Fear of the unknown – overcoming resistance to ‘new’ damages models

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After the adoption of a "novel" damages model caused controversy in the *Tethyan v Pakistan* case, a panel at GAR Live Advanced Damages Workshop explored how best to make a tribunal comfortable with lesser-known models and asked whether labels such as "modern" might be counterproductive.

Ronnie Barnes, an expert witness and head of international arbitration at Cornerstone Research, presented on “modern discounted cash-flow analysis” – the valuation method that led to a challenge by Pakistan to Bulgarian arbitrator **Stanimir Alexandrov**.

Modern DCF captured broader attention when, as reported in GAR, the state unsuccessfully applied in July 2017 to disqualify Alexandrov from the ICSID panel hearing its dispute with Tethyan Copper Company - among other things because the “rare valuation method” the claimant had proposed was also at issue in another case in which he was acting as counsel.

The ICSID tribunal hearing that case issued a final award in July, ordering Pakistan to pay just over US$4 billion in damages to Tethyan Copper Company, plus US$1.7 billion in pre-award interest.

Barnes explained to delegates what modern discounted cash-flow, or “modern DCF”, actually is and how it differs from the “traditional DCF” methodology more commonly seen in international arbitrations.

Traditional DCF is implemented by determining expected cash flows at each future point in time, and then discounting these at a discount rate that properly accounts for: (i) the time value of money and (ii) the systematic risk that is inherent in future cash flows.

Barnes said that in certain cases, that approach may be “overly simplistic” – as it assumes that risk accumulates at a constant rate over time and that all cash flow components (revenues, variable costs, fixed costs) should be discounted at the same rate.

As he has previously argued in an article for GAR, Barnes says that there are two key points to make about modern DCF. Firstly it is not “modern” at all, but is in fact an accumulation of ideas that had been around in corporate finance literature for a number of years.

Secondly, it is not an alternative method to traditional DCF – it is an alternative means of implementing DCF under certain circumstances, such as when risk or uncertainty in the cash-flow stream that is being valued arises from an exposure to the price of a traded commodity.

Another key feature of modern DCF is "real options analysis" which accounts for the optionality embedded in many managerial decisions, for example the ability to reduce production when output prices fall. This approach is particularly advantageous in situations where the evolution of a project is highly path-dependent, as is the case in oil and gas or in the pharmaceutical industry, and often requires the use of simulation models.

Having explained the background to the methodology, Barnes had two key questions: 1) was the tribunal right to adopt the modern DCF methodology in the *Tethyan* case? And 2) what are the challenges around using valuation techniques that, while commonly used in the financial world, break new ground in arbitrations?

Approaching novelty

Debevoise & Plimpton partner **Samantha Rowe**, whose firm had represented Tethyan in the ICSID arbitration, said that the case was a great example of how you could give comfort to a tribunal that a new methodology is a reliable basis for awarding damages.

Although there had been a "confluence of factors" that gave the tribunal the confidence to adopt modern DCF, Rowe felt that one of the key factors had been the use of that methodology by buyers in the mining industry to assess the value of similar assets.

In particular, the tribunal had been persuaded by an opinion issued by the Special Committee of the Canadian Institute of Mining, Metallurgy and Petroleum on Valuation of Mineral Properties, which the panel found reflected "international best practices".

She also noted that the fact that modern DCF had not yet been adopted in an ISDS case was not a "death knell" for the tribunal. She said the same had been true of traditional DCF, which had been used to value investments for decades before an investment tribunal adopted it and felt comfortable using it to assess damages.

From the perspective of the tribunal when faced with a new methodology, independent arbitrator **Lucy Greenwood** said it was important to remember in the face of a lot of science that "awarding damages is a real art".

Tribunals should always go back to the fundamental principle that in awarding damages they are seeking to compensate a claimant, but not penalise a respondent, for the wrongful act, she said.

Ultimately Greenwood said the ideal methodology is one that most accurately generates a sum that best reflects those fundamental principles.

Valuation specialist **Travis Taylor** of Versant Partners said that he had in a recent case used a methodology not dissimilar to modern DCF, that had pushed the risk into the cash flows by delaying monetisation of tax losses by three years and then discounting at the risk-free rate. That result was then compared to non-delayed monetisation using a traditional DCF approach.

Taylor said he had "certainly veered away" from describing that adjustment as anything like modern DCF but said he could see the tribunal "mulling it over and becoming more comfortable with it".

Asked about his approach to modern DCF, **Iain McKenny** of third-party funder Profile Investment said that his company's quantum department relies on a multitude of different valuation techniques to provide greater clarity than any one method; and an overreliance on singular "optimistic" models by third-party funding applicants did not provide sufficient clarity.

Bad labelling?

There was an intervention from the floor by **Richard Caldwell** of the Brattle Group – the expert firm that provided the modern DCF methodology in the *Tethyan* case.

He reiterated that the circumstances of the *Tethyan* case had meant that modern DCF was the most appropriate damages model. Explicit consideration of different risk factors such as country risk was necessary because traditional approaches would not work well. Caldwell also observed that the explicit valuation of management options within modern DCF would generate a different damages result from traditional DCF.

Barnes said to Caldwell that if he picked up a corporate finance textbook and looked for "modern DCF "in the index, he would not find it - despite how prevalent the underlying methodology is in the financial world. Did he think that the use of an "idiosyncratic" label led Pakistan to think that the model should be challenged?

Caldwell said he could not comment on where the label for modern DCF came from but agreed with Barnes' earlier remarks that "certainty equivalents" has been used by the Brattle Group for a long time.

"I agree that the name may have given rise to some fear in *Tethyan*, but it is also a standard method that has been around for a long time".

Summing up, the session's co-chair **Alexander Demuth** of Alvarez & Marsal said that modern DCF was in fact not modern as it used long-established economic principles.

"Nonetheless, using it requires thorough analysis and presentations to the tribunal in order to provide comfort," he said.

GAR Live Advanced Damages Workshop was held at Pinsent Masons' London offices on November 8. Co-chaired by Demuth and WilmerHale partner John Tremor, the conference was supported by Cornerstone Research, Nera Economic Consulting, Profile Investment, Versant Partners, Erdem & Erdem Law Office and Arbitration Ireland.

A speaker's dinner was held the previous day, which was sponsored by Alvarez & Marsal.