwaiti law, international law

Arbitrators Prof. Paul Reuter – President Prof. Hamed Sultan Sir Gerald Fitzmaurice	Timeline of the dispute 24 March 1982 – arbitral award
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I. Executive Summary

In 1948 Kuwait granted to Aminoil, a US company, a 60-year oil concession. The price for the concession was based on a fixed royalty for every ton of oil recovered. The Concession Agreement contained a stabilization clause that prevented Kuwait from unilaterally annulling or altering the terms of the Agreement.

In 1961 Kuwait and Aminoil supplement the fixed-royalties principle of the Concession Agreement with a 50/50 profit-sharing arrangement. In 1973 the parties agreed on another set of changes to the Concession Agreement further increasing the Government's 'take'. Although the 1973 Draft Agreement was never ratified by the Kuwaiti parliament, in a separate letter the parties agreed to apply the agreement *as if* it was ratified. Subsequently, Kuwait demanded to further increase its 'take' under the 'Abu Dhabi formula' agreed by the OPEC countries. Aminoil did not consent and in 1977 Kuwait nationalized the concession with an envisaged payment of 'fair' compensation.

On the basis of a separate arbitration agreement, Aminoil initiated arbitration proceedings contesting the nationalization as contrary to the stabilization clause. Aminoil also challenged the 1973 agreement and the 'Abu Dhabi formula' and claimed damages of almost US\$ 3 billion (largely lost profits until 2008). Kuwait counterclaimed and requested the sums allegedly owed to it by Aminoil under the 1973 agreement and the 'Abu Dhabi formula'.

The Tribunal found that both 1973 Draft Agreement and 'Abu Dhabi formula' were valid and applicable to Aminoil's concession. The Tribunal further determined that the nationalization was lawful and did not violate the stabilization clause, as the latter prevented only 'confiscatory nationalizations'. The Tribunal held that in accordance with the 1962 UN Resolution, Aminoil was entitled to 'appropriate compensation'. The latter was calculated by the Tribunal on the basis of Aminoil's assets valued using their replacement cost (the net book value method was rejected as inadequate) and Aminoil's value as a going concern estimated on the basis of Aminoil's legitimate expectations of a reasonable rate of return. The resulting amount was decreased by Aminoil's debt to Kuwait, leaving US\$ 83 million in compensation. This amount was adjusted to account for inflation; compound interest was awarded.

II. Factual Background and Claims of the Investor

In 1948, the Sheikh of Kuwait granted to Aminoil, a US company, a 60-year concession for the exploration and exploitation of oil and gas in a designated territory in Kuwait. The price for the concession included a down-payment plus a fixed royalty of US\$ 2.50 for every ton of oil recovered subject to a minimum annual royalty of US\$ 625,000. The Concession Agreement contained a stabilization clause that prevented the Sheikh from unilaterally annulling or altering the terms of the Agreement. In 1954 Aminoil began commercial production and exportation of petroleum products.

Following the developments in the neighbouring Middle East countries, in 1961 Kuwait and Aminoil agreed to modify the Concession Agreement and supplement the fixed-royalties principle with a 50/50 arrangement, according to which Aminoil had to share half of its profits with the Government. After the declaration of Kuwait's independence in early 1960-s, the Aminoil concession continued. However, in 1973 the final set of revisions to the Concession Agreement was agreed; they were designed to take account of changes in the global oil market and envisaged, among other things, an increase of the payments due from Aminoil, in compliance with OPEC-led agreements aimed at increasing the 'take' of the producer governments in oil business.

The 1973 Draft Agreement between Kuwait and Aminoil was subject to ratification by the Kuwaiti parliament, but this never occurred. However, in December 1973 Kuwait's Minister of Finance and Aminoil signed a letter, in which the company agreed to make payments *as if* the 1973 Draft Agreement was effective. In the arbitration, however, Aminoil questioned the validity and effect of the Draft Agreement and of the letter.

Continued OPEC-driven transfer of power away from oil companies to the producing governments led to the adoption of the 'Abu Dhabi formula'. Following the dramatic increase of oil prices in 1973, the OPEC took a decision to introduce the agreement reached by the producing governments in Abu Dhabi, which further increased the average government 'take' from operating oil companies. Kuwait and Aminoil failed to reach compromise on this issue and on 19 September 1977, by Decree Law No.124, Kuwait enacted that Aminoil's concession should be terminated; that Aminoil's assets in Kuwait should revert to the State; and that 'fair' compensation should be paid to Aminoil.

Subsequently, the parties concluded a separate Arbitration Agreement, whereby the disputes between the parties had to be resolved 'on the basis of law' by an *ad hoc* tribunal of three members. Both parties presented their claims to the Tribunal:

- The Government's main claims included approximately US\$ 140 million under the financial provision of the 1973 Draft Agreement, under the 'Abu Dhabi formula' and in respect of liabilities of the company assumed by the Government after the nationalization.
- Aminoil's main claims included the repayment of US\$ 423 million paid under the 1973 Draft Agreement, which the company now said should *not* have been paid because the agreement was ineffective, as well as lost profits calculated until the natural termination of the concession, in the amount of US\$ 2,587 million. (para.xix)

III. Findings on Merits¹

¹ Decision on the merits was taken by the majority of the Tribunal, with one arbitrator, Sir Gerald Fitzmaurice, dissenting. The dissent, however, did not extend to the Tribunal's findings on compensation.

A. Applicable law

On the basis of the Arbitration Agreement, the Tribunal determined that it should apply both Kuwaiti law, as the law most directly involved, and public international law, which formed a constituent part of Kuwaiti law. The Tribunal did not expand on the relationship between Kuwaiti law and international law but held that in this case they were not in conflict with each other. (paras.6-10)

B. Validity of the 1973 Agreement and the ‘Abu Dhabi’ Formula

The Tribunal found that both 1973 Draft Agreement and ‘Abu Dhabi formula’ were valid and applicable to Aminoil’s concession. Thus, the Tribunal concluded that Aminoil owed to Kuwait what was due under these instruments. (paras.15-79)

C. Nationalization

The crucial issue in the arbitration was whether or not Decree Law No.124 of 1977 was a valid act of nationalization. The question of validity turned on the ‘stabilization clause’ of the Concession Agreement which prevented the Sheikh from unilaterally modifying or annulling the concession, apart from certain grounds laid down in the agreement.

The majority of the Tribunal refused to read the ‘stabilization clause’ as an outright prohibition of nationalization that would cover the whole period of concession. It found that due to the changed circumstances and Kuwait’s development as an independent State, it enjoyed ‘special advantages’ in the contractual equilibrium. According to the Tribunal, the given stabilization clause no longer possessed its ‘former absolute character’; rather, the clause impliedly prohibited nationalizations of ‘confiscatory character’, that is, without ‘proper indemnification’, but did not rule out nationalization *per se*. Therefore, the majority of the Tribunal held that the nationalization was lawful provided that it did not possess any confiscatory character. (paras.88-102)

IV. Findings on Damages

A. Law Applicable to the Determination of Damages

As far as the determination of compensation was concerned, the Tribunal applied ‘principally international law’. (para.142)

B. Standard of Compensation

To determine the standard of compensation for a lawful nationalization, the Tribunal referred to the UN General Assembly Resolution 1803 (XVII) of 14 December 1962 (adopted unanimously). This Resolution provided that in cases of nationalization, ‘the owner shall be paid appropriate compensation’.

The Tribunal noted two tendencies (in approaches of different States) – one of which seeks to ‘reduce compensation almost to the status of a symbol’, and the other ‘assimilates the compensation due for a legitimate take-over to that due in respect of illegitimate one’. (para.143)

The Tribunal did not attempt to determine the general principles underlying the notion of ‘appropriate compensation’ but stated instead that an award of ‘appropriate’ compensation ‘is better carried out by means of an enquiry into all the circumstances relevant to the particular concrete case’. (para.144) At the same time, to arrive at the appropriate compensation the Tribunal used certain concepts that may be generally applicable (see the following section).

The Tribunal also noted that there was ‘no room for rules of compensation that would make nonsense of foreign investment’ (para.146). The Tribunal also interpreted the stabilization clause as prohibiting any measures of confiscatory character. (para.159) In other words, the Tribunal rejected the first of the two tendencies mentioned above.

C. Basis to Reach the ‘Appropriate Compensation’

The Tribunal based its approach on the concept of ‘legitimate expectations’. This concept was derived by the Tribunal from a premise that every long-term contract involves economic calculations, and the weighing-up of rights and obligations, of chances and risks, constituting the contractual equilibrium. ‘It is in this fundamental equilibrium that the very essence of the contract consists’. (para.148)

The said contractual equilibrium gives rise to the legitimate expectations of the parties. To assess both the equilibrium and the expectations, one should look at the original text of the contract, as well as at the amendments, the interpretations, and the behaviour manifested along the course of its existence. (para.149)

The Tribunal found indications – in the Concession Agreement and in the ‘attitude of Aminoil’ – that Aminoil’s ‘aim was to obtain a “reasonable rate of return” and not speculative profits’ (‘a moderate estimate of profits’). The Tribunal determined that this was Aminoil’s expectation; in light of this expectation the appropriate compensation had to be assessed. (paras.159-160)²

² Elsewhere in the Award (when discussing Aminoil’s debts to Kuwait), the Tribunal mentioned that a ‘balanced appraisal’ led it to fix US\$ 10 million as a reasonable rate of return for Aminoil. (para.176(2))

D. Date for Establishing the Value

The compensation was established as at 19 September 1977 – the date of the nationalization decree. Relevant values were then adjusted to the date of the Award.

E. Evidence

The Tribunal requested the parties to produce a joint report on questions of quantum and parties did so. The Tribunal used the relevant Joint Report as a main source for its calculations. Where there were differences between experts of the parties, the Tribunal took ‘the mean of the two totals indicated’.³

The Tribunal also noted that in respect of certain factors, it did not possess any data ‘numerically worked out’. The Tribunal said to have taken each of these factors into account ‘within the global conspectus of a balanced indemnification.’ The Tribunal did not name those factors, nor did it show how it dealt with them.

F. Heads of Damages and Valuation

1. Claims and arguments of the parties

Aminoil put forward two methods of calculating its loss, both including future profits:

- 1) The first method was to project expected profits forwards, to the natural termination of the concession, and then bring to the present value by means of discounting.⁴ On this basis, the claim was over US\$ 2.5 billion plus interest. This claim did not include the value of Aminoil’s fixed assets, as under the Concession Agreement these were to revert to the Government free of charge at the natural termination of the concession.
- 2) The alternative method was based on a premise that the Tribunal might only allow its claim for loss of profits for a limited period, rather than for a period until the natural termination of the concession. This claim included a sum in respect of lost profits and a sum representing the depreciated replacement value of the fixed assets at the end of this period. (Aminoil furnished examples of results calculated over ten year periods). (para.152)

Kuwait contested these methods and argued that compensation should be limited to the ‘net book value’ of Aminoil’s fixed assets that could be ascertained from the company’s books of accounts. Kuwait maintained that in the course of nationalizations of oil concessions that had occurred in the Middle East in the 1970-s, this method had acquired ‘an international and customary character, specific to the oil industry’, generating a customary rule valid for the oil industry – *lex petroli*. (para.155)

³ The ‘mean’ is simple average.

⁴ The projection of profits was based on the following elements: (a) the annual volumes of crude oil to be produced and refined products to be manufactured and sold; (b) the prices at which Aminoil’s sales would have been made; (c) the operating and capital expenditures which Aminoil would have incurred; and (d) the tax and other payments which Aminoil would have made to the Government. See R. Young and W.L. Owen, “Valuation Aspects of the Aminoil Award”, *The Valuation of Nationalized Property in International Law*, Richard B. Lillich ed., Vol. IV (1987), pp.15-16.

2. Tribunal's response to the arguments of the parties

The Tribunal stated that both methods suggested by Aminoil were acceptable in principle but disagreed with Aminoil's assumptions and calculations. The latter were based on the contractual conditions fixed in 1961, whereas in light of the Tribunal's earlier findings, they should have been done with reference to the 1973 Agreement and the 'Abu Dhabi formula' (those provided for a larger Government 'take'). The Tribunal also stated that Aminoil's projection had not been based on the 'reasonable rate of return' – a concept adopted by the parties in the course of their relations and negotiations.

The Tribunal rejected the 'net book value' method proposed by Kuwait as an expression of *lex petroli*, on the grounds that:

- The precedents of compensation for nationalization, to which Kuwait referred, were reached through negotiations rather than arbitrations. A result of such negotiations had usually been a complex deal between an investor and a State, which involved, in addition to compensation for a nationalized concession, a preferential relationship, prospects for future advantages or other arrangements suitable to the investor.
- The said precedents had not constituted an expression of *opinio iuris* and therefore could not be viewed as rules of international law.
- Consents of investors had been given under the pressure of very strong economic and political constraints and could not constitute general rules applicable in other cases. (paras.156-157)

3. Heads of damages accepted by the Tribunal

The Tribunal decided that it would be 'just and reasonable to take some measure of account of all the elements of the undertaking.' The Tribunal singled out two such elements, which were appraised separately and then summed up:

- 1) the value of the undertaking itself, as a source of profit (later also referred as a 'going concern');
- 2) the value of the totality of assets. (para.164)

4. Valuation of physical assets

The Tribunal noted that it was impossible to postulate 'any absolute rule' on the valuation of assets but suggested that 'only values for accounting or taxation purposes' could be utilized. The value of assets had to be established on the date of transfer and to take due account of the depreciation they have undergone. (para.165)

The Tribunal held that the '**net book value**' would be suitable only in cases of recent investment, where the original cost of assets was not far from the present replacement cost. In other cases, taking account the pace of inflation and the fact the books of accounts always reflected the original (historical) cost of assets, the Tribunal held that

‘it would be unfair’ to calculate the value of depreciating assets ‘on the basis of a superannuated cost consisting of the original purchase price, when that price has no relation to the actual present cost.’ (para.166) The Tribunal said that the ‘net book value merely gives a formal accounting figure which, in the present case, cannot be considered adequate.’ (para.178(2))

For this reason, the Tribunal considered appropriate a **depreciated replacement value**. On this basis, **fixed** assets were evaluated. For non-fixed assets, the Tribunal relied on the figures in the Joint Report, without explanation of the valuation method used. (para.178(3))

5. Valuation of the undertaking as going concern

The Tribunal did not separately quantify (at least in the Award) an amount of compensation for the undertaking as a going concern (‘a unified whole the value of which is greater than that of its component parts’) but stated that it had taken account of the legitimate expectations of the owners, the profits having been restricted to the reasonable level. (para.178(1)) The Tribunal did not specify the number of years it used to calculate Aminoil’s return.

6. Calculation

To calculate the overall amount of compensation, the Tribunal summed up the values of the fixed and non-fixed assets and took account of the legitimate expectations of the concessionaire, with the resulting figure at 19 September 1977 being US\$ 206,041,000. The Tribunal did not show how it reached that figure; no indication was given as to how the total sum had been allocated between the assets and the lost profits.

The Tribunal further deducted from that figure the amount that it had found Aminoil owed to Kuwait (on Kuwait’s counterclaims). After the deduction, the sum of compensation decreased to US\$ 83 million.

G. Inflation Adjustment

To determine what compensation was due at the time of the Award (1982), the Tribunal adjusted the amount of compensation to account for inflation. The rate of inflation was fixed by the Tribunal at 10%, determined by reference to the price of refined petroleum products on the American market. (paras. 171, 178(5))

H. Interest

The Tribunal also awarded a ‘reasonable rate of interest’ determined at 7.5% (without explanation), compounded annually. (para.178(5))

V. Implications / Initial Analysis

- According to the Tribunal, the ‘**appropriate compensation**’ consists of an element for the value of the assets taken and an element for the loss of legitimate expectations’ on the part of the investor. In other words, the compensation was determined on the basis of *damnum emergens* and *lucrum cessans*.
- To make an award of **lost profits**, the Tribunal used a fairly unusual (in the damages context) concept of ‘**legitimate expectations**’ as a basis of its approach. The Tribunal derived legitimate expectations from contractual equilibrium.
- The Tribunal stated that any **valuation method** that is based on future projections will include **speculative elements**. (para.154(b))
- From the reasoning of the Tribunal, it appears that a ‘**reasonable rate of return**’ (‘moderate estimate of profits’) should not be generally applicable as a legitimate expectation of an investor; this expectation can be different in every particular case and should be derived from evidence. In this case, the Tribunal essentially used the concept of ‘legitimate expectations’ of a ‘reasonable rate of return’ to diminish an award of lost profits (basically, it set a maximum annual profit for an investor).
- The Tribunal used terms such as ‘just’, ‘reasonable’, ‘fair/unfair’ in its award of damages. This shows that international law applicable to determination of compensation involves an ‘**equitable**’ element.
- The Tribunal clarified the issue of **valuation of physical assets**. Although it refused to establish any absolute rule on this matter, it would seem that any valuation of assets should be assessed:
 - On the basis of the actual cost of assets (rather than original purchase price, unless the two stand close to each other);
 - On the date of transfer of assets;
 - Taking account of depreciation;
 - Adjusted to account for inflation up to the date of the Award.
- **Net book value** (which is based on historical cost) would be an appropriate method of valuation only if the impact of inflation on the price of assets has been negligible due to low inflation or a short period of time between the acquisition of the assets and their expropriation (which may be another way of saying where net book value will not be greatly different from the depreciated replacement value). In other cases, **replacement value** would be an appropriate method of valuation of assets.
- **Net book value** is different from **residual asset value**. The latter is based on the original cost and reflects actual physical depreciation, whereas the former, while also based on the original cost, reflects depreciation at the rate accepted for book and tax purposes. **Net book value** is an accounting concept rather than a correct measure of true value.⁵
- The Tribunal did not look at the amount of **actual investments** (aside from the assets) made by Aminoil over the life of the concession or the extent to which it had recovered its original capital investments.

⁵ R. Young and W.L. Owen, “Valuation Aspects of the Aminoil Award”, *The Valuation of Nationalized Property in International Law*, Richard B. Lillich ed., Vol. IV (1987), pp.12-13.

- This is probably the only case where parties submitted a **joint report** on the matters of quantum of damages. It seemed to have simplified the task of the Tribunal. Where the parties' experts could not agree on figures, the Tribunal simply took an average between the two figures. In other words, this is an example of overt application of the '**splitting the baby**' approach.
- The Tribunal did not indicate how it arrived at the final figure. Some commentators suggested that the final figure was quite possibly the result of discussion of the conference room which did not turn solely on arithmetic. Certain vagueness may have been the price of unanimity.⁶

VI. List of Commentaries to the Case

M. Hunter and A. Sinclair, "Aminoil revisited: Reflections on a Story of Changing Circumstances" in T. Weiler (ed.), *International Investment Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law* (Cameron May, 2005), pp. 347-381.

F. Mann, "The Aminoil Arbitration" (1983) 54 *BYIL* 213.

G. Marston, "The Aminoil Arbitration" (1983) 18 *JWTL* 177.

P Norton, "A Law of the Future or the Law of the Past? Modern Tribunals and the International Law of Expropriation" (1991) 85 *AJIL* 474.

A. Redfern, "The Arbitration between the Government of Kuwait and Aminoil" (1984) 55 *BYIL* 65.

F. Tésou, "State Contracts and Oil Expropriations: The Aminoil-Kuwait Arbitration" (1984) 24 *Va J Intl Law* 323.

R. Young and W.L. Owen, "Valuation Aspects of the Aminoil Award", *The Valuation of Nationalized Property in International Law*, Richard B. Lillich ed., Vol. IV (1987), pp.3-30.

⁶ *Ibid.*, p.29.