Dispute perspectives
Bridging the gap between experts
Bridging the gap

When the claimant’s expert values a business at US$1 billion, the respondent’s expert arrives at $195 million and the Tribunal at $487 million, you’d be forgiven for wondering how on earth the same claim is potentially worth such wildly different amounts. You might also wonder how Tribunals manage to determine the “right” value, given the gap between the experts’ opinions. Do they just give up and “split the baby”?

What drives such wide differences in value? Are experts taking extreme positions on the same issues to support their clients? In most cases that’s not true and misunderstands what may have driven the experts to different conclusions.

Our analysis of nearly 100 Tribunal awards over a 25 year period identifies some good explanations for these wide differences. In this article we consider some of the key drivers of the gap and what can be done to bring experts closer together.

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1 OIEG v Venezuela (ICSID case ARB/11/25) award dated March 2015 ("OIEG v Venezuela") paragraphs 668 and 820, being the values for 100% of the business.

2 As explained in our original article (http://bit.ly/IAdamages) these awards primarily relate to investment treaty arbitration.
What is driving the gap?

If you ask a different question, you’ll get a different answer

Perhaps the most common explanation for difference is that experts are instructed to value damages on different bases. This is commonly driven by the underlying legal basis of the claim. If your claim is that your asset was illegally expropriated, you ask your expert to value it on that basis, not on the basis that it was legally acquired. We consider the impact of these different approaches in detail in another article but suffice it to say, lawful vs unlawful expropriations can drive very different damages calculations.

Another driver of difference is that experts are asked to produce valuations on a different date or using a different fact pattern. Experts often need to rely on inputs which may be hotly disputed by the parties. Different instructions and assumed fact patterns naturally lead to different outcomes.

In Occidental Petroleum v Ecuador, the claimant and respondent provided separate expert evidence on the volume of oil reserves in a certain holding. The Tribunal noted this was “the most significant component in the application of the DCF model™ and, unsurprisingly, incorporation of these figures into the quantum experts’ reports immediately produced divergent valuations which had nothing to do with a difference of opinion between them.

Even science needs judgement

Valuation may involve scientific techniques but it also requires the exercise of judgement as to which techniques to apply and exactly how to apply them. An expert will often use a number of different valuation methodologies and reflect on the potentially different results shown before coming to a conclusion. Two experts may quite legitimately disagree as to which is the most appropriate method in particular circumstances. For example, one expert might adopt an historical cost approach, which values an investment as the sum of all the money historically invested. The other party’s expert may take the view that the right measure is not what was invested but what the returns should have been and value loss using discounted cash flow (DCF) or market based techniques.

In 36 cases where the claimant proposed either an DCF/market based approach (30 cases) or an asset value/historical cost approach (6 cases) the respondent agreed with the claimant’s methodology in 16 cases.

As the graph above shows, respondents were significantly less likely to agree with a proposed DCF or market based approach (accepted in 37% of cases in which it was proposed by claimants) than with an historical cost or asset based valuation (accepted in 83% of cases in which it was proposed by claimants). There were nine cases where the parties agreed that DCF was an appropriate methodology. While that sounds promising, in four of those cases, the respondent found DCF produced a zero value and in the remaining five, arrived at a value that was, on average, 14% of the value ascribed by the claimant. Clearly, methodology is not the only driver of difference.

We will cover the reasons why Tribunals reject DCF methodologies in a future article but the end result is that in these cases an historical cost approach was preferred.

<table>
<thead>
<tr>
<th>Methodology</th>
<th>Accepted by Respondent</th>
</tr>
</thead>
<tbody>
<tr>
<td>DCF/market approach</td>
<td>37%</td>
</tr>
<tr>
<td>Asset value/historic cost</td>
<td>83%</td>
</tr>
</tbody>
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Of these however, Tribunals rejected the DCF methodology in some 40%.

Our research shows that the DCF methodology was proposed as a primary valuation methodology in 55 of 95 cases.

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4. Occidental Petroleum v Ecuador, paragraph 718.
5. In some cases, although an award gives the respondent’s valuation, it does not provide details of the methodology adopted.
Apart from that you agree, right?
So if the methodology is the same, and the instructions the same, do you get the same answer? Not necessarily – a key driver of difference is often that there can be genuine differences of opinion between experts.

As a rule of thumb, the more assumptions required, the smaller the chance that two experts will agree. DCF models are normally complex and involve a wide range of assumptions and inputs – a change to one element can produce a significant change in the value of the business. The use of estimates is an inherent feature of accounting, nowhere more so than when building counterfactual models. Tribunals have recognised this in past awards: “The word “estimates” is quite appropriate in trying to establish value loss in a case involving a license valid until 2027.”

In the case of OIEG v Venezuela, the claimant’s expert used a weighted average of the damages calculated through different methodologies – DCF, comparison with similar listed companies and prices paid for similar businesses (all of which were within a reasonably narrow range). The respondent’s expert used DCF with two other methods as a cross check. However, they reached widely different results.

So, why were the numbers so different? Firstly, the experts adopted different assumptions in some key respects – the cost of goods sold, how sales prices might change, the amount of capital investment and whether or not to include exports in the calculation. The claimant’s expert’s projected value of future cash flows was higher than that of the respondent.

No less important was that they proposed different discount rates – a difference of over 5% that drove a large part of the difference in value assessment. While the experts agreed on the use of the Capital Asset Pricing Model (CAPM) and of a weighted average cost of capital (WACC), their differing view on the many inputs into the calculation of the discount rate resulted in a big gap. Even after the Tribunal had indicated the correct inputs to the calculation, this difference in discount rates alone resulted in a $350m gap between the experts’ valuations.

Assessment of a discount rate is complex and, more often than not, contentious. We’ll look in more detail at the elements of the calculation of discount rates calculation and why differences arise in a later article.

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6 CMS Gas Transmission Company v The Argentina Republic, award dated May 2005, paragraph 419.
7 OIEG v Venezuela award, paragraphs 654 to 656.
8 OIEG v Venezuela award, paragraph 669 et seq.
9 OIEG v Venezuela award, paragraph 762 et seq.
10 OIEG v Venezuela award, paragraph 818.
How can we bridge the gap?

**Divergent opinions are still valuable**

The good news is that even where experts’ valuations differ significantly, Tribunals can find the experts’ analysis useful in reaching an award. For example, in OIEG v Venezuela, the Tribunal produced its own DCF calculation using inputs from both parties’ experts’ reports.

Perhaps inevitably this resulted in the Tribunal’s valuation being between the amounts originally proposed by the two experts. Was this splitting the baby? Far from it. The Tribunal provided a carefully reasoned analysis of its decisions on each area of disagreement, devoting four pages of the award to considering the appropriate methodology, sixteen pages to the input assumptions and ten pages to the discount rate.

**Narrowing the gap**

We’ve seen that there are reasonable explanations for significant differences in the valuation of claims. While difference is perhaps inevitable when parties see the world through different lenses, there are things which could narrow the gap and make the Tribunals’ job easier:

1. Bifurcating trials;
2. Setting the same exam question;
3. Joint meetings/statements;
4. Witness conferencing; and
5. Tribunal appointed experts.

**Bifurcating trials**

Splitting trials to consider liability and quantum separately is really a question for the legal profession and beyond the scope of this article. We note simply that while there are pros and cons, deciding on liability issues first does often reduce the scope of disagreement on quantum issues.

**Set the same “exam question”**

Ideally, parties would agree to ask the experts to answer the same question. In reality, there is rarely a consensus over the experts’ instructions, not least because a claimant’s expert may have already produced a report before the respondent’s expert has been appointed. Tribunals could do more to facilitate agreement on the scope of experts’ reports by focusing counsel on these questions. The saving in time and costs of having experts addressing the same issue could be significant compared with the current practice where experts’ ships sometimes pass each other in different directions. If this focus cannot be achieved at the outset of the case, there may be several opportunities thereafter. It may be possible, having considered parties’ experts’ primary reports, to identify the key factors that are most likely to influence the Tribunal’s award. The experts could be instructed to address those factors in a way that will assist the Tribunal in making an informed determination.

In Flughafen Zurich v Venezuela11, the experts were asked to produce a model which would show the impact on damages of flexing the four parameters where they were not in agreement. In the process of producing the model (which each did separately), the experts resolved one area of disagreement and the Tribunal was more easily able to analyse and conclude on the remaining three areas.12

A similar approach was adopted in Tidewater Investment v Venezuela13 where the Tribunal asked experts to prepare illustrative tables showing the effect of different assumptions on their calculations. The Tribunal commented that these “proved of very considerable assistance to the Tribunal in its deliberations” and “produced a significantly greater convergence in figures than had been the case in the experts’ reports that were filed in the written phase” albeit that there continued to be “material differences in the approach adopted by the experts, which in turn affect the figures presented.”14

**Joint meetings**

It is not always clear from awards whether experts have been asked to produce a joint statement. Anecdotal evidence is that while meetings of experts and the production of joint statements is common in, for example, UK High Court litigation, the procedure is less common in arbitration. In our view joint statements can be an effective way of Tribunals understanding those issues on which the experts agree and the reasons for and significance of differences of opinion.

In Occidental Petroleum v Ecuador, the Tribunal asked the parties to produce a joint report estimating a fair market value of the investment using a DCF methodology with certain parameters set by the Tribunal itself. Once the experts adopted common parameters, they were able to agree on the most reasonable approaches and methodology and produce a jointly agreed fair value of the most significant element of the valuation.15

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12 Flughafen Zürich v Venezuela, paragraphs 818 to 822.
14 Tidewater Investment v Venezuela, paragraph 198.
15 Occidental Petroleum v Ecuador, paragraphs 694 to 702.
Witness conferencing
A lot has been written on the subject of “hot tubbing”. We’ll spare you more here aside from two key thoughts. Firstly most practitioners agree that hot tubbing can be useful in understanding the nuances of two experts’ differing views. Secondly, while it is anecdotally common in arbitration, our research found only 5% of cases where awards refer to it. It may of course be that the approach was adopted in more cases but simply not commented on in the award.

Tribunal appointed experts
Where there is a great deal of divergence and/or calculations are highly complex, a Tribunal might appoint its own expert to help it navigate the differences.

In El Paso Energy International Company v The Argentine Republic, the Tribunal appointed its own expert “in view of the number and complexity of the accounting issues relating to the damages assessment, as evidenced by the diverging views given on many relevant questions by the Parties’ experts.” The Tribunal’s expert reviewed and commented on six areas in which the parties’ experts disagreed and the Tribunal relied on his views extensively when arriving at its conclusions on quantum.

A Tribunal appointed expert tends to be appointed in addition to those appointed by the parties as opposed to filling the role of single joint expert. Such an appointment is therefore likely to increase cost. That said in extreme cases the approach may help Tribunals address issues outside their own expertise when all other approaches have failed.

Conclusion
There are a number of good reasons why experts come up with different valuations for the same claim. Despite these differences, Tribunals still generally find experts’ reports helpful and it is rare for a Tribunal simply to disregard the experts entirely.

It is fundamental to the adversarial process that parties must be allowed to put their case and the gap between claimant and respondent valuations is unlikely ever to close. That said, Tribunals need tools to allow them to pick apart and evaluate what they have been told. It is reasonable for Tribunals to ask the experts to justify why their approaches differ, whether it be due to a difference in instructions, ambiguity on facts or genuine differences of professional opinion. In our view encouraging Tribunals to clarify the exam questions for experts and greater use of joint statements can only help narrow the gap.
Our capabilities in international arbitration and other disputes

For over 30 years, we have been working with clients to establish facts, analyse issues and develop dispute resolution strategies. Our specialist team advises on the financial, economic and valuation aspects of claims. We assist clients throughout the dispute resolution process and provide independent expert testimony. We work on a wide range of disputes including litigation, arbitration, mediation, expert determination and regulatory matters.

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• We have a team of expert forensic accountants, economists, valuers and engineers who specialise in disputes. Our experts are experienced in providing written and oral testimony in a range of fora. Our opinions on liability, causation and damages convey complex matters in plain English.

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• Our experts have extensive experience of testifying, including under the rules of major dispute resolution institutions including the ICC, ICSID, LCIA, UNCITRAL, DIAC, AAA, SCC and others.

• 12 of our testifying experts are recognised in the Who’s Who Legal listing of leading arbitration expert witnesses, including six based in London and others based in Frankfurt, Paris, Prague and other locations globally. We have further dispute specialists across our global network.

• We sponsor and contribute to studies conducted by the School of International Arbitration, Queen Mary, University of London. The most recent study was published in 2013, “Corporate Choices in International Arbitration: Industry Perspectives”.

• We host an annual Investment Treaty Arbitration conference in Prague, aimed at bringing together state representatives and other interested parties to discuss trends in Investment Treaty arbitration.

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