Use of Economics in International Arbitrations

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When one talks with practitioners about the use of economics in the context of International Arbitrations, the conversation basically focuses on damages determination and what methodologies to use to determine amount of harm. Very often the discussion becomes dry and both sides end up being frustrated. No doubt discussions around discount rates or valuation methodologies, for instance, could become a dry topic between two different professionals if the discussion is not kept within the context of the issue at hand – the claim. However, experts and counsels have forgotten that there is always an economic rationale behind any claim and methodological calculation. This rationale can be used to make a claim or counterclaim more robust. The use of economics in international arbitrations is not limited to damages. Economics is key to formulate a strong case before a tribunal either in commercial or investment state settings.

To grasp this idea in the context of international arbitrations either at the commercial or the investment-state level, one needs to go back to the basic instrument behind any commercial relationship – the contract.

Business and investment contracts are legal documents and at their core they represent a codification of a commercial relationship between parties. Since a contract is a legal memorialization of a financial/economic arrangement, economic principles underpin those relationships. So contracts are economic documents and are a key factor that allow market economies to work and do so efficiently. This means that contracts:

> i) allow parties to rely on each other to abide by the terms and conditions as agreed in the contract;
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> ii) are paramount instruments that facilitate large and long-lived infrastructure projects because once an investment is committed, the investor is at risk for a substantial, long term and immobile investment and the other party for the reliability of the investors;
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> iii) are an economically efficient way to allocate a given set of risks, rewards and obligations when negotiated freely since the terms and conditions have been captured in a voluntary and mutually beneficial agreement. If that balance is upset, either because one of the parties sees an opportunity to maximize its gain or there is an event that disrupts the anticipated gain for one or

both parties, then economic efficiency is lost.

Since economic principles underlie the contracting structure in either the basic agreement or any further amendments, the use of economics to interpret contracts is indispensable. Such economic interpretation must reflect the commercial and economic objectives and expectations of the parties when the contract was signed. In the context of international disputes, this means to analyze whether a claim, for instance, of contract breach or infeasibility is inconsistent with the initial commercial and economic principles explicitly or effectively agreed to by the parties. In addition, it means checking whether the balance of risks and rewards inherent in the contract has been maintained or has been altered, and the economic repercussions of any possible modification by the arbitrators.

So, economics is a fundamental input for counsel because it helps not only to determine damages, but also to understand and assess the principles surrounding a commercial relationship. By using economics as a tool, practitioners can formulate a well-structured case from the beginning; not limiting themselves to the breach of legal clauses but more importantly assessing the state of a commercial relationship and how it has been affected by an event or how it might be altered by an award.

The following war stories illustrate how the use of economics in the context of international arbitrations complements and supports the legal analysis and informs tribunals. I was a consulting expert in those cases.

The first story refers to a request for contract modification. Claimant's integrated gas/electricity project consisted of the monetization of fuel reserves by generating and transmitting the commodity to a market. Claimant argued that due to changes in market conditions of its commodity, contract royalties should be reduced. It also claimed that it was not treated fairly and that one of its integrated activates had been harmed due to paying high royalties.

The economic and commercial analysis undertaken brought to light several key facts:

i) the failure to link a contract modification request with the plain language terms in the contract;

ii) the development of unsupported market arguments to justify the renegotiation of the contract that were not in line with the reference markets agreed initially by the parties;

iii) the likely unbalancing of the risks and rewards established in the contract since the counterparty was not receiving any benefits from the proposed contract changes;

iv) the development of unfairness arguments that were not a precondition for contract reform; and

v) the flawed argument of contract infeasibility. Essentially, economic analysis showed that the claim had no valid basis and that any contract modification should only be based on the terms of the contract as agreed by both parties since there was no economic support for contract infeasibility.

The second story refers to a power distribution concessionaire in the South Asian market. Claimant argued that a “comfort letter” committed the international investor to fund power costs owed to an energy supplier. The economic analysis undertaken in this case showed several facts:

i) the misunderstanding and misapplication by government authorities of the fundamentals of a power sector reform, e.g. economic efficiency, competition, attraction of private investment and the opportunity to earn an adequate return, etc.;

ii) the failure of the government and regulatory agency to comply with its obligations, e.g. collection enforcement, payment of due bills, power theft reduction, etc.; and

iii) the misrepresentation that funding operating losses through equity contributions was a common business practice when the holding company had been structured to shield itself from those practices. Effectively, by using economic principles of utility regulation and market restructuring, it was noted to the tribunal that the claim was baseless and that failure to comply with economic fundamentals and basic utility regulation principles had financially encumbered the investor.

Finally, the third story is a commercial arbitration case that involved the purchase of a power and desalinization plant. The claim referred to a breach of warranties when the plant became nonoperational after the asset was acquired. Economic analysis was used in the case to:

i) assess historical and projected future financial information;

ii) determine damages based on lost profits and direct cost approaches;

iii) assess damages based on reading of the case facts; and

iv) assess the indirect effects of lost revenue and long plant shutdowns such as the ability to make further investment, and the negative impact on commercial relationships with 3rd parties and off-takers. Again, by using economic principles the tribunal was informed about the economic and commercial implications that a breach of warranties had brought upon the investors and the need for compensation for the harm caused.

As the war stories above illustrate, economic analysis is a very important and valuable tool in the context of international disputes. It helps in understanding the underlying principles of a commercial relationship and assesses whether the allocation of responsibilities and rewards that originally was agreed by the parties has been affected. It also helps to determine alternatives to rebalance a contract if such a balance has been altered.

The use of economic principles in the context of commercial or investment-state arbitrations is not different as one can infer from the examples above. The principles are the same. The difference basically just relies on the applicable legal framework and the specific heads of claim. The expert and counsel need to work together to develop robust arguments within the applicable law to make stronger cases.

Finally, as the case stories show, economic analysis is a tool that not only informs tribunals, but also allows them to become aware of the tradeoffs between the economic benefits of providing relief via contact modification with the economic harm from disturbing the allocation of rights and obligations agreed by the parties in a contract.