> "RISK INCLUDES VARIABILITY RELATING TO BOTH 'OUT PERFORMANCE' AS WELL AS 'UNDER PERFORMANCE'"

# Treaty Arbitration:
# Unpacking the Discount Rate – Part II

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This is the second of two articles that discuss the use of discount rates in assessing losses in international arbitration. In this article, we explore how "country risk" can affect the value of investments and the approaches taken to incorporate this risk in damages calculations in international arbitration.

## DEFINING "COUNTRY RISK"

We explained in Part I of this article that the discount rate applied in a discounted cash flow valuation depends, in part, on the risk attaching to the asset being valued. We also explained that risk has a precise meaning in the context of valuation theory: the variability of future cash flows around anticipated returns. An implication of this definition is that risk includes variability relating to both 'out performance' as well as 'under performance'. This can be contrasted with the use of risk in everyday language, which tends only to be associated with adverse outcomes.

When valuing assets in less developed economic markets, valuers must have regard to both adverse outcomes that are less prevalent in developed economic markets (such as the chance of labour disruption) and increased variability of future cash flows around anticipated returns (for example, more macro-economic volatility). Both types of risk are sometimes referred to, in aggregate, as "country risk".

This can include **political risk** (higher taxes on profits, expropriation, inability to repatriate profits, etc.), **macroeconomic risk** (inflation, currency instability, high or unstable interest rates, etc.) and **environmental risk** (war, labour disruption, natural disaster, etc.).

A potential source of confusion when discussing country risk is that some valuers adjust the discount rate to try to take account of all of these "country risks", whereas other valuers adjust the discount rate only to take account of risk as commonly understood in valuation theory (variability of future cash flows around anticipated returns). If taking the latter approach, valuers may consider whether it is also necessary to modify cash flow projections to take account of adverse outcomes associated with investments in the relevant country.

## COUNTRY RISK IN INTERNATIONAL ARBITRATION

The characteristics of an investment may affect its exposure to country risk, and should be taken into account when valuing a business interest in a country. Consider the differences in the risk profiles of two companies investing in different businesses in the same country on the same date. One investment is made in a company that extracts a natural resource that is sold on world export markets in hard currency. The other is a manufacturing business that relies on domestic inputs and sells its products on domestic markets in local currency. Clearly these two investments made on the same date, in the same country, face different exposure to the country risks of the host state.

Of particular relevance in a number of recent arbitral awards is the extent to which tribunals should take

account of a state's propensity to expropriate when valuing expropriated assets. Since market conditions, timing of investment, and the nature of investment are unique to each dispute, there is no one approach that can fit all cases. Investments tend to "price in" the chance of expropriation, so that if an investment is made in a favourable or unfavourable investment climate (in terms of the chance of expropriation), it should lead to different outcomes.

Suppose an investment is made when a state is acting favourably towards foreign investors. The chance of expropriation is relatively low. Suppose also that a new government is then formed that is more hostile towards investors. The chance of expropriation rises, and the value of the asset falls accordingly. If the state eventually expropriates the investment, then at the date of the expropriation the value of the investment was already adversely affected by the prior actions of the state. The question for the tribunal is how that perceived chance of expropriation should be taken into account in compensating the investor. The options available to the tribunal include:

- **Option 1:** Compensation on the basis of no perceived chance of expropriation.
- **Option 2:** Compensation on the basis of the relatively low-perceived chance of expropriation that existed at the date of the investment.
- **Option 3:** Compensation on the basis of the value immediately before expropriation, taking into account the higher perceived chance of expropriation that existed at that time.

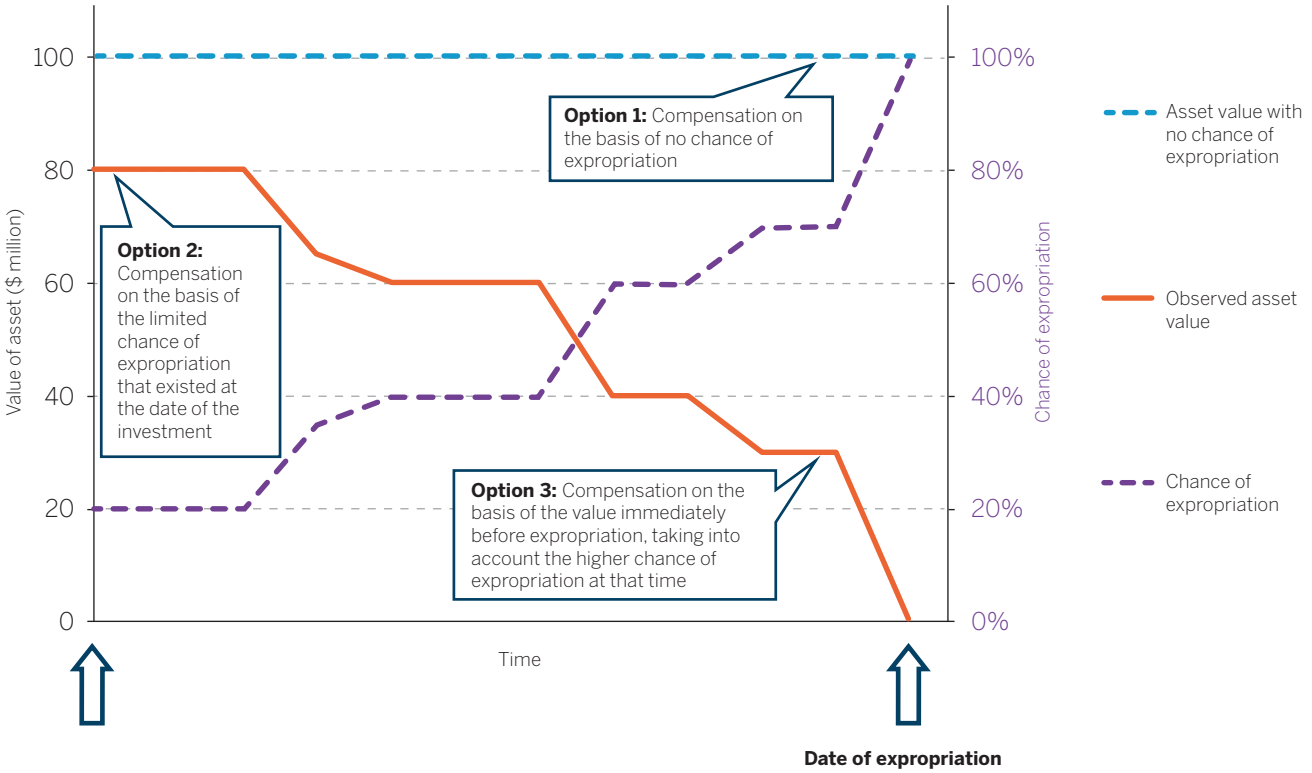
Figure 1 illustrates the available choices, assuming a 20 percent probability of expropriation on the date of investment. The blue dotted line is the value of the asset before taking account of the perceived chance of expropriation, and this is assumed not to change. In theory, this is the value of the asset to the government or to an investor that will be fully compensated in the event of expropriation (Option 1).The value of the asset after taking account of the chance of expropriation—the solid orange line—falls as the perceived probability of expropriation rises.

Each of the options described has different results. If compensation is on the basis of no perceived chance of expropriation (i.e. $100 million in Figure 1), then there is a chance that the investor is over-compensated. In Figure 1, the value of the asset, even at the date of the initial investment, was only $80 million. Therefore, **Option 1** puts the investor into a better position than they would have been absent the expropriation.

Applying **Option 2**, two investors might invest in similar assets, with the same expected cash flows absent any perceived chance of expropriation, but at different dates. If one invested at a time when the state's propensity to expropriate was low, and another when the propensity to expropriate was high, then the compensation would differ for the two investors.

**Option 3** potentially creates incentives for states to act in ways that drive down the value of an asset prior to an expropriation. Further, the value of the asset in the state's hands ($100 million in Figure 1) is much greater than compensation to the investor ($30 million), potentially creating incentives to expropriate.

**FIGURE 1: COMPENSATION FOR AN EXPROPRIATED ASSET**



A number of recent awards involving Venezuela have considered this issue, with contrasting conclusions. The table below summarises the tribunals' views on how to take account of the state's propensity to expropriate in four of these awards. In each case, the "country risk premium" or "CRP" (the adjustment made to the discount rate to reflect country risk) depended in part on the tribunal's views regarding how to take account of the chance of expropriation.

A feature of some of the Venezuelan awards is the attempts by experts and tribunals to make adjustments to the discount rate to take account of country risk and to isolate the chance of expropriation in those adjustments. There is very little consensus between valuation practitioners (and experts) on how country risk should be measured or to what extent different types of country risk can be 'diversified away' by holding a portfolio of investments.

There is also limited consensus as to how different types of country risk should be incorporated into a valuation. In principle, many types of country risk (including a state's propensity to expropriate) should be taken into account in a probability weighted estimate of cash flows (since they cause adverse outcomes, rather than increasing the variability around the projected return); however, this can be difficult to do in practice and a common solution is to attempt to incorporate an adjustment for these factors within the country risk premium. Even among those who favour making adjustments to the discount rate to include a country risk premium, there is no consensus about how that premium should be calculated. Methods we see applied in practice include:

1. **Sovereign yield spreads:** the spread of the yield on a government's traded USD debt over comparable bonds issued by the US government. This is calculated using market yields, where available, or using an implied premium based on the government's credit rating for countries without traded USD denominated debt.
2. **Scaled sovereign yield spread:** the sovereign yield spread is sometimes scaled upwards to reflect the fact that equity is riskier (more volatile) than debt, for example, scaling the country default spread by the ratio of the standard deviations of equity and government bond prices.

| Award | Tribunal's view |
|---|---|
| Gold Reserve Inc. v Venezuela | • Adopted a CRP of 4 percent<br>• "It is not appropriate to increase the country risk premiumto reflect the market's perception that a State might havea propensity to expropriate investments in breach of BITobligations" (paragraph 841)<br>• Appears to be consistent with Option 1 in the list above |
| Flughafen v Venezuela | • Adopted a CRP of 7.9 percent<br>• "A Government that through the adoption of new politicalattitudes, adopted after the investment was materialized,which increases the country risk, cannot benefit from awrongful act attributable to it, that reduces the compensation payable." But also concluded that: "When in 2004the Claimants decided to invest ... the country risk alreadyexisted, and investors were well aware of the existence ofpolitical and legal uncertainties... The political and regulatory risk existed before the investment, and in the shorttime in which investors maintained it, its quantificationcould not be significantly altered." (paragraphs 905and 907)<br>• This appears to be broadly consistent with Option 2 |
| Mobil v Venezuela | • Did not quantify the CRP, but applied an overall discountrate of 18 percent<br>• Stated that "the compensation must correspond to theamount that a willing buyer would have been ready to payto a willing seller in order to acquire his interests but forthe expropriation, that is, at a time before the expropriationhad occurred or before it had become public that it wouldoccur... The Tribunal considers that the confiscation riskremains part of the country risk and must be taken intoaccount in the determination of the discount rate."(paragraph 365)<br>• Appears to be consistent with Option 3 |
| Tidewater v Venezuela | • Adopted a CRP of 14.75 percent<br>• Considered that this "quantifies the general risks, includingpolitical risks, of doing business in the particular country,as they applied on that date" (paragraph 186)<br>• Potentially consistent with Option 3 |

Sources: ICSID Case No. ARB(AF)/09/1; ICSID Case No. ARB/10/19; ICSID Case No. ARB/07/27; ICSID Case No. ARB/10/5.

3. **CDS (Credit default swap) spreads:** this method is similar to a sovereign yield spread approach. A sovereign CDS spread represents the premium (in basis points) paid on insurance against the default of a particular company or sovereign entity, above the premium paid in insurance against the default of the base country's debt (usually the United States).
4. **Volatility of local stock market:** this method derives a country risk premium by comparing the volatility of the local market (in hard currency terms) to the volatility of developed stock markets.
5. **Credit rating regression analysis:** this method uses statistical analysis to derive a relationship between credit ratings and expected (or required) returns to equity investors.

One observation on the different methods we have described is that they can lead to very different estimations of the country risk premium. Further, in arbitration, the perceived chance of expropriation is often considered as a particularly important component of country risk. However, the statistics resulting from the methods described may or may not be correlated with a state's propensity to expropriate. As a consequence, not only is it difficult to arrive at any consensus on the calculation of an appropriate country risk premium, it is even more challenging to attempt to isolate one aspect of country risk (such as the chance of expropriation).

## CONCLUSION

The choice of discount rate can have significant effects on valuations and, consequently, on the awards rendered by tribunals. Differing opinions regarding to what extent, and how, discount rates should be adjusted for country risk can lead to particularly large differences in value. The divergent views of experts on this topic is not surprising: it reflects a lack of consensus in academic analysis and also the difficulties in drawing conclusions from data observed in emerging markets.

At the same time, tribunals must consider whether they should include or exclude the effect of a state's perceived propensity to expropriate in their assessments of value. Whatever the right answer in principle, in practice it is very difficult to isolate the chance of expropriation in any measure of country risk. In the circumstances, it seems likely that country risk will continue to be a topic of debate for the foreseeable future.

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