Should Expropriation Risk Be Part of the Discount Rate?

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For many years, there seemed to be little difference between lawful and unlawful expropriations because, in both cases, tribunals would set reparations at the fair market value of the investment before the expropriation took place. In this article, I explore the handling of expropriation risk used by tribunals in cases of unlawful measures (which I call confiscation risk) so that reparations fulfils the Chorzów objective to ‘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’. I review five recent awards that have considered the issue of the exclusion of confiscation risk from the discount rate. Some tribunals have argued that confiscation risk should be extracted from country risk and excluded from the discount rate. New theoretical methods and estimation procedures will have to be devised to achieve that goal.

1 INTRODUCTION

In cases of lawful expropriation, Bilateral Investment Treaties (BITs) include provisions to determine compensation, often by reference to the fair market value (FMV) of the expropriated investment immediately before the expropriation took place.1 In cases of unlawful expropriations and violations of the fair and equitable treatment (FET) standards,2 ‘the assessment of the damages payable due to unlawful acts … is largely governed by customary international law’.3 In those cases, tribunals have relied on accepted principles of international law as set forth in

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2 Henceforth I will use the expression ‘unlawful expropriation’ to refer to both unlawful expropriation and violations of the FET standards.
3 Sergey Ripinsky & Kevin Williams, Damages in International Investment Law 48 (BIICL 2008).

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the Factory at Chorzów (‘Chorzów’) case\(^4\) and the International Law Commission (ILC) Articles on State Responsibility\(^5\) to hold the sovereign to a higher standard of compensation than in the case of lawful expropriations. Those principles maintain that it is not enough to compensate by awarding monetary damages equivalent to the FMV of the confiscated property at the time of the taking; instead, claimants are entitled to full reparation. Indeed, as the tribunal in Chorzów stated, it means that the compensation:

> ...is not necessarily limited to the value of the undertaking at the moment of dispossession, plus interest to the day of payment. This limitation would only be admissible if the Polish Government had had the right to expropriate, and if its wrongful act consisted merely in not having paid to the two Companies the just price of what was expropriated; in the present case, such a limitation ... would be tantamount to rendering lawful liquidation and unlawful dispossession indistinguishable in so far as their financial results are concerned. (emphasis added)\(^6\)

For many years, there seemed to be little concrete difference between lawful expropriation and unlawful measures because in the latter case, tribunals would still set the reparation at the FMV of the expropriated investment before the expropriation occurred.\(^7\) This state of affairs started to change a decade ago when the Vivendi tribunal posited that the higher standard of compensation required in the case of unlawful measures ‘permits, if the facts so require, a higher rate of recovery than that prescribed’ in the case of lawful expropriations.\(^8\) The tribunal in Siemens A. G. v. Argentine Republic affirmed that ‘under customary international law, Siemens is entitled not just to the value of its enterprise on the date of expropriation, but also to any greater value that enterprise has gained up to the date of this Award, plus any consequential damages’.\(^9\) A recent award is more categorical in stating that ‘conflating the measure of damages for a lawful taking with the measure of damages for an unlawful taking is, on its face, an unconvincing option’.\(^10\)

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4. ‘That reparation must, so 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, the award, if need be, of damages for the loss sustained which would not be covered by restitution in kind or payment in place of it: such are the principles which should serve to determine the amount of compensation due for an act contrary to international law.’ Factory at Chorzów (Germany v. Poland), Merits, Judgment, PCIJ (Ser. A) No. 17 (13 Sept. 1928) 47.


6. Chorzów, supra n. 4, at 47.


In this article, I explore how tribunals have handled expropriation risk in cases of unlawful expropriations (which I call confiscation risk) in an attempt to ‘wipe out all the consequences of the illegal act and re-establish[es] the situation which would, in all probability, have existed if that act had not been committed’. In the next section, I provide an overview of the Discounted Cash Flow (DCF) method to provide a framework for the discussion of the impact of the choice of parameters. In the third, I review five recent awards that have considered the issue of the exclusion of confiscation risk from the discount rate. They cover the period of systematic expropriations in Venezuela (2005–2010); they were dispatched within six months of each other; awarded significant damages and the tribunal’s opinion seemed to differ on the issue of the appropriateness of factoring country risk – particularly expropriation/confiscation risk – into the DCF valuation. The last section offers some conclusions.

2 QUANTUM AND THE DISCOUNT RATE

‘A loss of investment is inherent in the notion of expropriation' and the value of an investment is intrinsically related to the generation of future uncertain net incomes. Forecasting such net incomes on the basis of information available is, ‘in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal’. The DCF method is forward looking: it determines the value of an investment by forecasting likely revenues and costs and discounting their difference (the expected future net cash flows) to the present. The choice of the appropriate discount rate is a central concern of the DCF method because its impact on the quantum of damages can be substantial: the larger the discount rate, the smaller the net present value of net cash flows.

Predictably, the rate of growth of net cash flows is also an essential determinant of the value of an asset, but the interaction between the two variables may be counterintuitive: far from offsetting each other, the higher the rate of growth of net cash flows, the more reactive the valuation to changes in the discount rate (see Figure 1).

11 Chorzów, supra n. 4, at 47.
12 Ripinsky & Williams, supra n. 3, at 13.
13 IRS Rev. Rules 59–60, para. 3.03. Referring to valuing the stock of closely held corporations, or the stock of corporations where market quotations are not available.
14 Even though it depends on the particulars of the case, an increase in the WACC from 10% to 25% may represent a decrease of 55% to 80% in the FMV.
The discount rate has to reflect the fact that a firm can finance its operations (including investments) with either equity or debt. The Weighted Average Cost of Capital (WACC) measures the cost to the firm of funding its investments with a mixture of those two types of financing; it combines the cost of borrowing with the rate of return that investors demand given the riskiness of the cash flow stream. The Capital Asset Pricing Model (CAPM) posits that the cost of equity should be equal to the expected return on risk-free securities (e.g. government bonds) plus a risk premium equal to the sensitivity of the expected return of that asset to the expected market return ($\beta$) multiplied by the market risk premium. Some valuation analysts add a country risk premium to reflect the non-diversifiable risk of operating in a given country. The measure often used for country risk is the sovereign default risk measured by Moody’s and Standard & Poor’s bond ratings. That spread combines the impact of different influences: global economic

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conditions, country-specific economic factors, liquidity of the country’s bond, and political risk, which reflect (among others) expropriation and confiscation risk. Recent awards have considered the argument that confiscation risk (the risk of an unlawful measure) should not be a component of the discount rate because its inclusion provides inappropriate incentives: increases in the number of unlawful measures raise country risk, thus increasing the discount rate and decreasing the value of expropriated assets. In other words, it becomes a mechanism for the sovereign to buy on the cheap. For example, the tribunal in *Flughafen Zürich A.G. y Gestión e Ingeniería IDC S.A. v. República Bolivariana de Venezuela* stated that ‘[a] State which increases country risk through the adoption of new political attitudes adopted after the investment materialized cannot benefit from a wrongful act attributable to it, to reduce the compensation payable’.

3 FIVE RECENT AWARDS: A BRIEF ANALYSIS

This section highlights some of the facts surrounding the awards in five recent cases that deal with these issues. I emphasize the sections of the awards relevant to the discussion.

3.1 GOLD RESERVE INC. v. BOLIVARIAN REPUBLIC OF VENEZUELA

The underlying dispute concerned the expropriation of Canadian mining company Gold Reserve’s interests in two mining projects in south-eastern Venezuela bound by the Brisas Concession (near-surface gold resources in a 500-hectare property) and the Unicornio Concession (rights to the hard rock mineralization underlying the Brisas Concession). Taken together, the two concessions form the Brisas Project. On 18 April 1988, the Brisas Concession was granted to a Venezuelan company which was acquired by Gold Reserve de Venezuela in November 1992.

The claimant alleged that, in March 2007, Venezuela began the expropriation of the Brisas Project by refusing to sign an Initiation Act required for authorized activity to commence. The respondent objected that the signing of the Initiation

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19 The original text in Spanish states, ‘Un Estado que a través de la adopción de nuevas actitudes políticas, adoptadas tras haberse materializado la inversión, incrementa el riesgo país, no puede beneficiarse de un acto ilícito que le es imputable, para reducir la compensación a pagar.’ *Flughafen Zürich*, supra n. 18, para. 905.
20 *Gold Reserve Inc. v. Bolivarian Republic of Venezuela*, ICSID Case No. ARB(AF)/09/1, Award (22 Sept. 2014).
Act was subject to the Administration’s discretion and that its refusal was motivated by environmental considerations. In April 2008, the government revoked the construction permit for reasons of public order; in May 2009, it terminated the Brisas Concession; in October 2009, it seized the claimant’s assets and occupied the site of the Brisas Project; and in June 2010, it terminated the Unicornio Concession.23

In October 2009, Gold Reserve initiated arbitration proceedings under ICSID’s (International Centre for Settlement of Investment Disputes - World Bank) Additional Facility Rules with reference to the Canada-Venezuela BIT. The tribunal concluded that Venezuela had breached the BIT’s FET provisions24 so egregiously that the compensation for such breaches had to reflect the seriousness of the violation.25

3.1[a] Quantum

The parties agreed, and the tribunal concurred, that the appropriate measure of damages was FMV and that April 2008 (when the Government of Venezuela declared the absolute nullity of the construction permit26) was the appropriate valuation date.27 Both valuation experts used the DCF method as their main method to assess damages,28 even though the claimant used the comparable transactions and market capitalization methods as well.

The DCF calculation was contingent on three types of parameters: the size of the reserves (and thus pit shape and design, the need for a buffer zone, the impact of stockpiling, and likely delays for obtaining permits); production rates (and thus metallurgical issues including ramp up, mill capacity, and metal recovery rates and concentrate grades); and financial issues (appropriate FMV methodology, metal prices, inflation rates, discount rates, delays in receiving revenues, and fuel and electricity costs).

On most of the issues related to the size of reserves, the tribunal sided with the claimant,29 except for the issue of a delay in the beginning of operations to obtain

23 Ibid., para. 26–28.
24 Ibid., para. 564.
25 Ibid., para. 615.
26 Ibid., para. 24.
27 Ibid., para. 681.
28 Ibid., para. 690.
29 Pit shape (Gold Reserve, supra n. 20, para. 709); ramp location (ibid., para. 711); buffer zone (ibid., para. 730); stockpiles (ibid., para. 758), even though the tribunal added an additional USD 28 million deduction (ibid., para. 762); oxidation (ibid., para. 765); mineral reserves (ibid., para. 777).
additional approvals\textsuperscript{30} and whether additional resources ought to be included.\textsuperscript{31} The tribunal also sided with the claimant on most of the metallurgical issues,\textsuperscript{32} except for the issue of recovery rates and concentrate grades where the tribunal found the respondent’s arguments more convincing.\textsuperscript{33}

Estimates of the FMV varied widely: \$1.374 billion for the claimants’ no-layback valuation,\textsuperscript{34} and zero in the respondent’s case. On most of the financial issues, the tribunal sided with the claimant.\textsuperscript{35} The claimant’s expert estimated that the discount rate ought to be 8.22%, while the respondent claimed it was between 16.5% and 23.8%.\textsuperscript{36} Most of the difference between those two estimates was attributable to the country risk premium included in the cost of equity: 1.5% in the claimant’s case and between 6.7% and 16.4% in the respondent’s. The tribunal deemed that the respondent’s rate:

was based on both full and ‘generic’ country risk … [and] thus took account of Venezuela’s policies at the time, including the President’s policy of ousting North American companies from the mining sector, thus increasing the risk significantly\textsuperscript{37}

but considered that:

it is not appropriate to increase the country risk premium to reflect the market’s perception that a State might have a propensity to expropriate investments in breach of BIT obligations.\textsuperscript{38} (emphasis added)

The tribunal found the respondent’s expert’s country risk premia to be too high because they included ‘some element reflective of the state policy to nationalize investments’ and found the claimant’s expert’s estimation of country risk too low because it only reflected labour risks and ignored other genuine risks that should have been considered, ‘including political risk other than expropriation’.\textsuperscript{39}

The tribunal’s attempt to extract confiscation risk from expropriation risk raises complex technical questions, as well as interesting conceptual issues. Damages are usually to be estimated as the FMV of the concern just before the

\textsuperscript{30} Ibid., para. 772.
\textsuperscript{31} Ibid., para. 780.
\textsuperscript{32} Ramp up rates (ibid., para. 790); mill capacity (ibid., para. 792).
\textsuperscript{33} Ibid., para. 814.
\textsuperscript{34} The claimant asserted it had acquired rights on a dozen parcels in April 2008 to use for infrastructure and services (ibid., para. 276). The tribunal ruled that the claimant had no rights to a North Parcel that would have allowed the claimant to extend or layback the pit into that parcel (ibid., para. 492).
\textsuperscript{35} Metal prices (ibid., para. 836); inflation (ibid., para. 838).
\textsuperscript{36} Ibid., para. 839.
\textsuperscript{37} Ibid., para. 840.
\textsuperscript{38} Ibid., para. 841.
\textsuperscript{39} Ibid., para. 841.
contested measures occurred or were known about. The internationally recognized definition of FMV is:

The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm’s length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

FMV (a hypothetical measure) should include the risk of lawful expropriation not only before the investment was made but even before the lawful expropriation took place in the same manner that it should include other types of risk. The actually observed market value of an asset reflects, among other things, the risk of unlawful state conduct as well as the risk of lawful expropriations; thus the market value of an asset is smaller than its payoff.

To determine the appropriate country risk premium, the tribunal considered various estimates used by analysts in 2008 and decided on a value of 4%, which implied a cost of equity of 11.92%, and a WACC of 10.09%. The country risk premium value used by the tribunal (4%) was 1.87% higher than the discount rate used by the claimant. This resulted in a reduction of USD 130 million in the value of the DCF. The tribunal accepted the claimant’s estimates of the other components of the cost of equity (equity market risk premium and beta) as well as of the cost of debt.

On the remaining financial issues, namely, capital and operating costs, revenue receipt delays, and fuel and electricity costs, the tribunal accepted the claimant’s estimates, which it found to be methodologically well-founded and conservative. The resulting quantum of damages was determined to be USD 713.03 million.

3.2 *Venezuela Holdings B.V., Mobil Cerro Negro Holdings Ltd., Mobil Venezolana de Petróleos Holdings Inc., Mobil Cerro Negro Ltd., and Mobil Venezolana de Petróleo Inc. v. Bolivarian Republic of Venezuela*.

The claimants alleged that Venezuela took a number of direct and indirect expropriative actions between 2001 and 2008 against two projects they were
involved in (Cerro Negro, a project to exploit extra-heavy crude, and La Ceiba, a project to explore and exploit an area with light and medium crude), ultimately culminating in expropriation.

In approximate chronological order, the actions included:

- unilaterally terminating the Cerro Negro Royalty Reduction Agreement and the Cerro Negro Royalty Procedures Agreement and increasing the royalty rate (2004–2005);
- increasing the income tax rate applicable (2006);
- imposing production and export curtailments (2006–2007); and finally
- directly expropriating Mobil Cerro Negro’s and Mobil Venezolana’s entire interests in mid-2007.46

The claimants initiated an arbitration under ICSID rules in September 2007 contending that the respondent wrongly expropriated their investments,47 failed to accord them FET,48 and took arbitrary and discriminatory measures that impaired the operation, management, use, enjoyment, or disposal of the investments,49 all in breach of the Netherlands-Venezuela BIT, and were thus entitled to *restitutio in integrum*.50

In the case of the Cerro Negro Project, the claimants argued that damages consisted of (1) the damages sustained as a consequence of the measures taken before the expropriation, plus (2) the loss of interests in that project, as a going concern, as a consequence of the expropriation. Given that the value of the lost interest in the Project had increased since the expropriation, the claimants contended that they were entitled to the FMV as of the date of the Award, about USD 14.5 billion.51 In the case of the investments at La Ceiba, the claimants considered that damages were properly measured by the value of the claimant’s actual investment, approximately USD 179 million.

Venezuela contended that the pre-migration measures did not violate the treaty and that the expropriation was lawful so the indemnity to be paid was the market value of the investment as of the date of the expropriation, which it estimated at USD 353.5 million.52

The tribunal ruled that it had jurisdiction over the four previously mentioned actions, except for the second one: the dispute about the increase in the income

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46 Ibid., para. 86.
47 Ibid., para. 128.
48 Ibid., para. 129.
49 Ibid., para. 130.
50 Ibid., para. 132.
51 Ibid., para. 133.
52 Ibid., para. 146.
As for the claimants’ first claim relating to the extraction tax, the tribunal rejected the allegations that the FET standard had been breached or that the claimants had been treated in an arbitrary or discriminatory manner. In the case of the third claim, the production and export curtailments that started in November 2006, the tribunal concluded that Venezuela had breached the FET standard and awarded damages amounting to USD 9 million. Finally, on the fourth claim, the direct expropriation of Mobil Cerro Negro’s and Mobil Venezolana’s entire interests, the tribunal ruled that it was lawful.

3.2 Quantum: Direct Expropriation

Having judged the expropriation to be lawful, the tribunal referred to Article 6(c) of the Netherlands-Venezuela BIT to rule that the compensation ought to represent the market value of the investments affected immediately before the measures were taken or the impending measures became public knowledge, whichever is the earlier and determined that it was to be calculated on 27 June 2007. Both parties agreed that damages should be estimated using the DCF method over the remaining life of the investment but disagreed on both the amount of the cash flows and on the discount rate to be used.

3.2 Net Cash Flows

In determining net cash flows, the tribunal adjudicated a number of issues relating to production volumes, oil prices, future revenues, operating expenses, and inflation adjustment of income taxes.

The claimants had argued that while ‘the initial production facilities were designed to produce 120,000 barrels per day, they retained the right to expand this amount … [and submitted] that, by applying thermal EOR (enhanced oil recovery) techniques, improving existing facilities and constructing a second upgrader, they would have produced 344,000 barrels of extra-heavy oil per day as soon as 2014.’ The tribunal denied the claimants’ argument because the expansion

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54 Ibid., para. 247.
55 Ibid., para. 248.
56 Ibid., para. 264.
57 Ibid., para. 306.
58 Ibid., para. 307.
59 Ibid., para. 308.
60 Ibid., para. 310.
The project would have required extending existing facilities and the maritime terminal, an unlikely occurrence given that a previous debottlenecking project to increase production 20% had been abandoned in 2004 when the authorities required a higher royalty rate. Furthermore, the project to increase production to 344,000 barrels a day would have required the approval of the Venezuelan authorities and, ‘in view of the position taken by the Administration in 2004 and 2005, such approval could not have been taken for granted by a prospective buyer in 2007’ so the tribunal decided to assume that production would not have increased. This is an example of what Borzu Sabahi and Diora Ziyaeva have called the negative side of Chorzów: the fact that ‘in developing a counter-factual or “but for” scenario as contemplated by the Chorzów Factory case, one must take into account the risk that a Government could impose new taxes on the investment’ a behaviour that is not necessarily supportive of investors’ interests.

The parties also agreed on the method to forecast the price of oil but disagreed on the value of the parameters. The tribunal sided with the claimants’ expert, because it appeared ‘that the forecast of WTI prices made by the [respondent’s expert] is based on data which, to some extent, no longer correspond to the situation as it was at the end of June 2007’ (the date of the taking) thus disavowing the use of hindsight.

3.2[c] Discount Rate

Regarding the discount rate, the tribunal observed that the major point of disagreement between the parties was how to estimate country risk. In particular, the parties disagreed as to whether the risk of uncompensated expropriation or confiscation risk should be excluded from the discount rate used to calculate the appropriate compensation due in the case of an expropriation.

The claimants submitted that a ‘valuation of the expropriated property that complies with the Treaty cannot include the risk that the property might be expropriated later without the compensation required by the Treaty’ – the confiscation risk – while it can incorporate other risks. The respondent contended ‘that the risk of taxation, regulation and expropriation are essential to the country risk of the investment and must be accounted for in determining the appropriate discount rate and the appropriate compensation in the case of expropriation’.

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61 Debottlenecking is the process of identifying areas and/or equipment in oil and gas facilities that limit the flow of product and modifying them so that overall capacity increases.
62 Mobil Cerro, supra n. 45, para 317.
63 Ibid., para. 320.
65 Mobil Cerro, supra n. 45, para. 328.
66 Ibid., para. 364.
risk and must be taken into consideration in the determination of the discount rate. The tribunal sided with the respondent, arguing that a hypothetical buyer willing to acquire the investment before the expropriation (or before the knowledge of an expropriation) would require a higher return to compensate for the risk of expropriation and thereby determining his or her willingness to pay. The tribunal thus considered that the risk of (lawful) expropriation is an integral part of country risk and therefore that it must be taken into account in the determination of the discount rate. It did not provide a method to estimate expropriation risk but referred to the estimates of other tribunals, in particular, the award in a parallel contract-based International Chamber of Commerce (ICC) arbitration which used an 18% discount rate. That rate excluded production risks (e.g. episodes of civil unrest, major unplanned outages due to accidents or equipment failures, and the possibility of Organization of the Petroleum Exporting Countries (OPEC) curtailments) which were taken into account directly when forecasting the volume of production. The tribunal awarded USD 1,411.7 million in damages, net of any Venezuelan tax and 3.25% post-award interest rate.

3.3 TIDEWATER INVESTMENT S.R.L. AND TIDEWATER CARIBE C.C. V. BOLIVARIAN REPUBLIC OF VENEZUELA

The Tidewater group, a US company founded in 1956 to supply marine transportation services in the Gulf of Mexico, began operations in Venezuela two years later, through a company called SEMARCA (Tidewater Marine Service, C.A. known as SEMARCA). It operated continuously for more than fifty years, providing services to Venezuela’s national oil company, Petróleos de Venezuela, S.A. (PDVSA), and some of its subsidiaries, Corporación Venezolana del Petróleo S.A. (CVP), PDVSA Petróleo, S.A. (PDVSA Petróleo) and PetroSucre, S.A. (PetroSucre). While its operations were originally confined to Lake Maracaibo, in the late 1990s they expanded to offshore locations, including in the Gulf of Paria. SEMARCA did not have a general concession contract with PDVSA or its subsidiaries; rather, it operated on a running account basis by means of short-term charter agreements providing services in both Lake Maracaibo and the Gulf of Paria.

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67 Ibid.
68 Ibid., para. 365.
71 The oil industry in Venezuela was nationalized in 1975.
Between February 2008 and February 2009, world oil prices fell by almost 60%, making it difficult for PDVSA to meet its payment obligations. By mid-2009, Tidewater’s Annual Report recorded that SEMARCA had accounts receivable of approximately USD 40 million. On 7 May 2009, the Government of Venezuela enacted a law reserving the assets and services related to primary activities of hydrocarbons to the State (‘Reserve Law’). The following day, the claimants were informed that they were subject to the Reserve Law and SEMARCA’s assets on Lake Maracaibo were seized, including its headquarters and eleven vessels. SEMARCA continued to provide services to PetroSucre in the Gulf of Paria until 12 July 2009 when four vessels were seized. The respondent accepted that it expropriated the claimants’ assets and that it was obliged to pay compensation for those expropriations. Therefore, the tribunal focused on three issues: the scope of the expropriation, its lawfulness, and the proper quantum of compensation.

3.3[a] Scope of the Expropriation

The claimants argued that Venezuela had expropriated directly valuable tangible assets belonging to them and expropriated indirectly SEMARCA, depriving them of a business with a fifty-year history of proven profitability. The respondent acknowledged that it had (directly) expropriated the claimants’ vessels, offices, and the short periods remaining in two contracts with PDVSA Petróleo72 but argued that the claimants remained the legal owners of the shares in SEMARCA after the enactment of the Reserve Law and that the company continued to operate, receive payments, and negotiate contracts. Thus, the respondent claimed ‘that, in the absence of a property right owned by SEMARCA being taken, there can be no indirect expropriation. In other words, the claimants cannot make an expropriation claim for rights or interests that the claimants never had’.73 This turned out to be a crucial legal question for determining damages.

The tribunal found contemporaneous evidence from Venezuelan courts that supported the conclusion that SEMARCA had been effectively nationalized, not only its physical assets. Indeed, a court had ruled that ‘the corporate entity Tidewater Marine Service Compañía Anónima, also known as SEMARCA, has become a part of the State of Venezuela, this being a matter of public knowledge within the country’.74 Thus, the tribunal decided that the claimants could not have exercised effective control over SEMARCA and that the effect of the respondent’s measures was the expropriation of the claimants’ investment in SEMARCA.

72 A towing contract and a supply contract. *Tidewater*, supra n. 70, para. 39.
While both parties agreed that the expropriation was for a public purpose related to the internal needs of Venezuela, they disagreed on whether it was lawful – the difference being whether in the first case ‘fair compensation represented by the value of the undertaking at the moment of dispossession and reparation in case of unlawful expropriation is restitution in kind or its monetary equivalent’.75

Venezuela argued that it had not sought to expropriate without compensation. The Reserve Law actually did contemplate compensation but the claimants argued that the expropriation was unlawful because the law limited the compensation to the book value of the assets and explicitly prohibited taking into account lost profits or indirect damages. This was inconsistent with the standard of compensation as defined by the BIT to be the market value of the investment expropriated immediately before the expropriation. The tribunal considered that ‘the Treaty standard of “market value” does not denote a particular method of valuation. The appropriate method of valuation depends upon the context. In some cases, the appropriate valuation may indeed be the book value of the assets’.76 The tribunal determined that the expropriation was lawful.

3.3[b] Quantum

Having deemed the expropriation to be lawful, the tribunal applied the standard of compensation enunciated in the BIT to calculate damages, that is, the FMV of the investment expropriated immediately before the expropriation, and it endorsed the use of the DCF method to assess the value of the claimants’ investment because it was a going concern with a proven track record of profitability for at least five years.77 The tribunal stipulated that this type of valuation is commonly referred to as an \textit{ex ante} valuation, but it does not mean that the valuation is unconcerned with future prospects because:

the Tribunal is not required to shut its eyes to events subsequent to the date of injury if these shed light in more concrete terms on the value applicable at the date of injury or validate the reasonableness of a valuation made at that date.78

The purpose of referring to subsequent events is not to present a hypothetical business that never in fact occurred and would not reasonably have been taken into account by a willing buyer prior to expropriation. Rather, it is permitted in cases where such events shed more light in concrete terms on the value of the

\begin{itemize}
\item \textit{Bid.}, para. 142.
\item \textit{Tidewater}, supra n. 70, para. 148.
\item For a more thorough analysis of the notion of going concern and its limitations, see José Alberro & George D. Ruttinger, \textit{Going Concern As a Limiting Factor on Damages in Investor-State Arbitrations}, 2 J. Damages Int’l Arb. (2015).
\item \textit{Tidewater}, supra n. 70, para. 160.
\end{itemize}
investment prior to expropriation. In assessing the value of the business at that date, the tribunal disregards business prospects that it considers to be too remote or speculative to justify inclusion.\textsuperscript{79}

In view of the significant differences between the parties’ valuations, the tribunal resorted to its own calculations and considered six variables that materially affected the quantum: scope of business; accounts receivables; historical cash flow; equity risk; country risk; and business risk.\textsuperscript{80}

In the first case, the core issue was whether, in addition to the fifteen ships used to support PDVSA and that were seized in July 2009, two ships contracted to Chevron in an exploratory drilling project had to be considered. The tribunal ruled that the Chevron contract would have been unlikely to reoccur in the future and thus could not be ‘treated as an ordinary part of SEMARCA’s operations for the purpose of valuing’ it.\textsuperscript{81} On the matter of the accounts receivable, the tribunal agreed with the claimants that they had to be included even though the respondent’s counsel had instructed its expert to exclude them on the basis that they had not been expropriated and the claimants were free to try to collect them. Regarding which cash flows to include in the valuation, the point of contention was whether fiscal year 2009 should be included given that, according to the respondent, it was exceptional in terms of profitability. Again, the tribunal sided with the claimants because it considered that all available information would have been considered by a willing buyer in view of the volatility of the oil industry.\textsuperscript{82} The tribunal sided with the respondent on the issue of the proper equity risk premium, arguing that the claimants’ expert had not used the most reliable primary data.

3.3\textsuperscript{[c]} Country Risk Premium

The tribunal found that the greatest difference between the estimates of the discount rate was the country risk premium: the claimants’ expert had adopted a country risk premium of 1.5%, while the respondent’s expert had adopted 14.75%. The claimants argued that political risk ought to be excluded from country risk to prevent a state from benefiting from its misdeeds.\textsuperscript{83} The tribunal rejected the argument and considered that the claimants’ expert had conflated two separate elements in the legal claim: whether or not there was liability\textsuperscript{84}; and how to calculate compensation if liability was found. Furthermore, it ruled that a BIT ‘is

\textsuperscript{79} Ibid., para. 161.
\textsuperscript{80} Ibid., para. 169.
\textsuperscript{81} Ibid., para. 172.
\textsuperscript{82} Ibid., para. 179.
\textsuperscript{83} Ibid., para. 183.
\textsuperscript{84} Ibid., para. 184.
not an insurance policy or guarantee against all political or other risks associated with such investment \(^{85}\) and that it does not prohibit the state from expropriating private property; it only requires the expropriation to be for a public interest and to be accompanied by compensation.

At the quantum stage, the tribunal had to ascertain the amount that a willing buyer would pay for the investment immediately before the expropriation, taking into account the risk associated with such cash flow under realistic circumstances. In other words, the tribunal had to consider the risk associated with investing in that particular country, a risk not directly correlated with the measure that gave rise to the claim, particularly because the market value should be calculated immediately before the taking, assuming that the willing buyer had no specific information about what is about to happen. Including expropriation risk in country risk is not a matter of allowing a respondent state to profit from its wrongdoing; it is, rather, a matter of abiding by the definition of market value. In this context, a wrongdoing is an unlawful measure. The tribunal ruled that it is appropriate to include a country risk premium that quantifies the general risks, including political risks, of doing business in the particular country, as it was reasonable to expect before the expropriation. The tribunal opted for a country risk premium of 14.75% proposed by Venezuela.

3.3[d] Business Risk

The respondent wanted the value of SEMARCA to be further reduced by 25% to take into account ‘the significant risk arising from its concentration on a single customer: PDVSA and its subsidiaries’.\(^{86}\) The tribunal was not swayed by the argument because the testimony of the PDVSA manager responsible for relations with private contractors indicated that it was likely that PDVSA would continue to need support services for the foreseeable future as evidenced by the fact that Venezuela had expropriated SEMARCA’s vessels for reasons of public interest. The tribunal did not consider that a willing buyer would have required a discount for the risk of loss of the business to its customer.\(^{87}\)

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\(^{85}\) Ibid.

\(^{86}\) Ibid., para. 192.

\(^{87}\) Ibid., para. 196.
3.4 FLUGHAFEN ZURICH A.G. Y GESTIÓN E INGENIERÍA IDC S.A. V. REPÚBLICA BOLIVARIANA DE VENEZUELA

The International Airport of the Caribbean Santiago Mariño located on Margarita Island is the second largest in Venezuela. In the 1990s, its management was transferred to the State of Nueva Esparta. In 1993, the state entrusted its management and administration to a Venezuelan private company, but eight years later the concession was rescinded and the government resumed direct management. In February 2004, the government of Nueva Esparta adjudicated the provision of the airport’s public service for twenty years to a consortium formed by IDC and Flughafen Zürich. A new governor the State of Nueva Esparta was elected in November 2004 and on 10 June 2005, he rescinded the contract. Three days later the police force took control of the airport. The consortium obtained a restraining order and took back the administration of the airport on 21 July 2005. After several more changes of control, on 30 December 2005, the Nueva Esparta Government took control of the airport with the help of the armed forces; in March 2009, the National Government took over the administration of the airport.

The tribunal opined that Venezuela breached Article 6 of both BITs prohibiting taking measures of expropriation or nationalization of investments protected by the treaties and considered that it was a direct expropriation. The tribunal also considered that it was an unlawful expropriation and that Venezuela committed a denial of justice to the detriment of the claimants.

3.4[a] Quantum

The claimants demanded as compensation the FMV of the investment on the date of the taking (30 December 2005) calculated with the DCF method, and the tribunal agreed. The tribunal identified two important variables to explain the differences in the damages valuation offered by the two sides: passenger traffic and

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88 Flughafen Zürich A.G. y Gestión e Ingeniería IDC S.A. v. República Bolivariana de Venezuela, ICSID Case No. ARB/10/19, Award (18 Nov. 2014).
89 Ibid., para. 57.
90 Ibid., para. 58.
91 Ibid., para. 68.
92 Ibid., para. 84.
93 Ibid., paras 103–107.
94 Ibid., paras 495–497.
95 Ibid., para. 529.
96 Ibid., para. 721.
97 Ibid., para. 786.
discount rate. Operating expenses also had a significant effect on damages and the tribunal sided with the claimant.

3.4[b]  Passenger Traffic

The experts of the two parties took opposite and incompatible positions: the respondent argued that historical figures should be used when available; the claimant contended that traffic should be determined on the basis of reasonable expectations held on the date of expropriation. The tribunal opted for the latter because it considered that the use of *ex post* information is inconsistent with the standard of compensation demanded by the BIT and customary international law. It determined that compensation should be the FMV immediately before the date of expropriation in the understanding that:

this value results from a hypothetical transaction between an independent buyer and an independent seller, who had access to all the relevant information available at that time, including historical data and forecasts about the future. Once the price is determined at that date, it is final and will not be affected by the fact that the forecast did or did not come true. The risk has been transferred to the buyer along with the thing – and that implies that *ex post* he made a ‘good’ or ‘bad’ acquisition. The same principle can also be expressed in more than financial terms. On the date of the expropriation, business risk is borne by the investor that is expropriated – and therefore he is paid the WACC. Starting on the date of the expropriation, the investor does not face business risk. He has been deprived of the company, and loses financial interest in it: if the company does well, the benefit is to the State, and if it goes wrong, it is the State who bears it. Therefore, since the investor does not face business risk, compensation from the date of expropriation does not accrue interests calculated with the WACC (which remunerates business risk), but merely at the accrued interest rate (which compensates for the delay in the payment of a financial debt).

The tribunal concluded that using actual operating results for the period 2006–2011 to carry out an *ex ante* valuation is a fundamental methodological error that cannot be overlooked because the airport was operated by third parties who were not the claimants after the expropriation. The fact that the airport’s actual results were disappointing is not the responsibility of the claimants and they cannot be used to reduce the valuation – in the same manner that the opposite, better-than-expected results could not be used to increase it. The relevant data are the reasonable expectations that an independent buyer would have had if it had valued the company on 30 December 2005. If, for example, expected Gross

\[98 \text{ Ibid., para. 818.} \]
\[99 \text{ Ibid., para. 849.} \]
\[100 \text{ Ibid., paras 852–854.} \]
\[101 \text{ Ibid., para. 855.} \]
domestic product (GDP) was a parameter used to value the investment, and a few years later there was an economic crisis so that GDP decreased and the expectations were not fulfilled, the tribunal ruled that the hypothetical price – and thus the compensation due because of the expropriation – could not be modified.102

3.4[c] Country Risk

The claimants argued that project risk was very small because an airport is a natural monopoly; damages were calculated in inflation-adjusted local currency eliminating currency risk; social risks were reduced by considering a 3% increase in real wages (equivalent to a 0.95% premium in the cost of equity); and legal, regulatory, and political risks should not be incorporated into the model, because these risks were controlled by the state and it should not be the case that a state increases risks under its control before an expropriation to significantly reduce the price to be paid.103

The tribunal considered that an investor choosing between a fully developed country and, alternatively, an emerging country, would choose the former unless the latter offers higher profit opportunity, and that the disadvantage of emerging countries is captured through the country risk premium. In 2004, investing in the management of an airport controlled by one of the states of the Bolivarian Republic of Venezuela implied an important legal, regulatory, and political risk. *Res ipsa loquitur*: a few months after the conclusion of the contract, a new governor came into power and the political and legal risks made it impossible for the normal development of the investment. The tribunal concurred with the claimants’ argument that a state that increases the country risk by adopting new political attitudes after an investment has materialized should not be able to benefit from an unlawful act that is imputable to it so as to reduce the compensation that it has to pay. But, the tribunal concluded this was not the case: when the claimants decided to invest in Nueva Esparta in 2004, the country risk already existed, and the investors were well aware of the existence of political and legal uncertainties. The political and regulatory risk existed before the investment was made and the tribunal concluded this risk could not have changed significantly in the short time during which the investors maintained their investment.104 The respondent argued that the country risk premium should be 7.9% and the discount rate 14.4% and the tribunal concurred.

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The dispute arose from the expropriation of the two largest plants producing glass containers in Venezuela. An expropriation decree was promulgated on 26 October 2010 and on that day the Bolivarian National Guard was sent to the plants owned by OI (Owens-Illinois Group, Inc.). Four years after the expropriation, no compensation had been paid. The tribunal found that the expropriation was unlawful and the BIT’s FET provisions had been breached.

3.5 Quantum

Both parties agreed that the compensation should equal the FMV of the investment on the date of the expropriation and the tribunal ruled that the DCF method should be used to calculate it. The claimant used a 20.39% discount rate while the respondent used 25.78%. Part of the difference was attributable to the different estimates of country risk: 2% for the former and 6% for the latter. The claimant’s expert argued that Venezuela’s policy of expropriation caused a generalized depreciation of Venezuelan companies, and that this global effect should be excluded from the model. He therefore proposed that the legal, regulatory, and political risks, which are controlled by the state, be excluded from the calculation of the discount rate.

While the tribunal agreed that repeated expropriations in Venezuela could have been perceived by investors as ‘negative messages’, it found that there was no evidence that those negative messages caused exactly a 4% increase in Venezuela’s country risk premium because the calculation methodology had not been provided and the reliance on external sources was not demonstrated. Thus, the tribunal set the country risk premium at 6%.

106 Ibid., para. 111.
107 Ibid., para. 153.
108 Ibid., para. 637.
109 Ibid., para. 649.
110 Ibid., para. 651.
111 Ibid., para. 659.
112 Ibid., para. 762.
113 Ibid., para. 777.
114 Ibid., paras 779–782.
SHOULD EXPROPRIATION RISK BE PART OF THE DISCOUNT RATE?

4 SHOULD THE DISCOUNT RATE INCLUDE EXPROPRIATION/CONFISCATION RISK?

In the five cases considered, the tribunals deemed that the proper way of estimating damages was to determine the FMV of the investment using the DCF method on the date of the taking and that the discount rate should include country risk.\textsuperscript{115} The tribunals also concurred that country risk combines several components whose contributions to the total are difficult to ascertain: macroeconomic risk (including a volatile economy); political risk other than expropriation risk (e.g. regulatory, legal, labour, and taxation risks); expropriation risk (reflecting the possibility of lawful expropriation); and confiscation risk (reflecting the possibility of unlawful expropriation).\textsuperscript{116}

The discount rate used by tribunals ranged from 10.09\% to 24.5\% and the tribunals used a variety of sources for their estimate of the country risk premium, which were quite different: a rate established in the related ICC case of \textit{Mobil Cero Negro}\textsuperscript{117}; Ibbotson-Morningstar in \textit{Tidewater} (14.75\%)\textsuperscript{118}; RBC Capital Markets Report in \textit{Gold Reserve} (4.0\%)\textsuperscript{119}; J.P. Morgan in \textit{Flughafen Zurich}\textsuperscript{120}; and Damodaran in \textit{OI} (6.0\%).\textsuperscript{121}

The tribunals agreed that expropriation risk should be part of the discount rate in the case of lawful expropriations and also seemed to agree that confiscation risk should not be part of the discount rate in the case of unlawful measures. In \textit{Flughafen Zurich}, the tribunal agreed with the claimant’s assessment that a state should not benefit from ‘new political attitudes’ adopted after an investment has materialized, if they lead to unlawful acts that increase country risk and reduce the compensation the state would have to pay. While agreeing to the general principle, the tribunal ruled that in this case the political and regulatory uncertainties present before the claimants decided to invest (and which must have been known to the investors) had not changed significantly in the short time during which the investors maintained their investment.\textsuperscript{122}

Similarly, in the \textit{Gold Reserve} case, the tribunal agreed with the claimant’s contention that:

\textsuperscript{115} The rates are often assumed to be constant through time, but need not be so.
\textsuperscript{116} \textit{Gold Reserve}, supra n. 20, para. 841; \textit{Flughafen Zurich}, supra n. 88, paras 799 and 903; \textit{Mobil Cero}, supra n. 69, paras 363–364; \textit{Tidewater}, supra n. 70, para. 73.
\textsuperscript{117} \textit{Mobil Cero}, supra n. 69, para. 367.
\textsuperscript{118} \textit{Tidewater}, supra n. 70, para. 189.
\textsuperscript{119} \textit{Gold Reserve}, supra n. 20, para. 842.
\textsuperscript{120} \textit{Flughafen Zurich}, supra n. 88, para. 899.
\textsuperscript{121} The awards do not offer information on the country risk premia for the other two cases.
\textsuperscript{122} \textit{Flughafen Zurich}, supra n. 88, paras 904–907.
it is not appropriate to increase the country risk premium to reflect the market’s perception that a State might have a propensity to expropriate investments in breach of BIT obligations … However, while the tribunal agreed in principle with the claimant’s position about excluding expropriation risk, it took issue with other aspects of the claimant’s calculation … the Tribunal also considered that the country risk premium adopted (by the Claimant) is too low, as it takes into account only labor risks and not other genuine risks that should be accounted for – including political risk, other than expropriation … The Tribunal therefore finds that the country risk premium should be increased to properly reflect the risks involved.123

Finally, in the OI European case, the tribunal agreed that Venezuela’s reiterated expropriations could be perceived by investors as negative messages in the business environment, but affirmed that the claimant had not proved that those negative messages did provoke an increase in the country risk premium.

Thus, the tribunals accepted the argument that a state should not be able to benefit from an unlawful measure and, therefore, the country risk premium should exclude the risk of unlawful expropriation – which I have called confiscation risk to differentiate it from expropriation risk. The tribunals determined that the other components of country risk should be part of the return to equity and had trouble finding a consistent method and data base to estimate expropriation/confiscation risk.124

5. CONCLUSION

Tribunals are increasingly incorporating into their awards compensation standards that are different depending on whether the government actions (e.g. expropriation) are considered to be lawful or not. This has raised theoretical complexities from an economic point of view and significant estimation problems. Table 1 presents some of the salient characteristics of the awards considered in this article, all of which determined that the proper way of estimating damages was to determine the FMV of the investment using the DCF method. While the claimants consistently argued that the expropriation risk should be excluded from the discount rate, the tribunals’ decisions depended on whether the expropriation was lawful or not. New theoretical methods and estimation procedures will have to be devised to achieve that goal.

123 Gold Reserve, supra n. 20, para. 841.
124 Country risks were calculated using different methods which intended to capture the risk associated with a country as a whole. The particular risk of expropriation faced by an investor in a particular industry is incorporated in the beta parameter used to calculate the cost of equity. Alternative valuation methods which capture risk on the level of cash flows can also be used.
### Table 1 Five Recent Awards: Characteristics

<table>
<thead>
<tr>
<th></th>
<th>Gold Reserve</th>
<th>Flughafen Zürich</th>
<th>Oi European B.V.</th>
<th>Mobil-Cerro Negro</th>
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<tbody>
<tr>
<td><strong>Date of dispatch</strong></td>
<td>September 2014</td>
<td>November 2014</td>
<td>March 2015</td>
<td>October 2014</td>
</tr>
<tr>
<td><strong>Valuation date</strong></td>
<td>April 2008</td>
<td>December 2005</td>
<td>October 2010</td>
<td>June 2007</td>
</tr>
<tr>
<td><strong>Award</strong></td>
<td>USD 713.0 million</td>
<td>USD 19.4 million</td>
<td>USD 372.5 million</td>
<td>USD 1.4 billion</td>
</tr>
<tr>
<td><strong>Lawful Violation FET</strong></td>
<td>NO</td>
<td>NO</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>Expropriation/Confiscation risk</td>
<td>EXCLUDE</td>
<td>EXCLUDE**</td>
<td>EXCLUDE**</td>
<td>INCLUDE</td>
</tr>
<tr>
<td><strong>Discount rate</strong></td>
<td>Claimant: 8.22% 4.6% 20.4% 8.7% 6.96%</td>
<td>Defendant: 16.5–23.8% 14.4% 25.8% 18.5–23.9% 24.57%</td>
<td>Tribunal: 10.09% 14.4% 23.0% 18.0% ≈ 24.5%</td>
<td></td>
</tr>
<tr>
<td><strong>Country risk</strong></td>
<td>Claimant: 1.5% 2.0%</td>
<td>Defendant: 6.7–16.4% 7.9% 6.0% 14.75%</td>
<td>Tribunal: 4.0% 7.9% 6.0% 14.75%</td>
<td></td>
</tr>
</tbody>
</table>

* I consider this FET violation as an unlawful measure because the tribunal concluded that Venezuela’s breaches of the BIT’s FET provisions were so egregious that the compensation had to reflect the seriousness of the violation.

** The tribunal agreed on the principle but disagreed on the estimate.