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How to approach expropriation risk as a controversial component of country risk in investment arbitration

M. Emirhan Havan[*]

ABSTRACT

Country risk premium is one of the principal factors that affects the value of investments and is based on the assumption that investments located in an unstable country are worth less than similar investments in a stable country. Tribunals impose a discount rate called a country risk premium in accordance with this by assessing the economic and political risks of the host country where the investment is being made. This article discusses whether a state can take advantage of its own unlawful acts that aggravate political risks in order to raise its country risk premium and thus the discount rate on the value of investments.

INTRODUCTION

Calculating damages to the value of investments is a challenging task. In order to cope with this complex and controversial task, investment treaties sometimes stipulate certain concepts to provide tribunals with at least a minimum benchmark while assessing the amount of compensation upon an award judgment. One of the most popular concepts in this context is fair market value. Accordingly, fair market value is usually defined as the price of an asset just before its expropriation decision becomes public[1] and can be attributed in a free market by reasonable and hypothetical informed sellers and buyers who take into account all the relevant circumstances.[2]

[*] Muhammet Emirhan Havan, PhD Candidate, University of Fribourg, Av. de l'Europe 20, 1700 Fribourg, Switzerland. Tel: +41 78 318 45 95; Email: emirhanhavan@hotmail.com. Scholarship holder of the Republic of Türkiye.

[1] This particular date is also referred to as 'last clean day'. See *Crystallex International Corporation v Bolivarian Republic of Venezuela*, ICSID Case No. ARB(AF)/11/2, Award (4 April 2016) para 891.

[2] 'Legal Framework For The Treatment of Foreign Investment' (The World Bank Group 1992) 11415 para 40 <https://documents1.worldbank.org/curated/en/955221468766167766/pdf/Guidelines.pdf> accessed 7 March 2024; Irmgard Marboe, 'Compensation and Damages in Investment Treaty Arbitration' in Katia Yannaca-Small (ed), *Arbitration Under International Investment Agreements: A Guide to the Key Issues* (2nd edn, Oxford University Press 2018) para 25.28; James Chen, 'Fair Market Value (FMV): Definition and How to Calculate It' (*Investopedia*) <https://www.investopedia.com/terms/f/fairmarketvalue.asp> accessed 7 March 2024; Ronnie Barnes, Phillip-George Pryce and Dustin Walpert, 'Country Risk Premium' in Barton Legum (ed), *The Investment Treaty Arbitration Review* (4th edn, Law Business Research Ltd 2019) 301 <https://www.nera.com/content/dam/nera/publications/2019/NERA%20Makholm%20&%20Olive%20Investment-Treaty-Arbitration-Review%20Edition-4.pdf> accessed 7 March 2024; *Rusoro Mining Limited v The Bolivarian Republic of Venezuela*, ICSID Case No. ARB(AF)/12/5, Award (22 August 2016) para 751.

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However, revealing the mindset of hypothetical buyers is equally tricky, and different assumptions dramatically change the legal redress to which a claimant is entitled. For example, according to empirical studies in 2021, although the investors who prevailed in investment arbitration had demanded $1.5 billion USD, they were only awarded $438 million USD.[3] This significant gap stems from the divergent calculation methods that exist among quantum experts and their internal factors. One of the most controversial components of the quantum phase is the country risk premium. This article will discuss the country risk premium, in particular the expropriation risk, and attempt to answer the question of whether it should be included in the country risk, and if so, to what extent.

THE ROLE OF COUNTRY RISK IN VALUATION

According to the famous International Court of Justice (ICJ) case *Factory of Chorzów*[4] and Article 31 of the Responsibility of States for Internationally Wrongful Acts as prepared by the International Law Commission (ILC) of the United Nations (UN),[5] full reparation is demanded in the case of unlawful damage.[6] In this regard, the pivotal importance of determining the exact value of the investment becomes clearer, as it is the most relevant element to finalizing the amount of the compensation.[7] If the value of the investment is determined to be higher than its market value, then the investor would be overcompensated. On the other hand, if the value of the investment is calculated below its actual market price, then the investor would be undercompensated, even if it is the prevailing party on the merits of the case. Both scenarios are unwanted, which is why the valuation methods and the country risk premium (as explained below) that are incorporated into the calculation are crucial.

Only in a perfect world would the value of an investment be the same in every jurisdiction. Because each country has its own unique nature and set of circumstances, the degree and types of risks to which investors are exposed vary according to the jurisdiction in which the investment is located. This particular risk significantly influences the value of an investment due to a fundamental economic axiom that suggests that people are risk averse, which means people are more inclined to pay more for investments with fewer marginal risks.[8] For example, an investment that offers $10 million USD of benefit to the right holder with an annual risk margin of 10 per cent (ie it can deliver a minimum of $9 million and a maximum of $11 million in profit at the end of the year) is more valuable than another investment that also offers $10 million USD

[3] Matthew Hodgson, Yarik Kryvoi and Daniel Hrcka, 'Empirical Study: Costs, Damages and Duration in Investor-State Arbitration' (The BIICL and Allen and Overy 2021) <https://www.biicl.org/projects/empirical-study-costs-damages-and-duration-in-investor-state-arbitration> accessed 7 March 2024. Similarly, by June 2007 the average amount of claims sought was approximately 343.4 million dollars while the average of the awards amounted to 10.4 million see Susan Franck, 'Empirically Evaluating Claims about Investment Treaty Arbitration' (2007) 86 North Carolina Law Review 1, 57–58.

[4] '… is that reparation must, as far as possible, wipe out all the consequences of the illegal act and reestablish the situation which would, in all probability, have existed if that act had not been committed' see *Factory at Chorzów (Merits)*, PCIJ SERIES A.-No. 17 (13 September 1928). This decision originated from a dispute in a State-State arbitration, yet it is now well settled that it can be used in investment arbitration, see *Gold Reserve Inc v Bolivarian Republic of Venezuela*, ICSID Case No. ARB(AF)/09/1, Award (22 September 2014) para 678.

[5] Responsibility of States for Internationally Wrongful Acts (2001) art 31. 'The responsible State is under an obligation to make full reparation for the injury caused by the internationally wrongful act'.

[6] See also *Amoco International Finance Corporation v The Government of the Islamic Republic of Iran, National Iranian Oil Company, National Petrochemical Company and Kharg Chemical Company Limited*, IUSCT (Iran-US Claims Tribunal) Case No. 56, Partial Award (17 November 1981) paras 191–93.

[7] Marboe (n 2) paras 25.07–25.08.

[8] James Searby, 'Measuring Country Risk in International Arbitration' in Christina L Beharry (ed), *Contemporary and Emerging Issues on the Law of Damages and Valuation in International Investment Arbitration* (Brill | Nijhoff 2018) 233 <https://brill.com/view/book/edcoll/9789004357792/BP000010.xml> accessed 10 November 2023; Florin A Dorobantu, Natasha Dupont and M Alexis Maniatis, 'Country Risk and Damages in Investment Arbitration' (2016) 31 ICSID Review 219, 221; Luis Bergolla, 'The Venezuela Awards: Tribunals Should Not Rule Out Expropriation Risk' (2017) 34 Arizona Journal of International & Comparative Law 123, 125.

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of benefits but with a risk margin of 50 per cent (ie it can deliver a minimum of $5 million and a maximum $15 million USD at the end of the year), even if the ceiling of the latter is more promising than the former. For these reasons, country risk becomes relevant at the quantum phase of an award and usually imposes drastic changes on the expected financial redress.

Country risk, or more specifically the country risk premium, is the discount rate that is applied to the risks of having invested in an emerging or developing state instead of a developed one, with the assumption that a project in such a country is more exposed to external risks than projects set up in developed countries.[9]

Country risk is not just formed by realized incidences. Mere risks that threaten an investment are sufficient for applying the discount ratio related to country risk, even if these threats never come about.[10] In addition, the country risk premium of a country that does not demonstrate any hostility against investments for a considerable period will likely decrease in the long term.

The subcomponents of country risk are perhaps the most controversial issues under this title. Nevertheless, one can argue that the literature has reached a minimum consensus about some of them. As far as I have observed, two main parts are found to form the country risk premium, one being economic risk and the other political risk.[11] In addition, some authorities enumerate additional components such as structural (eg conditions of infrastructure, qualified labour force, rule of law)[12] or cultural (eg cost of transactions and negotiation, corruption, nepotism, language barriers, religion)[13] risks as a part of the country risk premium.

Political risk has been conceived as unexpected changes in the credibility of the state and is composed of the risk of change of government or political instability, discontinuity in government politics, invasion, war, civil war, terrorism, nationalism, and dependence on other countries or/and international institutions. As for economic risk, the following instances can be listed: a slowdown in economic growth, deficit, depreciation of the exchange rate, and inflation.[14]

Several ways exist for figuring out the country risk premium rate, and these usually entail sophisticated financial analyses and mathematical calculations not covered in this article. Nonetheless, a cursory enumeration and simple explanation can be stated in order to create a general vision of the effort of quantum experts. The sovereign default spread method involves the difference between two government bonds, one from a developed state and the other from the host state, and is accepted as a benchmark.[15] Other examples that have been presented as measurement methods by the doctrine are the method involving relative volatility of equity and debt markets, which measures the margin between the volatility of the host state and a reference

[9] 'The assessment of a suitable discount rate for an investment in a developing market or emerging economy (eg countries in the former Soviet Union) requires the investor to consider risks in addition to those related to investments in more mature, developed economies (such as the United States or Germany). The exercise is one of assessing a risk premium over there turn required on investments in more mature, stable economies'. For this definition, see Anthony Charlton, 'Discounted Cash Flows – Part 2, Valuation and the Financial Crisis' (*Kluwer Arbitration Blog*, 26 January 2012) <https://arbitrationblog.kluwerarbitration.com/2012/01/26/discounted-cash-flows-part-2-valuation-and-the-financial-crisis/> accessed 7 March 2024. Alternatively see also Searby (n 8) 233: 'A country risk premium can be understood as the premium for risk associated with investing in a country where the potential outcomes are more variable than those available from investing in a low-risk benchmark country such as the United States, Germany, or the United Kingdom. A higher country risk premium, all else equal, suggests that investment returns in that country will be more variable'; see Barnes, Pryce and Walpert (n 2) 299: 'it refers to those risk factors the foreign investor would not face in its domestic market, such as political instability in the host country and potential shifts in a government's economic policy; for example, the nationalisation of private industries and the imposition of protective tariffs'.

[10] Dorobantu, Dupont and Maniatis (n 8) 222.

[11] Marcos D Garcia Dominguez, 'Calculating Damages in Investment Arbitration: Should Tribunals Take Country Risk into Account' (2017) 34 Arizona Journal of International and Comparative Law 95, 99; Dorobantu, Dupont and Maniatis (n 8) 221.

[12] Searby (n 8) 234.

[13] Dominguez (n 11) 100.

[14] The list is taken from Dominguez (n 11) 100.

[15] Robert Ginsburg, 'Country Risk Analysis and Investor-State Dispute Settlement: A New Approach' (2018) 50 Georgetown Journal of International Law 425, 439; Barnes, Pryce and Walpert (n 2) 305.

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state,[16] its country risk or sub-risk ratings,[17] the relative standard deviation approach, and the implied equity market risk premium.[18,19]

JUSTIFICATIONS AND CRITICS OF COUNTRY RISK PREMIUMS

Before analysing expropriation risk, country risk itself should be mentioned to not be exempt from criticism. Thus, the basis on which the country risk premium is justified and the dissenting opinions about that methodology may be elaborated upon at this stage.

Justifications for country risk

In theory, investors can avoid country risk by diversifying their investment portfolio. This means that an investor who works with several jurisdictions that have different country risk rankings (ie some developed and some emerging countries) or perhaps different types of country risk (ie state A's risk concerns economic instability, while state B's concerns cultural or political challenges), instead of devoting all their financial capacity in a single project, is likely to be better off in terms of eliminating possible future threats toward their income flow projections.[20]

Unfortunately, this is not the case in most instances according to empirical studies. Firstly, investment projects cannot easily be divided into small shares to allow investors to be minor contributors; rather, these projects entail a vast amount of capital just to enter the market. Secondly, global markets have become more and more intertwined with time; hence, finding an isolated secure investment habitat is no longer possible.[21] Thirdly, investors are usually home-biased, which means they tend to remain in their home country rather than explore different investment ecosystems, even if diversification is needed to ease the risks in their investment portfolio.[22]

The main reason behind country risk is the fact that international investment treaties are not insurance policies against all risks, especially those that were foreseen (or should have been foreseen) at the time of investment.[23] An investment decision simply involves responsibility for a business decision regarding which risks rest on the shoulders of the investor.[24] Although not directly related to country risk discussions, supportive reasoning for this view was mentioned in *Cengiz İnşaat v. Libya*. In that decision, the claimant tried to increase its damages by claiming certain profits that had been anticipated from the investment in question. The tribunal rejected their claim, saying that the regions where the investment had been established were remote and exposed to higher risk. This was confirmed by the revenue premiums of the investment, which appear to have incentivized the contractors to pursue projects in remote areas. Therefore, the

[16] Ginsburg (n 15) 441; Barnes, Pryce and Walpert (n 2) 305.

[17] Ginsburg (n 15) 441; Dominguez (n 11) 99.

[18] Searby (n 8) 242–44.

[19] For the most common methods used to calculate damages, see Tigran Ter-Martirosyan, 'Damages Considerations in Central Asian Investment Arbitrations' (*Kluwer Arbitration Blog*, 5 May 2019) <https://arbitrationblog.kluwerarbitration.com/2019/05/06/damages-considerations-in-central-asian-investment-arbitrations/> accessed 7 March 2024.

[20] Searby (n 8) 238; Tiago Duarte-Silva, 'Country Risk' in John A Trenor (ed), *The Guide to Damages in International Arbitration* (4th edn, Law Business Research Ltd 2021) <https://globalarbitrationreview.com/guide/the-guide-damages-in-international-arbitration/4th-edition/article/country-risk#:~:text=One> accessed 26 May 2022; Aswath Damodaran, 'Country Risk and Company Exposure: Theory and Practice' (2003) 13 Journal of Applied Finance 63, 64.

[21] Duarte-Silva (n 20).

[22] Searby (n 8) 238; Caroline Banton, 'Home Bias: What It Is, How It Works, Special Considerations' (*Investopedia*) <https://www.investopedia.com/terms/h/homebias.asp> accessed 7 March 2024; Damodaran (n 20) 64.

[23] Samuel Weglein, Todor Stoyanov and Ellie Liu, 'The Venezuela Awards: Dealing with Expropriation Risk' (*Kluwer Arbitration Blog*, 9 October 2019) <https://arbitrationblog.kluwerarbitration.com/2019/10/09/the-venezuela-awards-dealing-with-expropriation-risk/> accessed 7 March 2024; Dominguez (n 11) 108.

[24] *CMS Gas Transmission Company v The Argentine Republic*, ICSID Case No. ARB/01/8, Award (12 May 2005) para 248; *Resolute Forest Products INC v Government of Canada*, PCA Case No. 2016-13, Final Award (25 July 2022) para 762.

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claimant could not be assumed to have reasonably anticipated profits[25] and should bear the consequences of the business decision they had made.

This is especially the case when the investor engages with an emerging country whose overall conditions are presumably unstable. Ultimately, the tribunal will not and cannot correct improvident business decisions in its final award.[26]

Criticisms against the use of country risk premiums

As mentioned above, economic and political risks are the two main components of the country risk premium. For economic risks, the discussions are relatively less intense than political risks, due to a country's economic risks falling within the risks of making a business decision.[27] Thus, taking its risks into consideration is not that problematic. As for political risks, however, the debates are more controversial. The states are usually bound by investment treaties, especially with regard to protecting foreign investments against unlawful governmental acts such as illegal expropriations, discriminations, or violations of fair and equitable treatment. Therefore, firstly, governments should not be allowed to benefit from their own wrongdoings by imposing a country risk premium discount, which was mainly provoked by their acts in violation of these duties, on damages. Because this issue will be handled in detail in the following section, it will not be further elaborated upon here.

Secondly, a risk exists that the country risk premium may incentivize states to aggravate the risks. The higher the country risk is (and thus the higher the related discount rate), the lower the amount of compensation the arbitral panel will render.[28] Governments that are aware of this fact may intentionally manipulate their country risk to increase the discount rate and decrease their liability.

The fact that mere risks are sufficient to enhance country risk premiums is explained above and also relates to the third critique against country risk. Because the mere existence of risk can aggravate the country risk premium, states with high country risk premium rates need to offer more incentives in order to attract investors. Thus, these states have to bear additional expenses to create a foreign investment-friendly perception in the market, even if they have no intention to undermine the expectations of the investors. According to one opinion, this can be inappropriate, as it is equivalent to making the state compensate investors before an unlawful act, irrespective of whether conduct has occurred that can cause its responsibility.[29]

Last but not the least, certain methods for determining country risk have also been subjected to several criticisms. From the perspectives of certain authors, sovereign bonds and related ratios have been exemplified as irrelevant for private companies due to the particular circumstances of the private sector. Accordingly, the tribunal in *Sempra v. Argentine* held that, even after the 2001 crisis, the credit risk of the government (which had been proposed for use as an indicator of country risk) and the country risk differ because the country risk for a private company is lower than for the government due to 'their regulated status and relatively lower business risk'.[30] For example, a local currency whose value is constantly devaluing may raise the country risk

[25] *Cengiz İnşaat Sanayi ve Ticaret AŞ v The State of Libya*, ICC Case No. 21537/ZF/AYZ, Final Award (7 November 2018) para 612.

[26] Dominguez (n 11) 109; Marboe (n 2) para 25.21. '… general deterioration of the economic situation of the country where the investment was made or the general circumstances of an ongoing development must not be compensated to the investor… The purpose of an investment treaty is not to put investors into a more favourable position than they would have been in the normal development of their investment within the circumstances provided by the host country'. See *CME Czech Republic BV v Czech Republic v Czech Republic*, *ad hoc* Arbitration, Final Award (14 March 2003) paras 561–62.

[27] Searby (n 8) 253, 257. For example, price fluctuation of input materials, possible environmental regulations, and macroeconomic changes may be pertinent for discount rate. See *Bilcon of Delaware et al v Government of Canada*, PCA Case No. 2009-04, Award On Damages (10 January 2019) para 277.

[28] Dorobantu, Dupont and Maniatis (n 8) 226.

[29] Dorobantu, Dupont and Maniatis (n 8) 226.

[30] *Sempra Energy International v Argentine Republic*, ICSID Case No. ARB/02/16, Award (28 September 2007) para 433.

premium as a result of severe economic conditions. However, if the investment project is concentrated on exporting its products from the host country to the venue where the manufacturing process is to be completed, depreciation in the currency of the host state in the eyes of third countries imposes no risk to the investor; instead, its income flow would be boosted thanks to the currency advantage. The same applies to the velocity of the equity method, which presumes that every company in the market is exposed to the same risk by disregarding the fact that each sector has its own unique micro dynamics.[31] In a similar vein, one can wrongly assume that all developed or emerging countries have similar conditions that are comparable to one another.[32] However, this is not always the case.

EXPROPRIATION RISK WITH REGARD TO COUNTRY RISK

Beyond certain theoretical opposition, tribunals refer to country risk in most cases at the quantum phase in order to evaluate the value of the investment and thus the amount of compensation. Nevertheless, the question of whether or not to include expropriation risk within country risk is still highly debatable. For example, after Hugo Chavez took over the government of Venezuela, and undertook some expropriation plans, foreign investors asked arbitral tribunals for financial redress. However, the claimants' and respondents' quantum experts could not agree on how to handle expropriation risk within country risk.

In short, a country that expropriates (lawfully or unlawfully) investments may deter possible investors from participating in that country's market due to expropriation being an undesirable scenario for investors. This means the country risk, and therefore the discount rate, will rise, and consequently the final award for compensation will decrease, which effectively means the government was able to influence its own liability through unilateral and unlawful acts.

On the one hand, it has been suggested that the states should not be able to benefit from their own unlawful acts by recalling the famous Roman principle of 'Nemo auditur propriam turpitudinem allegans' (no one can invoke its own wrongdoing).[33] Some reflections of this principle can be seen in investment arbitration. For example, the tribunal in *Stans Energy Corp. and Kutisay Mining LLC v. Kyrgyz Republic (II)* held that 'damages for an unlawful dispossession should not be lower than those for a lawful one' when it availed itself of a provision for lawful taking to calculate the damage for an unlawful one.[34] Thus, the tribunal accepted that a state should not be in a better position to commit an unlawful act when comparing the scenario to one in which it had complied with the law. Because political risk is caused by governmental acts, states should additionally bear the consequences of these risks, as they have better conditions for avoiding them.[35]

On the other hand, some believe that quantum calculations should have nothing to do with the merits of the case. These are merely economic analyses, and therefore shall encompass all factors that can affect the decision of a hypothetical buyer assigning a price tag to an investment subjected to an investment dispute.[36]

[31] Ginsburg (n 15) 442–43.

[32] Ginsburg (n 15) 443. For a similar conclusion, see *Rusuro Mining v. Venezuela* (n 2) para 782. Ginsburg also challenged the idea that emerging countries are inclined to interfere with foreign investments first in cases of economic distress. According to the author, the dependence of these countries on international institutions like the IMF prevents them from violating their responsibilities against foreign investors. See Ginsburg (n 15) 444.

[33] Weglein, Stoyanov and Liu (n 23); Dominguez (n 11) 120.

[34] *Stans Energy Corp and Kutisay Mining LLC v Kyrgyz Republic (II)*, PCA Case No. 2015-32, Award (20 August 2019) para 674.

[35] Dominguez (n 11) 121.

[36] See Opinions of Mr. Vladimir Brailovsky and Dr. Daniel Flores in *Saint-Gobain Performance Plastics Europe v Bolivarian Republic of Venezuela*, ICSID Case No. ARB/12/13, Decision on Liability and the Principles of Quantum (30 December 2016) para 662. See also *Tidewater Investment Srl, Tidewater Caribe, CA v The Bolivarian Republic of Venezuela*, ICSID Case No. ARB/10/5, Award (13 March 2015) para 185.

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Several tribunals have handled this problem in various ways. Despite the fact that the principle of *stare decisis* does not exist in investment arbitration, several pertinent decisions will be commented on in order to present the whole picture. For the sake of clarity, the decisions of several tribunals will be classified according to their approaches toward expropriation risk. The plan will be as follows: those that favour excluding it from country risk, those that favour including it, and the third midway approach that attempts to consolidate the previous two options.

Expropriation risk should be excluded

Some tribunals have decided to exclude expropriation risk from country risk calculations. One of the first decisions to have eliminated expropriation risk from the country risk premium is *Phillips Petroleum Co. Iran v. Iran.*[37] In this case, the tribunal held that, although an investor in September 1979 (the date of the Iranian [Islamic] Revolution) would have foreseen the upcoming revision in the investment contract, he could not have projected the extent of its effects; therefore, the expropriation risk should not be included.[38]

The leading decision in which the arbitral panel decided to exclude expropriation risk from the country risk premium is *Gold Reserve v. Venezuela*. Gold Reserve had a project called the Brisas Project that was composed of two main concessions: the Brisas Concession and the Unicornio Concession.[39] Towards the end of the concession term, the claimant requested an extension for the Brisas Concession, which the local authorities rejected due to the alleged insolvency and 'failure to comply with a number of Special Advantages'. Next, the local authorities confiscated some assets of the claimant, occupied the Brisas Project, and terminated the Unicornio Concession due to the claimant allegedly having failed to initiate exploitation within the required time and being in breach of the Special Advantages.[40] The tribunal held that the respondent had violated its obligations with regard to fair and equitable treatment[41] yet nonetheless rejected the expropriation claim.[42]

What is more relevant here is the question of how the tribunal assessed the expropriation risk in the case. According to the tribunal, even if no expropriation had occurred within the government's measures, the fair market value was still pertinent for determining the claimant's damages.[43] Although the quantum experts of both parties had agreed on the discounted cash flow method, they diverged on the discount rate based on what they considered components of country risk. The respondent's expert argued that the risk should cover Venezuela's policy about ousting US companies from the mining sector, whereas the claimant party understandably attempted to exclude this. Consequently, the discount rate of the claimant figured at 1.5 per cent, while the respondent had suggested a rate between 6.7 per cent and 16.4 per cent.[44] The tribunal, bearing in mind that it had not found expropriation, held that the tendency of the State to expropriate the investment in violation of its international responsibilities could not be used to enhance the country risk premium.[45] The tribunal fixed the discount rate at 4 per cent, as it found the figure the claimant had proposed to be too low. This was because, though expropriation risk had been excluded, the political risks could not be entirely overlooked within the ambit of country risk.[46]

[37] *Phillips Petroleum Company Iran v The Islamic Republic of Iran, the National Iranian Oil Company*, IUSCT Case No. 39, Award No. 425-39-2 (29 June 1989).
[38] Ibid. para 152.
[39] *Gold Reserve v. Venezuela* (n 4) paras 10–13.
[40] Ibid. paras 26–28.
[41] Ibid. para 615.
[42] Ibid. para 669.
[43] Ibid. para 674.
[44] Ibid. para 840.
[45] Ibid. para 841.
[46] Ibid. para 842.

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The tribunal in *Rusoro v. Venezuela* excluded expropriation risk, without referring to this term explicitly, when calculating the claimant's damages while seeking the most appropriate valuation method for this endeavour. The tribunal first defined what the fair market value was. Then, it stipulated that the price that would be hypothetically given in a free market by well-informed buyers had decreased prior to Venezuela's expropriation decision because of governmental measures issued in 2009 and 2010.[47] Given that the bilateral investment treaty (BIT) between the parties had foreseen that the value of the expropriated assets would be determined according to the date 'immediately before the expropriation or at the time the proposed expropriation had become public knowledge' and given that the hypothetical buyer would have been aware of these measures (ie expropriation risk), the fair market value of the assets had devalued, and depreciation in value would have been known to be inescapable.[48] By relying implicitly on the principle of *nemo auditur propriam turpitudinem allegans* in the following paragraph, the tribunal explained the contrary argument and stated:

> The Tribunal has already concluded that the intensification of the gold export restrictions contained in the 2010 Measures are incompatible with the Treaty. Consequently, the effect of the increased export restrictions must be excluded from the valuation of Rusoro's enterprise – otherwise the State would be deriving advantage from its own wrong.[49]

The tribunal ultimately appeared to adopt the latter view and to have opted out of the fair market valuation method to eliminate the adverse effects of the government's unlawful measures it had subsequently adopted once the investment had been made.[50] In this case, the tribunal has intended to prevent the state from benefitting from its unlawful acts by unilaterally causing the expropriation risk to increase, although the measures in question effectively undermined the value of the investment.

The tribunal in *Tethyan Copper Company Pty Limited v. Pakistan* rejected reflecting the so-called nationalization risk in calculating the damages, but with an odd reasoning compared to the above cases. In its judgment, the tribunal refrained from deciding whether nationalization risk could be a component of calculation as a rule and did not explain its opinion. Instead, it stated that, while the respondent had insisted on the inclusion of the nationalization risk, it did not clarify the concrete impacts of this inclusion on the final result.[51] The tribunal further solidified its standing by referring to certain witnesses who had stated that, despite the political instability of Pakistan, the nationalization of a foreign investment project was not a likely instance.[52] The tribunal concluded that, even if the nationalization risk was to be regarded, 'It has not been established that a buyer would have considered this a significant risk from a factual point of view'.[53] Consequently, it held that it did not have to resolve the nationalization risk enigma, because a prospective buyer would in no event take it a decisive determinant.

A similar result appeared in *Stabil LLC and Others v. Russian Federation*, where although the quantum experts had disagreed on the point of whether the political and regulatory risks can be considered as a factor in the country risk, they subsequently found premium rates that differed only slightly (1.8% and 2%) and ultimately reached a consensus on 2 per cent as an appropriate rate. Consequently, the tribunal accepted 2 per cent without making any further discussion.[54]

[47] *Rusuro Mining v. Venezuela* (n 2) para 754.
[48] Ibid. paras 755–56.
[49] Ibid. para 757.
[50] Ibid. 777–80.
[51] *Tethyan Copper Company Pty Limited v Islamic Republic of Pakistan*, ICSID Case No. ARB/12/1, Award (12 July 2019) paras 1560, 1562.
[52] Ibid. para 1561.
[53] Ibid. para 1563.
[54] *Stabil LLC and Others v Russian Federation*, PCA Case No. 2015-35, Final Award (12 April 2019) paras 384–86.

Again, no reason suggests a different solution would have ensued if the tribunal were to have specifically discussed expropriation risk.

Expropriation risk should be included

In spite of the reasoning of the *Gold Reserve v. Venezuela* panel, several disputes can be found where the tribunals had decided in favour of the respondents. The tribunal in the *Venezuela Holdings v. Venezuela*[55] case had decided that there was indeed an expropriation[56] but it was in fact lawful, despite the fact that the government had not compensated the investor.[57] Therefore, the tribunal continued with calculating the value of the investment to determine the amount of compensation for a lawful expropriation pursuant to Article 6(c) of the BIT.[58] In the award, the panel underlined how the parties could not reach a consensus on whether to include confiscation risk under country risk.[59] The applicable article of the BIT suggested in its wording that 'The measures are taken against just compensation. Such compensation shall represent the market value of the investments affected immediately before the measures were taken or the impending measures became public knowledge'.[60] From the perspective of the tribunal, this text requires ascertaining how much a hypothetical buyer would pay to acquire the investment before the measure becomes publicly known, with the hypothetical buyer apparently having to take into account the possibility of expropriation. Therefore, confiscation risk should be presumed as a component of country risk.[61]

Similar discussions can be observed in tribunals' reasoning regarding political risk in general terms. Due to the arguments that are relied on being principally the same, including them here would be appropriate. One example is the tribunal in *Tidewater v. Venezuela*, whose dispute arose from an alleged governmental seizure of the assets of the claimant who was providing marine transportation services.[62] Like the *Venezuela Holdings v. Venezuela* tribunal, the arbitral panel in *Tidewater v. Venezuela* had decided that the expropriation was lawful except for compensation. Consequently, the tribunal had the responsibility to fix the compensation amount in line with the relevant BIT.[63] In the quantum phase, the claimant's expert proposed ignoring the influence of political risks on country risk, as under BITs, the states submit to certain international obligations. According to the expert, unlawful deviation from BITs should not be awarded by permitting states to benefit from elevated country risk premiums.[64] Nevertheless, the arbitral panel stipulated that the expert conflated two different concepts: the liability of the state, which is a matter of legal debate of substance, and the determination of the market value of investment consisting of economic surveys. The latter is concerned with the exact price the market would attribute to the project and has nothing to do with whether the state had violated its international obligations.[65] According to the tribunal, whether the respondent State would profit from its unlawful act as a consequence of including political risk in the country risk

[55] *Venezuela Holdings, BV, et al (case formerly known as Mobil Corporation, Venezuela Holdings, BV, et al) v Bolivarian Republic of Venezuela*, ICSID Case No. ARB/07/27, Award (9 October 2014).

[56] The existence of the expropriation was conceded by both parties, see ibid. para 288.

[57] Ibid. para 306. 'Exxon Mobil Is Awarded US$1.6 Billion in ICSID Claim against Venezuela – to Be Set off against Award in Parallel Contractual Arbitration' (*Arbitration notes*, 16 October 2014) <https://hsfnotes.com/arbitration/2014/10/16/exxon-mobil-is-awarded-us1-6-billion-in-icsid-claim-against-venezuela-to-be-set-off-against-award-in-parallel-contractual-arbitration/> accessed 7 March 2024.

[58] *Venezuela Holdings v. Venezuela* (n 55) para 306.

[59] Ibid. para 364.

[60] Agreement on encouragement and reciprocal protection of Investments between the Kingdom of the Netherlands and the Republic of Venezuela signed 22 October 1991, entered into force 1 November 1993.

[61] *Venezuela Holdings v. Venezuela* (n 55) para 365. Consequently, the tribunal rendered the decision with a discount rate of 18 per cent while the claimant's proposal had been 8.7 per cent, and the respondent's between 18.5 per cent and 23.9 per cent.

[62] *Tidewater v. Venezuela* (n 36) paras 24–25.

[63] Ibid. para 146.

[64] Ibid. para 183.

[65] Ibid. paras 184–85.

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premium does not matter. The sole important fact is that a hypothetical buyer would obviously take into account such risks while assessing the value of the project; therefore, political risks are deemed to be a component of country risk.[66] In this case, even though the tribunal did not refer to expropriation risk directly, its reasoning approved the approach adopted by *Venezuela Holdings v. Venezuela* and therefore deserves mention here.

A similar line of argument was also followed in the *Saint Gobain v. Venezuela*[67] proceedings. Referring to the excerpts from the *Tidewater v. Venezuela* case, which explain the reason for distinguishing the matter of legal responsibility and the economic calculation regarding the value of the investment, the tribunal decided these two issues to indeed be independent from each other.[68] Consequently, the award held that, due to the argument suggesting that governments cannot be permitted to benefit from their own unlawfulness being irrelevant, political risk 'including the alleged general risk of being expropriated without payment of (sufficient) compensation' should be reflected in country risk.[69] As opposed to the *Tidewater v. Venezuela* case, the tribunal here referred to the political risk but with a particular reference to the expropriation risk.

In *OI European Group v. Venezuela*, the quantum experts as usual disagreed on the rate of the country risk premium. The experts for the claimant and the respondent proposed different respective figures of 2 per cent and 6 per cent. Again, the main reason behind this disagreement was the inclusion of political risks triggered unilaterally by states in the country risk premiums. According to the claimant, legal, regulatory, and policy risks were controlled solely by the state, and Venezuela had depreciated the value of the investments by 'implementing a policy of expropriations, and it has repeatedly expropriated privately owned companies'. Accordingly, the claimant argued that the government was the principal actor who had caused a general depreciation in the value of the investments in Venezuela, and this depreciation should have been disregarded for calculating country risk.[70] However, the tribunal rejected this reasoning and held that, while a country risk of 2 per cent may correspond to a developed country like Italy, this was obviously incomparable with Venezuela. According to the tribunal, investors make their investments in developing states instead of developed states only if they are offered 'an opportunity to obtain higher profits in the developing country', and this situation is captured by country risk premiums. Hence, there is no way Italy and Venezuela could be subject to the same country risk premium.[71] In the relevant part of the decision, the tribunal neither discussed the pertinence of considering the unlawfulness of the acts of the state that had increased the country risk nor mentioned expropriation risk. Nevertheless, the tribunal appears to have embraced the fact that Venezuela is a risky country for an investor and thus that the investor should accept the natural consequences of its decisions. Therefore, the tribunal implied in its reasoning that all the factors that affect the value of investment should be taken into consideration, irrespective of their lawfulness.

Converging the two divergent approaches

An alternative solution was brought onto the stage by the *Flughafen v. Venezuela* tribunal, which combined these two contradicting cases. The main discussion in their decision was again on the

[66] Ibid. para 186. In the end, the tribunal fixed 14.95 per cent for the country risk, while the claimant and the respondent had proposed 1.5 per cent and 14.75 per cent, respectively. Ibid. para 190.

[67] *Saint Gobain v. Venezuela* (n 36).

[68] Ibid. paras 717–18.

[69] Ibid. para 723. Judge Charles Brower expressed his disquiet regarding the solution of the majority of the tribunal by stating in his dissenting opinion that what the tribunal did in its holding was 'take[ing] away with one hand what it has purported to give the Claimant with the other'. See *Saint-Gobain Performance Plastics Europe v Bolivarian Republic of Venezuela*, ICSID Case No. ARB/12/13, Concurring and Dissenting Opinion of Judge Charles N. Brower (30 December 2016) para 3.

[70] *OI European Group BV v Bolivarian Republic of Venezuela*, ICSID Case No. ARB/11125, Award (10 March 2015) para 777.

[71] Ibid. para 780.

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inclusion of political risks. However, because the arguments that the tribunal relied on were the same ones used for discussing expropriation risk, this study refers to the tribunal's reasoning here.

Just was the case in the previous decisions, the parties could not find a common answer on whether to include political risk within country risk. The claimant had the view that legal, regulatory, and political risk cannot be evaluated under country risk because these are solely controlled by government initiatives; thus, the government should not be able to reduce the amount of compensation before the expropriation by inventing new risks for the investor.[72] Conversely, the respondent suggested that country risk was comprised of not only business risks but also the economic, financial, political, and social risks that an investor in an emerging state may possibly confront.[73]

The *Flughafen v. Venezuela* tribunal accepted the legal positions of both parties to a certain extent. Firstly, the tribunal argued that political risk ought to be included because investors chose emerging states in order to profit from extra advantages by comparing the equivalents in developed countries, and that margin is covered by country risk.[74] On the other hand, the possibility of raising the country risk with unilateral acts after receiving the investment and taking advantage of maximized discount rates at the quantum phase thanks to the subsequent unlawful acts should not be protected by international law.[75]

In this case, the arbitral panel sought to have the two different views converge by using a timeline as a benchmark in order to determine which state measures that are capable of influencing the country risk premium could be referenced. Accordingly, the types of conduct that had existed prior to the investment decision were deemed to be within the elements of country risk, as the investor should have contemplated all the surrounding circumstances of the investment beforehand. However, the government could not cut down the final compensation amount in the award by invoking acts that came into play after the investment had already been settled in the host state.

Another approach that can be classified as convergent can be observed in *Conocophillips Petrozuata B.V. et al. v. Venezuela*. In this case, the tribunal directly referred to unlawful expropriation risk and stated:

> The discount rate should not serve as a premium for unlawful acts committed by the host State that are detrimental to the investment. Therefore, to include the risk of unlawful expropriation or other unlawful state measures into the determination of the risk/profit equation of the Project, and henceforth, into the discount rate is inappropriate.[76]

The tribunal obviously adopted a view that supports the exclusion of the expropriation risk in its judgment by relying on the famous *nemo auditur propriam turpitudinem allegans* principle.[77] However, it deepened its reasoning in the above paragraph, stating this to not mean that the expropriation risk would be completely disregarded, because there is no reason to exclude the risk of lawful expropriation. The BIT between the respondent and the home state of the

[72] *Flughafen Zürich AG and Gestión e Ingenería IDC SA v Bolivarian Republic of Venezuela*, ICSID Case No. ARB/10/19, Award (18 November 2014) para 898. The original language of this award is in Spanish, an unofficial English translation, which is also referred in this article, can be found via the following link: https://ccsi.columbia.edu/files/2013/12/1.-Flughafen_v_Venezuela_-_Laudo-Translated-partially.pdf (since the link is not directing the guests directly to the relevant document anymore, wayback machine (https://archive.org/web/) is recommended to access the document.).

[73] Ibid. para 899.

[74] Ibid. para 901.

[75] Ibid. para 905.

[76] *Conocophillips Petrozuata BV, Conocophillips Hamaca BV, Conocophillips Gulf Of Paria BV and Conocophillips Company v Bolivarian Republic Of Venezuela*, ICSID Case No. ARB/07/30, Award (8 March 2019) para 906.

[77] Ibid. para 908.

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claimant foresaw a framework in which the host state could lawfully expropriate the investment project. To do so paying 'just compensation' consistent with the wording of the relevant provision would be sufficient in addition to other requirements. According to the tribunal, just compensation was not equal to the exact value of the investment (ie full recovery); in fact, it was lower in value. Thus, a risk also exists for the claimant to be deprived of its investment in exchange for just compensation. In other words, the investor was deemed to have risked the difference between full recovery and just compensation. This particular risk (ie lawful expropriation risk) should not be disregarded.[78] In fact, by stating that the state cannot benefit from its wrongdoing, the *Conocophillips Petrozuata B.V. et al. v. Venezuela* tribunal is clearly closer in principle to the approach that supports the exclusion of expropriation risk. However, the following statement regarding lawful expropriation brings a new perspective to the stage and, to some extent, causes the two opposing opinions to converge. On one hand, it excludes expropriation risk in principle, whereas on the other hand, it embraces it as long as the expropriation complies with the BIT.

What is the most appropriate approach?

As seen above, minor divergent preferences concerning the inclusion of expropriation risk and political risk in the calculation of the country risk premium bring about substantial differences regarding the amount of financial redress to which a claimant is entitled. Therefore, the positive and negative aspects of the above-mentioned approaches need to be scrutinized in order to ascertain the most appropriate solution.

First of all, one can easily argue that any controversies can be avoided by explicitly incorporating calculation methods for fair market value (or other concepts that refer to the value of the investment) in BITs by stating whether the country risk and its subcomponents will be deemed relevant or not in order to overcome any contradiction in the understandings of the parties in case of a possible dispute. In any case, however, tribunals are required to check the relevant provisions of the BIT between the host state and the home state of the investor. If a provision exists that excludes country risk or any subcomponents within it, then the arbitrator must refrain from using it in the quantum phase.

One should always bear in mind that compensation under international law is required to be 'in full', which also means not excessive. This principle cannot be diluted because of the existence of a state's very evil acts. The unlawfulness of the act, the fault of the state, and the ceiling of the award (ie the total value of the damages) are not interrelated issues. An arbitral tribunal may consider the fault of the state while exercising its margin of appreciation in calculating the compensation. However, this cannot exceed the total damages the claimant had incurred, as international law does not yet recognize the concept of punitive damages.[79] As a consequence, a tribunal that ignores the country risk premium despite being supposed to incorporate it may probably find a higher figure for compensation than the exact value of the project. This would result in an *excès de pouvoir* by rendering an award beyond the framework of the applicable law. Consequently, the tribunal would risk the award being set aside or annulled. In this regard, the components of the country risk premium become pertinent. For the sake of clarity, the possible risks that an investor has to consider should be tackled separately so that the interrelations between these particular risks and country risk concept can be understood easily.

An investor who has made an investment decision may confront three types of risks. Firstly, it might face instances that can be qualified as *force majeure* events. These are beyond the control of the investor and the state and are therefore out of the protective scope of a BIT.

[78] Ibid. paras 907, 910.
[79] Dominguez (n 11) 115.

Secondly, they might face business risks because of global or local economic flaws; nevertheless, these kinds of risks are closely interrelated with business decisions. In fact, this is exactly what a business decision is. Hence, investors cannot relieve themselves from the unwanted consequences of their decisions because they were supposed to have foreseen such possibilities. The tribunals are right to hold that investment treaties and arbitration should not be conceived as a comprehensive insurance policy that shields investors from any risk. Instead, they operate as alternative mechanisms that provide substantial legal protection for investors, vest jurisdiction in arbitral bodies, and foresee special recognition and enforcement procedures.[80] Furthermore, these risks are the reason why investors may profit from a project.[81] Expected profit and economic risks are like two sides of a coin; they cannot be separated just because the investor is unsatisfied with the result. The third is the political climate of a country, especially if it is an emerging one with a particular propensity to expropriate. As underlined several times in this article, this is maybe the most controversial dimension under country risk. Even though tribunals have adopted various approaches, none have been sufficient at revealing the whole picture. The following paragraph will be devoted to presenting a comprehensive method for handling expropriation and political risk within the country risk premium.

First and foremost, to suggest that expropriation risk is excluded per se would be inappropriate, as the state is already bound by its responsibilities under the BIT and cannot rely on its own wrongdoing to escape liability.[82] As the *Tidewater v. Venezuela* and *Saint Gobain v. Venezuela* tribunals rightfully decided, an act's unlawfulness and financial consequences are different matters. This distinction is similar to a lottery game; winning the lottery and the amount of the prize are two different things. Accordingly, even if you prevail substantially in an investment arbitration proceeding (here the lottery), that fact cannot modify the value of your investment (the prize), because winning a case and the amount of the award to which you are entitled are again two independent things.

At this point the question must appear to what extent, if at all, these political risks should be included in the damages calculation. For as some authors have suggested, the ability of states to raise country risk resultantly decreases the amount of compensation likely to be awarded, and unlawful acts should not be rewarded by international law. For this reason, I suggest that the hypothetical buyer who assigns a price tag to its investment projects should take expropriation risk into consideration as it stands at the time when the investment decision is made, not at the time immediately before a state measure is taken. This hypothetical buyer actually profits from the fact that an investment already exists in the host country, as without this their well-informed mindset could not exist. In short, some risks emerge based strictly on the very existence of the investment. To put this differently, before being able to confront these risks, investors must first establish their investment projects.

In order to clarify potential outcomes that result from the application of this method, the following possibilities can be outlined. As long as the measures that are capable of increasing country risk are taken only to raise the discount rate for a particular investment, they cannot be taken into consideration because a hypothetical buyer could not have foreseen them, and they are right to presume that the state would not intentionally undermine the value of their investment at the time the investment decision is made. Therefore, no risk can occur here unless and until

[80] Bergolla (n 8) 125.
[81] For a similar conclusion, see *Conocophillips Petrozuata B.V. et al. v. Venezuela* (n 76) para 869.
[82] Tribunals are more confident in referring to the measures that may adversely affect the value of the investment in the quantum phase if the measures are possibly lawful. For instance, in *9REN Holding S.À.R.L. v. Spain*, the tribunal majoriy held that the possibility that Spain may reduce the tariffs in a regulatory framework without violating its international obligation should be regarded as a factor that might affect the decision of 'a prudent and well-informed investor'. See *9REN Holding SÀRL v The Kingdom of Spain*, ICSID Case No. ARB/15/15, Award (31 May 2019) para 412.

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the investor establishes 'this particular investment' because the hostility is directed specifically at 'this particular investment'.

Secondly, a risk that is already present when the investor makes the investment decision will already have been taken into account, as any hypothetical buyer would consider it. Additionally, this risk is also most probably due to the investor being able to profit from some superior benefits or extra incentives in exchange for investing in a country with elevated country risk, as rightfully stated by the *Flughafen v. Venezuela* tribunal. Disregarding this reality may cause the investor to receive double compensation, with part stemming from the extra incentives provided by the state to balance the country risk and the other from a high compensation value due to the expropriation risk not being reflected in the country risk premium.

The third scenario involves a political atmosphere that subsequently develops in the natural course of politics and becomes more hostile against foreign investors. In this case, this possible hostility should be included in the country risk premium when it is apparent before the investment decision is made, as any hypothetical buyer would have considered it when making its investment. However, if this possible hostility was not apparent, the foreseeability of this situation at the time of the investment decision should be analysed. Unless the hypothetical buyer could and should have foreseen it, risks that appeared only recently should not be included in the country risk premium.

Another problematic point is that the objection to the inclusion of political risk disregards the fact that the investment is settled in the host state. Namely, even if investors are protected by investment treaties, they cannot isolate themselves from the destiny of the state. More or less, they became a part of the host country; hence, to accept that investors should be sheltered against any negative consequences that emerge in the host country would be inappropriate. If these consequences constitute a violation of investment treaties, they should certainly be corrected as foreseen in the treaties. However, this does not mean that investors can also isolate themselves from the natural and objective results of being settled in a particular state. The extent to which the political risks (including expropriation risk) created by the host state should be included should be decided according to the methodology suggested above.

Before the conclusion, one last point should be stated relevant to the present discussion. All the above-mentioned cases opting for variant approaches regarding expropriation risk's placement within the country risk premium have underestimated the effect of the existence of a BIT. While I have appraised the view suggesting merits and quantum phases to be distinct from each other, this does not mean that BITs have no function in the calculation of country risk. The existence of a BIT should be counted as a factor that reduces the country risk premium, because even the mere fact that the state has promised not to breach the obligations it has undertaken there may rightfully give the impression to the investor (and any hypothetical buyer at the time of the investment decision) that the state is eager to create an atmosphere friendly to foreign investors.

CONCLUSION

The conditions under which an investment has been established apparently have a direct influence on its value, especially if the host state is an emerging one. Quantum experts attempt to manage the heavy task of determining the discount rate arising from the country risk premium, which is almost always a matter of dispute for parties. In addition to the need to justify the country risk premium, its subcomponent of political risk triggered unilaterally by the host state (ie expropriation risk) urges further justification. Several arbitral tribunals have opted for different approaches. Nonetheless, each of them has its own drawbacks in allocating intra-party risk. Because BITs are not comprehensive insurance policies, an investor cannot just hide behind a

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BIT for any risk to which the investment is exposed. Risks that fall beyond the control of the parties and the risks that emerge from business risks and *force majeure* have been deemed to fall within country risk. As for expropriation risk, I suggest that the time when the investment decision is made should be accepted as the benchmark with regard to the hypothetical buyer method, not the time just before an expropriation decision (or in the broader sense, any political decision) is taken. Tribunals should not ignore the existence of a BIT as a factor to be taken into account in reducing the country risk premium.

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