Kluwer Arbitration Blog

The Venezuela Awards: Dealing with Expropriation Risk

Samuel Weglein, Todor Stoyanov, Ellie Liu (Analysis Group) · Wednesday, October 9th, 2019

This post analyses a series of ICSID arbitration awards against Venezuela since 2014 to understand a pressing concern in many investment arbitrations today: how to deal with the risk of expropriation in quantum calculations. Getting this right is critical to ensure that host states do not benefit from their own wrongful conduct and that investors do not receive "insurance" against risks they considered at the time of their investment.

From a methodological point of view, one approach that valuation professionals frequently use to determine the value of an investment is the discounted cash flows ("DCF") method. The DCF method determines the value of an investment as of a certain date by projecting future cash flows to be generated by the investment, and discounting these cash flows back to that valuation date using a discount rate reflecting the riskiness of the investment. In the DCF method, the specific risk associated with investing in a foreign country can be accounted for by including a country risk premium in the discount rate. Country risk represents the incremental risk associated with investing in a foreign country, broadly covering macroeconomic, political (including expropriation risk), exchange rate, and other country-specific risks. The DCF approach was widely used by quantum experts in all of the arbitration awards against Venezuela that we discuss below.

The awards against Venezuela in 2014 (*Gold Reserve*, *Venezuela Holdings* and *Flughafen*) and 2015 (*OI European* and *Tidewater*) kicked off a debate over how expropriation risk should be treated. At its essence, the debate focuses on the question of whether, and under what circumstances the risk of expropriation should be included in the country risk premium in quantum calculations. In each award, the tribunal's goal was to determine the fair market value of the expropriated assets, taking into account their unique characteristics and the lawfulness of the act of expropriation. This raises an important question: how does the legality of expropriation affect the determination of quantum calculations? Some authors (*Bergolla* (2016) and *Alberro* (2016)) looked at the 2014 and 2015 awards and argued that the risk of appropriation should be included in lawful expropriations (*Venezuela Holdings* and *Tidewater*) and excluded in unlawful expropriations (*Gold Reserve*, *Flughafen*, and *OI European*). In *Dominguez* (2016), it was argued that expropriation risk should always be excluded so the host states do not benefit from the materialization of risks under their own control.

The recent awards in *Saint Gobain (2018)* and *ConocoPhillips (2018)* shed more light on the tribunals' reasoning, clarifying the debate. Specifically, the tribunal in *Saint Gobain*, consistent with *Tidewater*, made it clear that there are two elements to evaluating country risk premium—(i) the question of liability and (ii) the assessment of fair market value. The tribunal stressed that the second element is “in essence an economic question [that] depends upon the value that the market would attribute to the investment in question”.

Arbitration tribunals typically rule on the these two matters separately. First, tribunals determine whether an act of expropriation existed. If so, tribunals then rule on the lawfulness of such expropriations. Once liability is determined, the tribunals then rule on the second matter—the fair market value of the investment. However, the assessment of the fair market value of the investment is independent of the tribunal’s decision on the lawfulness of the expropriation. As the tribunal in *Tidewater* explicitly stated, and later on referenced by *Saint Gobain*:

> [I]n determining the amount of that compensation by reference to a discounted cash flow analysis, the Tribunal should consider the value that a willing buyer would have placed on the investment. In determining this value, one element that a buyer would consider is the risk associated with investing in a particular country. Such a factor is not specific to the particular State measure that gives rise to the claim. … Rather the country risk premium quantifies the general risks, including political risks, of doing business in the particular country, as they applied on that date and as they might then reasonably have been expected to affect the prospects, and thus the value to be ascribed to the likely cash flow of the business going forward.

Building on the decision in *Saint Gobain*, the tribunal in *ConocoPhillips* found:

> An investment treaty does not prevent an expropriation, or in fact, any other public measure possibly impacting a particular undertaking. […] The point is not that an applicable treaty would have eliminated regulatory or country risk, but rather that it would have managed or mitigated it.
>
> Properly assess[ing] the political risk of doing business in a particular state [is] a query that is <u>economic and not legal</u>. Hence, <u>whether or not the underlying public measure is deemed lawful or not, is irrelevant</u>.

Much of the debate following the awards against Venezuela in 2014 and 2015 overlooked the separation of the legal and economic question that was initially spelled out in *Tidewater*. Instead, the debate appeared to be focused on prescribing a formulaic approach for the treatment of expropriation risk, based on whether the tribunal found the host state’s acts to be lawful or unlawful. Reviewing the tribunals’ decisions through the prism of the *Saint Gobain* and *ConocoPhillips* awards, we find that, in fact, the tribunals in the 2014 and 2015 awards consistently focused on the economic rather than on the legal question in their determination of whether to include or exclude expropriation risk in the country risk premium. Specifically:

- The tribunal in *Gold Reserve* rejected both the claimant’s and the respondent’s estimates of country risk premium for being overly exclusive (excluding even general political risks) or overly inclusive (including the increased expropriation risks after the date of expropriation), and adopted an estimate of expropriation risk from an industry report.
- The tribunal in *Venezuela Holdings* ruled that the country risk premium should account for expropriation risk because a “hypothetical buyer would take [expropriation risk] into account

when determining the amount he would be willing to pay".

- The tribunal in *Flughafen*, while agreeing that a government cannot benefit from a wrongful act attributable to it, ruled that "[w]hen in 2004 the Claimants decided to invest in Nueva Esparta, the country risk already existed, and investors were well aware of the existence of political and legal uncertainties", including the risk of expropriation in the country risk premium.
- The tribunal in *OI European* also included the risk of expropriation in the country risk premium, relying on data from Professor Damodaran, because this was consistent with "the normal practice in the financial world of assessing companies". Importantly, the tribunal in *OI European* considered the claimant's expert's attempt to strip out the risk of expropriation allegedly caused by "negative messages in the business environment about potential expropriations" that Venezuela would have generated, but found that it had not been demonstrated that these "negative messages" had caused an increase in Venezuela's country risk premium at the time.
- The tribunal in *Tidewater* noted that "determin[ing] the 'market value' of the investment … is in essence an economic question [that] depends upon the value that the market would attribute to the investment in question". The tribunal further stated that, according to the World Bank Guidelines, "this is an amount that willing buyer would pay to a willing seller of the investment immediately prior to the taking in question" and that, where this amount is determined by a DCF analysis, the World Bank Guidelines "specifically invite a consideration of 'the risk associated with such cash flow under realistic circumstances'".

It is possible that as the members of arbitration tribunals changed from one case to another, differences across decisions may arise. However, it is more likely that because these tribunals were faced with businesses of diverging characteristics and distinct "as-of" valuation dates, they all had different quantum aspects to consider. Therefore, while some tribunals supported the separation of the economic and the legal aspects explicitly, others might have chosen to do so in a less explicit way—*i.e.*, through the adoption of an appropriate country risk premium. Eventually, however, when we compare the country risk premia adopted in these awards, we see that the tribunals have been approaching this topic in a relatively consistent manner.

In all the Venezuelan awards, the tribunals eventually adopted a country risk premium estimated using some industry standard methods. In the more recent awards, regardless of the expropriation's lawfulness, the tribunal adopted a country risk premium validated by Professor Damodaran's model, which reflects the general risk associated with investments in a country, therefore including expropriation risks.

This raises a question—if the value of an expropriated investment is determined as of the expropriation date, and the compensation does not depend on the lawfulness of the expropriation, what is preventing the state from expropriating assets at will without procedural transparency? Other than the obvious outcome of losing potential investors, state countries in unlawful expropriations are also liable for a bigger share of the legal fees and arbitration costs. For example, in unlawful expropriations such as *OI European* and *Saint Gobain*, the tribunal determined that the respondent shall pay for part of the claimants' legal fees and all of the arbitration costs. On the contrary, in lawful expropriations such as *Tidewater*, the tribunal ordered each party to bear its equal share of fees and costs.

Conclusion

In calculating quantum in expropriation-related matters, economic experts should resist the temptation to adopt off-the-shelf approaches—such as always including or excluding expropriation risk in the country risk premium—and should delve deeply into the relevant details, considering all the risks that a willing buyer would have considered immediately prior to the expropriation. This is particularly relevant in investment arbitration disputes where there is no formal doctrine of precedent and assessing the fair market value of an investment could warrant differing approaches from case to case.

To make sure you do not miss out on regular updates from the Kluwer Arbitration Blog, please subscribe here. To submit a proposal for a blog post, please consult our Editorial Guidelines.

This entry was posted on Wednesday, October 9th, 2019 at 3:00 am and is filed under Damages, Expropriation, Investment Arbitration, Venezuela
You can follow any responses to this entry through the Comments (RSS) feed. You can leave a response, or trackback from your own site.