Kluwer Arbitration Blog

Towards a Consensus in the Country Equity Risk Premium Debate in International Arbitration?

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Country Equity Risk Premium (CERP) represents the additional return equity investors require to compensate for the heightened risks of investing in a particular country. These risks may arise from political instability, economic volatility, currency fluctuations, expropriation threats, and weaknesses in the legal and regulatory framework. Each of these risk components can, in principle, be separately estimated, and their individual effects on the quantum of damages or the valuation of the investment can likewise be systematically assessed (Bekaert et al., 2016).

The treatment of the CERP in investment valuation, particularly in the context of international arbitration, has long been a source of conceptual ambiguity and practical disagreement. Despite its critical impact on damages calculations or valuations, there remains no uniform approach to estimating, interpreting, or applying CERP—whether in whole or in part. This article argues that an emerging consensus is beginning to form around a more refined treatment of the CERP, one that rejects simplistic all-or-nothing methodologies in favor of approaches that distinguish between treaty-protected and non-protected elements of country risk. To make this case, the current article first clarifies the conceptual and economic foundations of CERP and its role in investment valuation. It then reviews the implications of the *Chorzów* standard in relation to lawful and unlawful expropriations. Building on that, the article evaluates the role of treaty protection in isolating risks that should or should not be reflected in the discount rate. Finally, it addresses the methodological tensions underlying current valuation practices, and proposes a principled path forward.

From Theory to Billions: The Practical Consequences of CERP Disputes

In valuation models, CERP is typically incorporated into the discount rate to reflect the heightened uncertainty associated with a particular jurisdiction. A higher CERP leads to a higher discount rate, thereby reducing the present value of projected cash flows—and consequently, the quantum of damages. This outcome may, in practice, align with the interests of respondents. Conversely, a lower or excluded CERP increases the valuation, often aligning with the interests of claimants.

Disputes over the appropriate treatment of CERP typically arise along two dimensions. First, experts may differ in their estimation methodologies, leading to divergent views on the magnitude of the CERP itself. Second—and more consequentially—even when experts converge on an

approximate estimate, there may be significant disagreement over whether all, none, or only a portion of the CERP should be included in the discount rate, particularly in the context of treaty protection. As a result, differences in expert opinions regarding CERP frequently produce substantial discrepancies in damages assessments, occasionally reaching the scale of billions of dollars. This concern was explicitly acknowledged by the tribunal in *ConocoPhilips v. Venezuela* (2019):

> "While [the experts'] positions are very close on the two first elements [of the discount rate], they are deeply divided in respect of the so called "country risk". … The members of the Tribunal, being exposed to suggestions so extreme that they manifestly cannot be retained, will have to make certain adjustments that some experts may consider to be a deviation from economic discipline. *Footnote:* This is said under the assumption that such a discipline exists. Serious doubts are permitted given the extreme discrepancies of the results from highly educated professionals who should have a scientific background allowing conclusions coming closer to one another in their elaboration and in their results." ¶¶ 831-32, 884.

The scholarly debate on this issue has also expanded in recent years. Earlier contributions include Alberro (2016), Bergolla (2017), Dominguez (2017), and Weglein et al. (2019), while more recent interventions by Harris et al. (2023) and Havan (2024) reflect continued efforts to refine both the estimation and application of CERP in damages models.

To anchor the analysis that follows, the discussion proceeds under the assumption that the dispute concerns the expropriation of an equity investment.

The *Chorzów* Stretch: Legal Intentions Versus Economic Valuation Principles

The *Chorzów* standard provides room for full reparation as compensation for unlawful expropriations, which is higher than the "just price" that it provides for lawful expropriations, where the just price refers to "the value of the undertaking at the moment of dispossession, plus interest to the day of payment." The reference to "the moment of dispossession" is consistent with a fair market valuation (FMV) performed just prior to the expropriation, known as the *ex-ante* approach to damages.

In seeking to operationalize the *Chorzów* standard's distinction between compensation for lawful and unlawful expropriations, some tribunals may have attempted to adjust the value of damages by including or excluding the CERP—reducing valuations in lawful cases and increasing them in unlawful ones (Alberro, 2016). However, this method of differentiation is not grounded in finance or economic theory, as the *ex-ante* value of an investment is independent of the legal characterization of the expropriation. Indeed, Alberro (2016) argues that prior to *Siemens v. Argentine* (2007) and *Vivendi v. Argentine* (2007), the tribunals did not distinguish between the FMVs of assets between lawful and unlawful expropriations. As an alternative consistent with *Chorzów* and economic theory, the tribunal in *Siemens v. Argentine (2007)* acknowledged the possibility of consequential damages and accepted performing an *ex-post* damages calculations that could achieve higher damages in unlawful expropriations. I next examine whether treaty protection warrants the exclusion of certain components of the CERP from the discount rate.

Beyond All or Nothing: Towards a Principled Accounting of Country Risk in Treaty Arbitration

The value of an investment at any given point in time is determined by the expectations of investors at that moment—expectations shaped by a range of factors, including the prevailing country risk *and* the existence of treaty protections. Under the standard assumption of rationality in economics, it follows that if treaty protection reduces the probability of unlawful expropriation—by strengthening incentives for lawful conduct or by enhancing the likelihood of receiving the "just price"—then such protection carries tangible economic value. Accordingly, where treaty protection exists, it would be inappropriate to include the full CERP in the discount rate, as doing so would overstate the actual risk faced by the investor. At the same time, treaty protection never eliminates all sources of country risk. Therefore, it is also inappropriate to exclude the CERP in its entirety. A principled valuation must instead identify and remove only the portion of the CERP that reflects risks mitigated by treaty protection.

This view rejects all-or-nothing approaches, which, in my assessment, ought to be discredited by arbitral tribunals. It is a view increasingly echoed in the literature. Harris et al. (2023) propose a method grounded in the framework of Bekaert et al. (2016), while Havan (2024) emphasizes the importance of aligning the assessment with expectations formed at the time of the investment decision—not those prevailing immediately prior to expropriation. Together, these contributions point toward an emerging consensus: that the treaty-protected portion of the CERP should be estimated and excluded, as affirmed by the tribunal in *ConocoPhilips v. Venezuela* (2019):

> *"The only way to achieve full reparation, and to avoid a result in which a State profits from its own unlawful conduct, is to exclude from the discount rate the risks and occurrence of Venezuela's unlawful actions."* ¶ 845.

I next turn to an empirical study that provides a concrete estimate to help quantify how treaty protection influences investment value.

Isolating Treaty-Protected Risk

Assuming that sovereign bond spreads serve as reasonable proxies for the CERP, one method for isolating the treaty-protected component is to approximate treaty protection through the lens of political risk. According to Bekaert et al. (2016), political risk accounts for approximately 31% to 34% of sovereign spreads, once adjusted for its correlation with other elements of country risk, including domestic macroeconomic volatility, global financial conditions, and bond market liquidity. It is important to note, however, that the political and other risk components estimated by Bekaert et al. (2016) are derived within a global (world) Capital Asset Pricing Model (CAPM) framework; hence, these estimates are isolated from global systemic (undiversifiable) risks. Accordingly, the application of these estimates in an arbitration context—particularly one involving emerging markets and a domestic or international CAPM—requires careful conceptual and methodological adaptation.

As previously noted, disputes surrounding CERP often extend beyond its application to its very estimation. I now turn to this foundational controversy.

Between Theory and Practice: The Scientific Limits of CAPM

Economics is both a science and a discipline—a broader term encompassing historical analysis and comparative studies. Finance is traditionally a scientific field of economics although it has expanded to include interdisciplinary elements. Within Finance, the field of study called "asset pricing" provides the theoretical foundation for valuation practices. The starting point for asset valuation, once future free cash flows are projected, is the expected return on the investment. One of the most fundamental scientific models for estimating this return is the Capital Asset Pricing Model (CAPM), developed by Sharpe (1964) and Lintner (1965). In this framework, the expected return represents the minimum required return for holding a risky equity investment—commonly referred to as the cost of equity (COE). The COE is typically used as the discount rate to compute the present value of the projected cash flows to equity.

Due to its scientific nature, CAPM is inevitably restrictive in certain important dimensions. Most importantly, CAPM models a single market, which could be a country or the world as long as the market is integrated (unsegmented), which means assets with the same risk should have identical expected returns to equity irrespective of the location within the market (Bekaert & Harvey, 1995). This assumption becomes problematic in the context of emerging markets, where reliable data are often scarce. As a practical solution, using a mature market COE and augmenting it by a the separately estimated emerging market CERP is widely adopted. Though unsupported by the formal structure of the scientific financial models like the CAPM, this adjustment reflects the broader disciplinary logic of economics. This methodological tension lies at the heart of the controversy surrounding CERP estimation. It also helps explain the divergence in expert opinions noted by the tribunal in *ConocoPhilips v. Venezuela* (2019): "While [the experts'] positions are very close on the two first elements [of the discount rate], they are deeply divided in respect of the so called 'country risk.'" ¶ 831.

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