# COMPENSATION BASED ON CIRCUMSTANCES IN INVESTMENT ARBITRATION

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## ABSTRACT

*The growth and success of an investment, and hence its profitability, are highly influenced by a variety of factors in the state in which the investment is made. Among these conditions are the economic and political climate. As a result, even the most inexperienced investor will consider the economic and political conditions prevalent in the host state prior to making an investment. These considerations may include the economy's resilience, the rule of law, the host state's overall attitude toward foreign investment, or the current tax structure. With this backdrop in mind, it is not surprising that investment arbitration tribunals are regularly confronted with the issue of how to account for the host state's economic and political context when determining the magnitude of investor claims. For example, in a number of recent instances taken against Venezuela, arbitrators were confronted with the difficult challenge of how to account for a discounted cash flow in the economic and*

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*political situation, mostly due to the adoption of an expropriation policy.*

*This paper will begin by outlining some of the fundamental concepts and methodologies underpinning quantum determinations in investment arbitration and will then discuss how tribunals have addressed economic and political realities in the host state when determining quantum. The latest Venezuela cases will therefore get special attention. Following that, some of the practical implications including so-called nation risk in a discounted cash flow analysis will be explained. This paper advocates for a strategy wherein stringent legality differentiation, incorporating all circumstances and dangers are taken into consideration.*

## I. INTRODUCTION

The factors present in the state in which an investment is made (hereinafter "host state") have a significant impact on the investment's development and success, and thus its profitability.[1] The political and economic climates are two examples of such circumstances. Therefore, even the most inexperienced investors will think about the host state's economy and political system before deciding whether to invest money there.[2] The tax system, the host state's attitude toward foreign

[1]Ahan Gadkari, 'Effectiveness of Measures to Prevent Treaty Shopping: Curbing Access to Certain Malls' (2021) 1(2) CJDR 20.
[2]*Himpurna California Energy Ltd v PT (Persero) Perusahaan Listruik Negara*, Final Award, 4 May 1999 (2000), 25 YBCA 11, para 364.

investment, and the stability of the economy are all factors that are considered.

Due to this setting, it is not surprising that investment arbitration tribunals frequently face the challenge of deciding how much weight to give to the economic and political climate of the host state in weighing investor claims. Specifically, in a number of recent cases brought against Venezuela, tribunals were faced with the challenging question of how to account for a deterioration in the economic and political climate, primarily as a result of the adoption of an expropriation policy, in a discounted cash flow (hereinafter "DCF") analysis.[3]

This paper will begin by discussing the basic principles and procedures that are used to determine the quantum in investment arbitration(**Section II**).Thereafter, the paper will go over how courts have considered the economic and political climate of the host state when determining the appropriate quantum**(Section III).**The most recent charges levelled against Venezuela will then be the focus of subsequent discussion**(Section IV).**Then, the paper will discuss some of the real-world consequences of DCF analyses that don't factor in so-called nation risk**(Section V).**

[3]*Gold Reserve Inc v Bolivarian Republic of Venezuela*, ICSID Case No ARB(AF)/09/1, Award, 22 September 2014; *Venezuela Holdings BV and others v Bolivarian Republic of Venezuela*, ICSID Case No ARB/07/27, Award, 9 October 2014; *Flughafen Zürich AG and others v Bolivarian Republic of Venezuela*, ICSID Case No ARB/10/19, Award, 18 November 2014; *Tidewater Inc and others v Bolivarian Republic of Venezuela*, ICSID Case No ARB/10/5, Award, 13 March 2015; *Tenaris SA and others v Bolivarian Republic of Venezuela*, ICSID Case No ARB/12/23, Award, 29 January 2016; *Saint-Gobain Performance Plastics Europe v Bolivarian Republic of Venezuela*, ICSID Case No ARB/12/13, Decision on Liability and the Principles of Quantum, 30 December 2016.

# II. QUANTUM FUNDAMENTALS IN INTERNATIONAL INVESTMENT LAW

Any quantum analysis in investment arbitration must begin with determining whether the host state unlawfully expropriated the investor (**Section A**) or whether the host state violated the applicable Bilateral Investment Treaty (hereinafter "BIT") (whether through illegal expropriation or a violation of another treaty standard). In certain circumstances, tribunals go beyond the amount expropriated in granting compensation to account for other losses and grant full reparation(**Section B**).[4] Tribunals may then use a variety of valuation procedures to arrive at the acceptable magnitude. This paper, however, will focus only on the DCF approach (**Section C**).

## *A. Compensation for Expropriation by the State*

For a long period of time, the common law criterion for determining the amount of compensation payable in the event of legal expropriation was contentious.[5] Developed nations have consistently defended the so-called *Hull formula*, which provides for fast, appropriate, and effective compensation[6] – effectively pushing for the award of the investment's 'fair market value' just prior to the authorised taking.[7] Generally, fair market value is defined in terms of the price that a willing buyer would generally pay to a willing seller for the investment.[8] Developing nations, on the other hand, have maintained

[4]*Case Concerning the Factory at Chorzów*, PCIJ Series A (No 17) 47.
[5]Irmgard Marboe, *Calculation of Compensation and Damages in International Investment Law* (2nd edn, Oxford University Press 2017), para 3.07.
[6]*CME Czech Republic BV v The Czech Republic*, UNCITRAL, Final Award, 14 March 2003, para 497.
[7]Borzu Sabahi and Nicholas J Birch, 'Comparative Compensation for Expropriation' in Stephan W Schill (edn), *International Investment Law and Comparative Public Law* (OUP 2010) 755, 761.
[8]World Bank Guidelines on the Treatment of Foreign Direct Investment, Section IV.5.

that compensation should be reasonable and determined in accordance with the host state's rules and regulations.[9]

The contention was finally resolved with the development of international investment treaties (hereinafter "IITs"). IITs often make explicit reference to the *Hull formula* or use comparative language.[10] Given that investor protection is virtually entirely accomplished nowadays via IITs, the conventional measure of compensation is the investment's fair market value immediately before the expropriation occurs or is publicly known.[11] Indeed, the *Hull formula* is so often used in investment treaties that tribunals regard it to be the usual international law norm for expropriation compensation.[12] Historically, the strategy supported by developing nations allowed for a variety of considerations in determining compensation, including the host state's capacity to pay and other economic and political conditions in the host state.[13] This is not to say that the Hull formula disregards the economic and political realities of the host state. On the contrary, economic and political considerations would inevitably alter the fair market value of an investment. After all, these variables may have a direct effect on an investment's profitability.[14]

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[9]'Charter of Economic Rights and Duties of States', UN General Assembly Resolution A/RES/29/3281 of 12 December 1974.

[10]KajHobér, 'Remedies in Investment Disputes' in Andrea K Bjorklund, Ian A Laird and Sergey Ripinsky (eds), *Investment Treaty Law: Current Issues III* (BIICL 2009) 3, 10.

[11]cf Article 5(2) Austria/Iran BIT; Article 5(2) Slovenia/Denmark BIT; Article 6(2) Azerbaijan/Finland BIT.

[12]CME (n 6) Final Award, 14 March 2003, para 498.

[13]Sergey Ripinsky and Kevin Williams, *Damages in International Investment Law* (British Institute of International and Comparative Law 2008).

[14]José Alberro, 'Should Expropriation Risk Be Part of the Discount Rate?' (2016) 33 Journal of International Arbitration 525.

### *B. Full Reparation*

The Permanent Court of International Justice ("PCIJ")established the criterion of full reparation most notably in the *Chorzów Factory case*, that:

> *"reparation must, as far as possible, wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if that act had not been committed. Restitution in kind, or, if this is not possible, payment of a sum corresponding to the value which a restitution in kind would bear [...] – such are the principles which should serve to determine the amount of compensation due for an act contrary to international law."*[15]

Due to the fact that full reparation must account for all financially assessable loss, it may extend beyond compensation for lawful expropriation.[16] However, in other instances, the difference may be irrelevant. Specifically, if the investor seeks reparation for the whole loss of the investment, full restitution and compensation for lawful expropriation are often synonymous. Indeed, some tribunals have expressly relied on the investment's fair market value when adopting the full restitution criterion.[17]

### *C. The DCF Method of Valuation*

Investment tribunals have used a variety of valuation techniques, including the stock market approach (which is based on the price of

[15]Chorzów Factory (n 4) 47.
[16]*Siemens AG v The Argentine Republic*, ICSID Case No ARB/02/8, Award, 17 January 2007, para 352.
[17]Gold Reserve (n 3) paras 678ff, 681; *Tenaris* (n 3) paras 514, 519; CME (n 6) Partial Award, 13 September 2001, para 618. This approach has however not remained without criticism, cf José Alberro, 'Should Expropriation Risk Be Part of the Discount Rate?' (2016) 33 JIntlArb 525, 526.

publicly traded shares),[18] the comparable companies approach (which is based on the share price of comparable companies),[19]and the book value approach (which is based on information contained in a company's balance sheet).[20] However, the DCF technique has been utilised most often — at least when future cash flows can be forecast with fair certainty.[21] The DCF technique is based on the premise that the value of an asset is equal to the present value of the future cash flows produced by the asset.[22] Thus, in a DCF analysis, the investment's future free cash flows are projected using specific assumptions and then discounted using a discount rate.[23] The justification for the discount is that future cash flows are less valuable than present cash flows, since they cannot be reinvested immediately.[24] The discount rate is sometimes equated to the so-called cost of capital, which is frequently computed as the weighted average of the investment's cost of equity and cost of debt.[25] Due to the fact that riskier investments have a higher cost of capital, the discount is often greater when the venture is more risky.[26]

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[18]*Crystallex International Corporation v Bolivarian Republic of Venezuela*, ICSID Case No ARB(AF)/11/2, Award, 4 April 2016, para 889.

[19]*Yukos Universal Limited (Isle of Man) v The Russian Federation*, UNCITRAL, PCA Case No AA 227, Award, 18 July 2014, para 1784 (annulled on unrelated grounds).

[20]Siemens (n 16) 355, 362ff.

[21]*Metalclad Corporation v The United Mexican States*, ICSID Case No ARB(AF)/97/1, Award, 30 August 2000, paras 119ff; Siemens (n 16) 355.

[22]Ripinsky and Williams (n 13) 195.

[23]George H Aldrich, 'What Constitutes A Compensable Taking of Property? The Decisions of the Iran–United States Claims Tribunal' (1994) 88 American Journal of International Law 585.

[24]Marboe (n 5) 5.193; Ripinsky and Williams (n 13) 197.

[25]Richard Walck, 'Methods of Valuing Losses' in Marc Bungenberg and others (eds), *International Investment Law* (Beck 2015) 1045, 1051; PwC, 'Rewarding expropriation?' 4 <www.pwc.co.uk/assets/pdf/rewarding-expropriation.pdf> accessed 15 June 2017.

[26]Christina L Beharry (ed), 'Measuring Country Risk in International Arbitration', *Contemporary and Emerging Issues on the Law of Damages and Valuation in International Investment Arbitration* (Brill | Nijhoff 2018)

In the context of DCF valuations, tribunals often use the term "country risk" to account for the economic and political conditions in the host state.[27] Country risk is a factor that is taken into account when calculating the cost of capital for a venture.[28] It encompasses a broad range of risk factors that are relevant to the host state, including political risks (e.g., policy changes, expropriation), macroeconomic risks (e.g., inflation, high levels of public debt), and environmental risks (e.g. civil unrest, natural disaster).[29] Generally, no national risk is taken for some countries, such as the United States of America or Switzerland.[30] For other nations, a 'country risk premium' will be included in the calculation of the cost of capital. This results in a larger discount rate and, therefore, a lower investment value.[31]

## III. THE GENERAL IMPORTANCE OF ADVERSE ECONOMIC AND POLITICAL CONDITIONS FOR QUANTUM DETERMINATIONS

Any valuation, whether for legal expropriation or treaty violation, is based on a 'but-for-scenario,' or an assumption about how the investment would have evolved in the absence of the legal take or treaty breach. It is self-evident that while designing this scenario, any consequences of the specific lawful take or violation of the IIT must be

<https://brill.com/view/book/edcoll/9789004357792/BP000010.xml> accessed 6 July 2022.

[27] *EDF International SA and others v Argentine Republic*, ICSID Case No ARB/03/23, Award, 11 June 2012, para 1262.

[28] Searby (n 26) 20.

[29] Florin A Dorobantu, Natasha Dupont and M Alexis Maniatis, 'Country Risk and Damages in Investment Arbitration' (2016) 31 ICSID Review 219, 221; Searby (n 26) 19; PwC, 'How is Expropriation Risk Captured in a Valuation?' <www.pwc.co.uk/services/forensic-services/disputes/how-is-expropriation-risk-captured-in-a-valuation.html> accessed 5 April 2022.

[30] Searby (n 26) 20.

[31] PwC (n 29); Searby (n 26) 23.

ignored.[32] What is more complicated is determining the amount to which general economic and political conditions of the host state should be incorporated in the but-for-scenario. Two distinct strategies are feasible. For one thing, one may argue that all economic and political situations of the host state must be considered. Alternatively, all economic and political situations of the host state might be considered, with the exception of those that constitute a breach of international law in and of themselves. Only the latter method, in the author's opinion, is feasible. After all, the tribunal will be developing the but-for scenario in order to determine damages in an IIT. Assuming a but-for situation in which the host state does not adhere to the IIT would thus be inconsistent. As a result, this method, which will be referred to as the 'legality differentiation,' a concept which has also found support in international investment law.

Early instances of the legality distinction may be found in the Iran–US Claims Tribunal's (hereinafter "IUCT") jurisprudence. The Iranian revolution in the late 1970s resulted in both the confiscation of foreign property and broader reforms to the economic and political environment.[33] The latter could not be disregarded at the quantum level for the IUCT. Thus, the IUCT decided in *AIG v Iran* that:

> *"[i]n ascertaining the going concern value of an enterprise at a previous point in time for purposes of establishing the appropriate quantum of compensation for nationalization, it is [...] necessary to exclude the effects of actions taken by the nationalizing state in relation to the enterprise which actions may have depressed its value. [...]*

[32]For legal takings, this follows from the formulation of compensation clauses in IITs which typically refer to the fair market value of the investment immediately before the expropriation has occurred or has become publicly known, n 11. For breaches of international law, this follows from the *Chorzów Factory* standard (n 4).

[33]For example, due to socio-economic changes, the market for certain products, such as western music, basically collapsed, *CBS v Iran and others*, 25 Iran-US CTR (1990) 131, para 52.

> *On the other hand, prior changes in the general political, social and economic conditions which might have affected the enterprise's business prospects as of the date the enterprise was taken should be considered"*[34]

According to the IUCT, economic and political factors must be included for value purposes unless they: (i) represent instances of nationalisation in and of themselves or (ii) materialised after the date of expropriation.[35]

In contemporary investment case law, the *Occidental v Ecuador case* exemplifies the legality distinction. In this instance, the investor and Ecuador had agreed into an oil production participation deal.[36] Ecuador finally terminated this participation contract,[37] which the tribunal said violated of the fair and equitable treatment obligation as well as constituted an unconstitutional indirect expropriation in violation of the US/Ecuador BIT.[38] Prior to and unrelated to this violation, Ecuador enacted what became known as *Law 42*, which compelled all firms operating under participation contracts to give 50% of their windfall earnings to the host state.[39] According to Ecuador, this has to be included into the quantum computation. As a result, the DCF value might have been reduced by USD 800 million in comparison to the investor's claim.[40]

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[34]*American International Group v Iran*, 4 Iran-US CTR (1983) 96, 107.

[35]*Khosrowshahi v Iran*, 30 Iran-US CTR (1994) 76, paras 49ff; Marboe (n 5) 5.138ff.

[36]*Occidental Petroleum Corporation and others v The Republic of Ecuador*, ICSID Case No ARB/06/11, Decision on Annulment of the Award, 2 November 2015, paras 5ff.

[37]Ibid para 22.

[38]Occidental (n 36) Award, 5 October 2012, paras 452, 455.

[39]Occidental (n 36) Decision on Annulment of the Award, 2 November 2015, para 23.

[40]Ibid para 469. The tribunal eventually awarded USD 1,769,625,000, cf Award, 5 October 2012, para 876. The amount was later reduced by an annulment commit- tee on unrelated grounds to USD 1,061,775,000, cf Decision on Annulment of the Award, 2 November 2015, para 586.

The tribunal conducted a thorough review of *Law 42* and concluded that it violated the participation contract and the promise of fair and equal treatment.[41] As a result of this finding, the tribunal determined that *Law 42* could not be included in the quantum analysis.[42] The tribunal decided, in that respect, that 'a State cannot reduce its liability for a wrongful act […] on the basis of another wrongful act[…].'[43] Furthermore, the tribunal made a clear distinction between 'changes in general political, social, and economic circumstances' preceding the treaty violation and the host state's breach of its responsibilities to the investor. While the former should be regarded a quantum matter, the latter cannot be considered.[44] Any alternative method would 'allow the Respondent to profit from its own wrongdoing, contrary to the general principles of international law explicitly proscribing this.'[45] Thus, case law demonstrates that the dividing line between economic and political situations is, in fact, the previously defined legality differentiation.[46] This technique has also been endorsed by academic commentators.[47]

[41]Occidental (n 36) Award, 5 October 2012, para 527. Note however the opposite finding by dissenting arbitrator *Stern*, Dissenting Opinion, 20 September 2012, para 12.
[42]Occidental (n 36) Award, 5 October 2012, para 546.
[43]Ibid para 541.
[44]Ibid para 543ff.
[45]Ibid para 546.
[46]CME (n 6) Final Award, 14 March 2003, paras 561ff; *American Manufacturing & Trading, Inc v Republic of Zaire*, ICSID Case No ARB/ 93/1, Award, 21 February 1997, para 7.13ff; *Sempra Energy International v The Argentine Republic*, ICSID Case No ARB/02/16, Award, 28 September 2007, para 397 (annulled on unrelated grounds).
[47]Marboe (n 5) paras 3.258, 5.138ff.

# IV. RECENT CASE LAW ON THE DCF APPROACH TO VALUATION

Recent cases against Venezuela demonstrate that the economic and political conditions prevailing in the host state played a significant role at the quantum stage, both in terms of the applicability of the DCF valuation approach in general (**Section A**) and the country risk premium applied in the DCF analysis (**Section B**). A thorough examination is thus necessary to ascertain how these examples relate to the legality differentiation (**Section C**).

## *A. Application of the DCF Approach in the Context of Economic and Political Conditions*

Concerning the effect that the host state's economic and political conditions may have on the general use of the DCF valuation technique, the award in *Tenaris v Venezuela* is notable. In this instance, the panel determined that Venezuela had wrongfully expropriated the investor[48] and proceeded to determine the investment's fair market value.[49] Notably, the parties and their respective experts agreed that the DCF approach was the most acceptable method for estimating future revenue.[50] Nonetheless, the judge rejected this procedure, instead awarding the amount paid for an investment made many years prior to the wrongful expropriation.[51]

The tribunal reached this determination after identifying a number of circumstances that made it difficult to forecast future cash flows with the required degree of confidence, including a very limited period of historical performance and uncertainty about future supply.[52] However, the tribunal included Venezuela's economic and political condition –

[48]Tenaris (n 3) paras 494ff.
[49]Ibid paras 514, 519.
[50]Ibid paras 520.
[51]Ibid paras 550ff.
[52]Ibid paras 525ff.

notably the implementation of an expropriation policy against foreign investment – in this combination of considerations. The tribunal said specifically that current uncertainties 'are compounded by other government interventions in the market place, as well as unstable inventories and shortages of a wide range of products in the Venezuelan market.'[53] The tribunal asserts that the:

> *"general economic conditions in Venezuela as well as the business situation [of the investment] did not, at the time of expropriation – or later – give rise to the likelihood that [the investment's] free cash flows could be projected with reasonable certainty."*[54]

Notably, the panel stated that by using the historical price rather than the DCF technique, the tribunal found that the quantum was likely substantially low.[55] Furthermore, the panel acknowledged that the host state's expropriation policy had contributed to an environment in which conventional methodologies to determining fair market value [like the DCF analysis] face significant difficulties.[56] Nonetheless, the tribunal did not seem willing to lower the bar for the degree of confidence necessary to adopt the DCF technique.

### *B. The Country Risk Premium in the DCF Analysis*

Venezuela's national risk was widely seen to have escalated significantly as a result of the state's expropriation measures in major industrial sectors. As previously stated, a larger national risk results in a higher discount rate, and consequently a lower claim. Thus, in a number of instances made against Venezuela, it was debated whether and to what degree political risk should be included in a DCF assessment as part of national risk. Investors often stated that this would not occur because Venezuela would benefit from its

[53]Ibid paras 527.
[54]Ibid.
[55]Ibid paras 567.
[56]Ibid.

expropriation strategy owing to lesser compensation or damages judgments.[57]

In *Gold Reserve v Venezuela*, the tribunal was tasked with resolving a dispute arising out of an investment in Venezuela's mining sector under the Canada-Venezuela BIT.[58] The case was specifically about the investment's mining permits being revoked and the subsequent acquisition of the investment's assets,[59] which the tribunal determined violated the criterion of fair and equitable treatment.[60] Invoking the *Chorzów Factory case* and the norm of complete compensation, the tribunal ruled that employing a 'fair market value approach' was justified in this instance, given the investor's entire loss of investment.[61] The tribunal used the DCF approach to estimate fair market value.[62] The parties differed on the discount rate, owing primarily to the nation risk premium that would be applied to the cost of capital calculation.

The tribunal determined that the host state's country risk premium was excessive because it was based on 'generic country risk,' which included the state's 'policy of ousting North American corporations from the mining industry.[63] The panel said that a nation risk premium should not reflect the market's assessment of a State's proclivity to expropriate investments in violation of BIT requirements.[64] Simultaneously, the tribunal determined that the investor's requested nation risk premium was insufficient. This was because the investor's nation risk premium was based only on 'labour risks and not other genuine risks that should be accounted for – including political risk,

[57]See also with regard to this argument in more general terms Searby (n 26) 23ff.
[58]Gold Reserve (n 3) para 3ff.
[59]Ibid para 26ff.
[60]Ibid para 564.
[61]Ibid paras 678ff and 681.
[62]Ibid para 831.
[63]Ibid para 840.
[64]Ibid para 841.

other than expropriation.'[65] Thus, the tribunal embraced a middle ground position, insisting on both the inclusion of broad political risks and the absence of the danger of expropriation.

In actuality, the tribunal's judgement created complications since neither party's quantum experts had computed a discount rate using the tribunal's country risk assumptions. As a result, the tribunal was forced to arbitrarily choose a discount rate between those calculated by the quantum experts.[66] Furthermore, since the tribunal was unable to do its own calculations using this discount rate, it relied on the investor's computation and subtracted a specific amount — a method that the tribunal readily recognised was 'rough' and 'back of the envelope'.[67]

In *Tidewater v Venezuela*, the panel disregarded this precedent. This case involved an investment business that provided naval support services to Venezuela's state oil corporation for hydrocarbon production.[68] Venezuela confiscated the investment firm's assets in 2009.[69] The panel decided that Venezuela's conduct constituted expropriation within the meaning of the relevant Barbados/Venezuela BIT, and that the expropriation was also legitimate due to the absence of compensation.[70] As a result, the tribunal set out to ascertain the investment's 'market value' (as required by Article 5 of the relevant Barbados/Venezuela BIT).[71] The panel used a DCF valuation in doing so.[72]

Regarding the specifics of the DCF valuation, both the parties and the tribunal placed a priority on nation risk. The investor advocated for a

[65]Ibid.
[66]Ibid para 839, 840 and 842.
[67]Ibid para 842.
[68]Tidewater (n 3) paras 13ff.
[69]Ibid para 24ff.
[70]Ibid para 121, 146. There is considerable controversy as to whether an expropriation can be considered lawful if it is enacted without compensation, Marboe (n 5) para 3.32ff.
[71]Ibid para 151.
[72]Ibid para 165.

relatively modest 1.5 percent national risk premium, adding that political risk should be excluded from the calculation. According to the investor, the state may potentially threaten enterprises, lowering their value and eventually acquiring them at a bargain.[73] This would be inconsistent with the legal object and purpose of the BIT's existence and would represent an unlawful benefit to the state.[74]

The investor's proposal was rejected by the tribunal. According to the tribunal, the quantum analysis should neglect only the specific measure at issue in the present instance.[75] On the other hand, generic risks, including political risks, associated with doing business in a specific nation had to be included as part of the country risk.[76] The tribunal made specific reference to the willing-buyer-willing-seller definition of 'market value' in reaching its conclusion, noting that one element that a buyer would consider is the danger of investing in a certain country.[77] Additionally, the tribunal expressly rejected the notion that by integrating political risk as part of national risk, the host state may profit from its own error.[78] In a nutshell, the tribunal said that the relevant BIT did not provide not an 'insurance policy or guarantee against all political or other risks associated with such investment.'[79]

*Venezuela Holdings et al v Venezuela*, filed under the Netherlands/Venezuela Bilateral Investment Treaty, was judged similarly. The case was a series of steps taken by Venezuela against an

[73]Ibid para 183.
[74]Ibid.
[75]Ibid para 186.
[76]Ibid.
[77]Ibid.
[78]Ibid.
[79]Ibid para. 184. Incidentally, in calculating compensation, the tribunal failed to properly apply its determinations on the country risk premium. That is because the tribunal (involuntarily) relied on a number provided by the investor's expert that had been calculated based on a country risk premium excluding political risk. The award was partially annulled for this reason, see Decision on Annulment, 27 December 2016, paras 181ff.

oil production venture, culminating in the state's eventual acquisition of the company.[80] The panel decided that an expropriation occurred but determined that it was legitimate since only compensation was lacking and it had not been shown that the state's compensation proposals were unreasonable.[81]

The tribunal's starting point in determining the quantum was that the BIT's compensation criteria had to be applied.[82] The BIT called for 'just compensation,' which was defined more precisely as the 'market value of the investments affected immediately before the measures were taken or the impending measures became public knowledge, whichever is the earlier.'[83] Given that the parties agreed on the requirement for a DCF valuation, the tribunal was required to determine the proper discount rate.[84] According to the investor, the country's risks are largely composed of the risk of uncompensated expropriation, which cannot be taken into Consideration.[85] Specifically, the investor asserted that a valuation of the expropriated property that complies with the Treaty cannot include the risk that the property right is expropriated later without the compensation required by the Treaty.'[86]

The investor's claim was dismissed by the tribunal. What seems to have been significant in that respect was the BIT's need for market value compensation. The panel, explicitly using the willing-buyer-willing-seller formula, postulated that a hypothetical willing buyer would consider the danger of expropriation when assessing the sum they were prepared to pay.[87] As a result, 'the confiscation risk remains part of

[80]Venezuela Holdings (n 3) paras 45ff, 86.
[81]Ibid para 288, 301, 305, 306.
[82]Ibid para 306.
[83]Ibid para 307.
[84]Ibid para 308ff.
[85]Ibid para 363.
[86]Ibid para 364.
[87]Ibid para 365.

the country risk and must be taken into account in the determination of the discount rate.'[88]

The opinions expressed in *Gold Reserve, Tidewater, and Venezuela Holdings* clashed head on in the case of *Saint-Gobain v Venezuela*, which was resolved under the France/Venezuela Bilateral Investment Treaty. Venezuela's unjustified seizure of a proppants factory indirectly owned by the claimant was the focus of this lawsuit.[89] The panel chose not to examine whether the expropriation was valid or unlawful, instead arguing that compensation should reflect the investment's fair market worth.[90] The nation risk premium became problematic once again when the DCF approach was used. While the claimant's expert relied on a procedure that, according to him, eliminated the 'risk of uncompensated expropriation,' the respondent's experts pushed for two ways that did not.[91]

When confronted with this dilemma, the tribunal was unable to reach a unanimous conclusion. The tribunal's majority agreed to incorporate the risk of unjustified expropriation in the nation risk premium.[92] The majority relied on *Tidewater*'s willing-buyer-willing-seller formula, arguing that the willing buyer would have considered all risks.[93] According to the majority, the 'notion of fair market value [...] requires the elimination of the specific measure that was subject of the Tribunal's finding on liability' but not 'a correction of the economic willing-buyer perspective on the basis of normative considerations.'[94] The relevant BIT cannot be used to insure against the broad risks

[88]Ibid.
[89]Saint-Gobain (n 3) para 5.
[90]Ibid para 602, 614, 627.
[91]Ibid paras 698-700, 725 and 734.
[92]Ibid para 723.
[93]Ibid at para 717.
[94]Ibid at para 719.

associated with investing in Venezuela that an interested buyer would consider before investing.[95]

Judge Brower sharply criticised the majority perspective in his dissenting opinion. Judge Brower reasoned, citing *Gold Reserve*, that incorporating the danger of uncompensated expropriation from which the investor is ostensibly freed equates to denying the investor the entire compensation to which it is entitled. In his words, '[i]t is like undertaking to restore to the owner of a severely damaged automobile a perfectly repaired and restored vehicle but then leaving parts of it missing because it just might be damaged again in the future.'[96]

Finally, for another perspective, the case of *Flughafen Zürich et al. v Venezuela* might be cited, which was filed under both the Switzerland/Venezuela and Chile/Venezuela BITs. The investors in this case got a 20-year operation licence for a Venezuelan airport in 2004.[97] The airport was taken by the state at the end of 2005.[98] The panel concluded that the state's acts constituted unconstitutional direct expropriation[99] and that the appropriate level of restoration was market value.[100] Due to the tribunal's decision to use a DCF valuation,[101] the nation risk required to be examined.

Throughout this conversation, investors advanced a relatively modest nation risk premium, which essentially compensates for the risk of rising labour costs.[102] According to the investors, legal, regulatory, and political risks could not be included since doing so would enable host

[95]Ibid.
[96]Saint-Gobain (n 3), Concurring and Dissenting Opinion of Judge Charles N Brower, para 3.
[97]Flughafen Zürich (n 3) para 971.
[98]Ibid.
[99]Ibid paras 509 and 511.
[100]Ibid paras 740 and 744.
[101]Ibid para 780ff.
[102]Ibid para 890.

nations to reduce the amount of damages payable in the event of an expropriation by raising the degree of country risk after the investment.[103] Surprisingly, the tribunal agreed in principle with this line of reasoning. The tribunal ruled that a state that increases country risk after an investment cannot profit from an increase in damages for an internationally wrongful act.[104]

However, this discovery eventually harmed investors. According to the tribunal, a significant national risk existed prior to the investors' investment owing to political and legal uncertainty.[105] As a result, there was no rise in country risk after the investment, and a country risk premium reflecting the whole nation risk, taking into account all political, legal, and regulatory elements, was required.[106] In practise, the tribunal discriminated between varying degrees of national risk over time, but not between risks associated with lawful and unlawful action.[107]

### *C. Analysis*

Recent jurisprudence on Venezuela's expropriation practises demonstrates markedly divergent views on how economic and political conditions of the host state should be accounted for at the quantum stage. The ramifications of these differences may be startling. For instance, critics have remarked that when calculating the national risk premium, including in the danger of expropriation might result in a

[103]Ibid para 898.
[104]Ibid para 905.
[105]Ibid para 907.
[106]Ibid.
[107]Incidentally, the claimant in the *OI European Group* case also argued for a reduction of the country risk premium in light of a state policy of expropriation. However, whether such a reduction was appropriate in principle was not addressed in this case. Rather, the tribunal rejected the proposal because it held that the country risk premium put forward by the respondent had not been calculated based on input data that could have been influenced by the state's expropriation policy, cf *OI European Group BV v Bolivarian Republic of Venezuela*, ICSID Case No ARB/11/25, Award, 10 March 2015, paras 775ff.

significant decrease in compensation or damages – up to one-third, depending on the circumstances.[108]

Arguably, the majority of the above awards are difficult to reconcile with the legality differentiation. To begin, the *Tenaris* tribunal's findings about the applicability of the DCF valuation technique seem dubious. To support its decision not to use the DCF technique and to award a probably rather reduced sum of damages, the tribunal cited, among other things, the uncertainty created by the state's expropriation policy.[109] However, under the legality differentiation, the tribunal should have dismissed the expropriation policy and its associated consequences, given that specific implementations of the expropriation policy had been found to violate international law by both the tribunal in this instance and other tribunals.[110] As a result, the tribunal could not claim that there was insufficient clarity about future cash flows due to Venezuela's expropriation policy. However, this may not have made a difference in the particular circumstance. After all, the tribunal emphasised a variety of other elements that contribute to uncertainty, including the short time of previous performance and product shortages across a broad range of items on the Venezuelan market.[111] These concerns may have been sufficient in and of itself to justify rejecting the DCF method as excessively unpredictable.

In terms of national risk premium assessments, the judgments in *Tidewater, Venezuela Holdings, and Saint-Gobain* likewise contradict the legality differentiation. All three tribunals refused to remove from the computation of the country risk minimum the risk of host state measures in violation of international law. To be sure, the preceding case law on legality discrimination is not directly relevant since it deals with overlooking specific violations of international law, not with disregarding the probability of violations. However, a consistent use of

[108]Dorobantu, Dupont and Maniatis (n 29) 220; PwC (n 25) 6.
[109]Tenaris (n 3) para 567.
[110]Ibid para 494ff; Flughafen Zürich (n 3) paras 509 and 511.
[111]Tenaris (n 3) para 525ff.

the legality differentiation necessitates that its consequences be extended to the risk level as part of the nation risk minimization analysis. After such, IITs establish that the danger of specific host state acts aimed against an investment must not materialise under international law. However, if these risks do not materialise, it would be contradictory to include them in the valuation's but-for scenario. The *Tidewater* and *Saint-Gobain* tribunals rejected this last premise, arguing that the relevant BITs did not provide 'insurance' against all political or other risks connected with an investment.[112] While this statement is valid, it overlooks the fact that IITs are truly insurance plans against certain political risks, like expropriation without compensation, unequal and inequitable treatment, and so forth. There is no room in the but-for-scenario for such hazards.

*Tidewater, Venezuela Holdings, and Saint-Gobain* all emphasised an additional reason why it is ostensibly important to cover all risks via the national risk premium. According to these tribunals, a willing buyer and a willing seller (i.e. the hypothetical people relevant under the fair market value criterion) would consider all risks while determining the investment's worth.[113] The tribunals, however, exaggerated the importance of the willing-buyer-willing-seller combination in making this case. The tribunals reasoned that the willing-buyer-willing-seller formula assists in establishing whether conditions constitute a but-for scenario. Indeed, the but-for-scenario must be defined first, only on the basis of legality differentiation. Only once the but-for scenario is defined (with the possibility of international law violations being overlooked) does the willing-buyer-willing-seller formula enter the picture and act as a valuation tool for the tribunal's benefit.[114]

Additionally, the *Flughafen Zürich case* contradicts the legality differentiation. In this instance, the tribunal made no distinction

[112]Tidewater (n 3) para 184; Saint-Gobain (n 3) para 719.
[113]Tidewater (n 3) para 186; Venezuela Holdings (n 3) para 365; Saint-Gobain (n 3) para 717.
[114]Dorobantu, Dupont and Maniatis (n 29) 224.

between expropriation risk and other political, legal, and regulatory issues. Rather than that, the tribunal distinguished between risks that exist before and after the investment is made. Taken at face value, this line of reasoning implies that general economic and political conditions may be ignored for determining the national risk minimum, even if they result from the host state's lawful action, as long as these events occurred after the investment was made. Thus, under the tribunal's view, even when the benefits of a tort reform benefiting consumers are not unlawful under international law, they might nevertheless be removed from the country risk premium. This strategy, one may argue, cannot be the correct one, since it would effectively transform IITs into generic insurance plans against any political risk.

As a result, the only example that fits the legality differentiation is *Gold Reserve*. The tribunal recognised a clear distinction here between general economic and political factors and the likelihood of international law violations. This methodology for calculating the nation risk premium is compatible with prior investment law and produces suitable results. It specifically assures that the host state is not rewarded with lower damages for policies that violate international law. Simultaneously, moral hazard is avoided since IITs are not transformed into blanket insurance plans against all economic and political conditions in the host state.

Furthermore, some have claimed that the legality or illegality of the expropriation is determinative when considering whether to incorporate the risk of international law violations in the country risk premium.[115] This position should be rescinded. In that sense, it is accurate that those tribunals that clearly declared the expropriations legal (e.g., those in *Tidewater and Venezuela Holdings*) subsequently included this risk in the national risk premium. However, in that respect, these tribunals did not explicitly rely on their findings of legitimate expropriation. Additionally, tribunals are tasked with

[115]Alberro (n 17) 546.

determining a hypothetical situation in where there is no legal take or violation of the IIT, respectively, in both instances of authorised and illegal expropriation. There is no reason why the danger of international law violations should be included in the former circumstance but not in the latter.

## V. PRACTICAL CONSIDERATIONS IN CALCULATING THE COUNTRY RISK PREMIUM

The preceding study focused only on the theoretical aspects of nation risk premium analysis - specifically, on the issue of whether risks may be included as a matter of law. How can these principles be employed in the actual assessment of the national risk premium? Regrettably, there is no universally applicable solution to this topic.

There are many methods for calculating national risk premiums.[116] The most common strategy is to derive some kind of risk from market data on the host state's sovereign bond yield ('sovereign risk method/country risk method') or the volatility of the host state's stock markets ('equity market risk method').[117] It is intrinsically difficult to disentangle the danger of international law violations from other country risk variables under these methodologies.[118] The sovereign risk and stock market risk methods both depend on market data and hence include all nation risk variables, as viewed by the market, without difference.[119] Under these methodologies, it is important to minimise

[116]For a brief summary of the most common methods cf. PwC (n 25) 8 and Marboe (n 5) para 5.206. For an analysis of country risk premiums for various countries pursuant to such methods cf *Damodaran*, 'Country Default Spreads and Risk Premiums', <http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/ctryprem.html> accessed 17April 2022.
[117]Searby (n 26) 20ff. For a discussion of the merits of these two approaches with a view to a country facing a high risk of sovereign default, see EDF (n 27) para 1263ff.
[118]PwC (n 29) 9.
[119]Dorobantu, Dupont and Maniatis (n 29) 231.

country risk by an estimate, based on an assumption about the amount to which the risk perceived by the market is comprised of the risk of international law violations.[120]

Alternatively, the country risk premium may be modelled by making specific reference to the individual components of country risk and integrating them into a single country risk premium (the 'specific factor risk technique').[121] Rating organisations do this by publishing national risk ratings that reflect a holistic evaluation of political, economic, and financial concerns.[122] This strategy is entirely subjective and is not based on market data.[123]

As these reasons demonstrate, it will virtually always be difficult to derive a country risk premium that eliminates the danger of international law violations on a solely empirical basis. Calls to judgement will become required. Although the resulting subjectivity is undesirable, it does not weaken the analysis as a whole. Tribunals are not required to establish quantum precisely but may make approximations and estimations.[124] According to the author, tribunals should use this authority when calculating the country risk premium in order to guarantee that the danger of international law violations is eliminated from the analysis.

Tribunals rely on expert information to establish the appropriate nation risk premium on a procedural level. Regrettably, in many arbitrations tribunals begin delving deeply into quantum issues only after the file has been concluded and the findings of the party-appointed experts have been filed. As seen by the *Gold Reserve case*, this may result in a

[120]PwC (n 29) 9.
[121]Searby (n 26) 22.
[122]International Country Risk Guide, <www.prsgroup.com/about-us/our-two-methodologies/icrg> accessed 17 April 2022.
[123]Searby (n 26) 22.
[124]*Khan Resources Inc and others v Government of Mongolia*, UNCTIRAL, Award on the Merits, 2 March 2015, para 375; *Quasar de Valors SICAV SA and others v Russian Federation*, SCC Case No 24/2007, Award, 20 July 2012, para 215.

less-than-ideal scenario. In this case, the tribunal determined that no expert had supplied a country risk premium (and, therefore, a damage estimate) that corresponded to the tribunal's risk assumptions, requiring the tribunal to do its own 'back of the envelope' calculation.[125] Tribunals might achieve more accuracy by proactively ordering both parties' valuation experts to conduct computations both incorporating and omitting pertinent risk elements.[126] This would enable the tribunal to choose from a pool of figures backed up by at least one of the party's experts, so increasing the dependability of the eventual damage figure.[127]

## VI. CONCLUSION

According to the author, recent judgments against Venezuela demonstrate two conflicting interests: Tribunals, on the one hand, seek to prevent moral hazard. From this vantage point, investment treaties should not be seen as insurance plans that cover investors against any risk arising from the economic and political environment of the host state, thereby absolving investors of the need to do their own due diligence. Tribunals, on the other hand, want to prevent a scenario in which host governments are rewarded for violating the relevant IITs. Tribunals have tried a variety of tactics in order to achieve a balance between the opposing views. According to the author, the right method is to apply a stringent legality differentiation, incorporating all circumstances and dangers in the hypothetical but-for scenario, save those that are inconsistent with international law in and of themselves. Regrettably, determining the national risk premium for the purposes of DCF valuation will not be attainable only on the basis of pure facts and data but would involve judgement decisions. Tribunals should be aware

[125]Gold Reserve (n 3) paras 839 et seq.
[126]Dorobantu, Dupont and Maniatis (n 29) 228.
[127]PwC (n 29) 6.

of this early on and explain pro-actively to the parties and their experts the need to produce data for various risk assumptions. This enables the tribunal to choose the most suitable figures at the conclusion and avoids poor 'back of the envelope' estimates.