

**CALCULATING DAMAGES IN INVESTMENT ARBITRATION:  
SHOULD TRIBUNALS TAKE COUNTRY RISK INTO ACCOUNT?**

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**TABLE OF CONTENTS**

I. INTRODUCTION.....	96
II. WHAT IS COUNTRY RISK?.....	97
A. Concept of Country Risk.....	98
B. Sub-Risks.....	99
C. Measurement.....	100
1. For Debt.....	100
2. For Equity.....	101
D. Insurance.....	102
III. INCORPORATING COUNTRY RISK TO VALUATION.....	103
A. Discounted Cash Flows.....	104
1. Discount Rate Premium.....	104
2. Probabilistic Adjustment.....	105
3. Cash Flows Haircuts.....	106
4. Cost of Protection Included in the Cash Flows.....	106
B. Market Approach.....	106
IV. ANALYSIS OF EXISTING AWARDS.....	108
A. Allocation of Country Risk.....	108
B. Reduction of Quantum.....	109
1. Country Risk in DCF.....	109
2. Country Risk in Market-Based Methods.....	111
C. Allocation of Expropriation Risk.....	111
V. SUGGESTED APPROACH.....	113
A. Accounting for Country Risk Depends Both on Law and Economic Theory.....	114
1. Legal Considerations.....	114
2. Economic Considerations.....	117
B. Under Most Legal Regimens and Current Economic Theory, Arbitral Tribunals Should Account for Country Risk.....	118
C. Arbitral Tribunals Should Exclude Sub-Risks Solely Controlled by the Host State's Government.....	118
1. Obligations Performed Under Debtor's Exclusive Will.....	118
2. Allocation of Risks.....	120

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D. Time of Measurement ..... 120

VI. CONCLUSION ..... 121

In a world where arbitration tribunals very frequently welcome claimants’ petitions for compensation, the quantum of damages matters. Sometimes the discussion about valuation is more important than that of the merits. Recently, there has been significant disagreement on whether country risk should be part of the calculus of valuation—and, if so, to what extent. Inconsistent awards have reached contradictory conclusions and led to more unpredictability in an already erratic area.

This paper aims to bring more clarity to the topic by explaining the elements that comprise country risk and how they affect different valuation methods. It then analyzes the positions taken by existing awards. Finally, after reviewing legal and economic arguments, it suggests that while country risk should usually be included, tribunals should exclude sub-risks of which the government is in full control (typically, expropriation risk) when calculating the quantum.

**I. INTRODUCTION**

Arbitration tribunals have often welcomed investors’ claims against foreign states.<sup>1</sup> Yet investors, host states, and tribunals differ on the quantum of valuation—often by a very large amount.<sup>2</sup> Common reasons for this level of variation include the use of different valuation methods; disagreement on the time, information, and assumptions included in the model; and discount factors. Among the latter, country risk presents several difficulties.

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<sup>1</sup> E.g., 46% of the disputes decided by arbitral tribunals under the Investment Center for Settlement of Investment Disputes (ICSID) Convention and Additional Facility Rules have final awards upholding the claims in part or in full. INT’L CTR. FOR SETTLEMENT OF INV. DISPUTES, THE ICSID CASELOAD-STATISTICS, ISSUE 2016-1, 14, <http://documents.worldbank.org/curated/en/372121468186843932/pdf/106048-NWP-PUBLIC-ICSID-Web-Stats-2016-1-English-final.pdf>. Additionally, among the disputes settled and proceedings otherwise discontinued under the ICSID Convention and Additional Facility Rules: 15% are settlement agreements embodied in an award at parties’ request; and 47% are discontinued at the requests of both parties. *See id.* at 14–15.

<sup>2</sup> By June 2006, claims in investment treaty disputes averaged around \$340 million but awards averaged about \$10 million. *See* Susan Frank, *Empirically Evaluating Claims About Investment Treaty Arbitration*, 86 N.C. L. REV. 1, 58 (2007). Saldarriaga & Kantor mentioned that since then the average recovery continues to be low, usually around one third of the claimed amount. *See* Andrea Saldarriaga & Mark Kantor, *Calculating Damages: Arbitrators, Counsel, and Experts Can Do Better Than They Have in the Past*, in *INVESTING WITH CONFIDENCE: UNDERSTANDING POLITICAL RISK MANAGEMENT IN THE 21ST CENTURY* 196, 197 (Kevin Lu et al. eds., 2009).

Parties and tribunals disagree on whether to account for country risk at all. When they do include it in valuation, discrepancy further extends to measurement alternatives, the time of the information, and country risk's sub-components. At the center of the problem is the risk that investors or tribunals see a host state's political, economic, and cultural climate as a breach of investment protection standards, or, conversely, that a host state tries to excuse itself from abiding by its legal duties on account of its sovereign power. Should country risk capture the possibility that a host state breaches its obligations towards the investor? Specifically, should a country risk premium reduce the quantum of damages? If so, to what extent? If not, why? And are there exceptions?

This paper analyzes the concept of country risk, its components, measurement and calculation alternatives, as well as insurance options in Part II. Later, Part III explains how different valuation methods incorporate country risk. Investment arbitration tribunals have reached conflicting conclusions on whether to account for country risk in the valuation stage, the appropriate method to discount it, and whether to include expropriation risk. Part IV reviews existing awards dealing with these issues. I make a suggestion of how to approach country risk in Part V.

## II. WHAT IS COUNTRY RISK?

In a perfect world, the same type of investments would have equal returns everywhere. In practice, different places and industries have diverse risk environments. A reasonable business person does not expect the same return for investing in the United States as in a developing nation.<sup>3</sup>

At the same time, because investors will experience more uncertainty outside mature economies, they will demand more benefits.<sup>4</sup> If investors are risk averse, any higher risk must be compensated with a higher return.<sup>5</sup> That is, before investing, investors will evaluate whether profits will make up for the higher exposure. Placing an investment requires an acceptable combination of return and

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<sup>3</sup> Peter Blair Henry & Prakash Kannan, *Growth and Returns in Emerging Markets*, in INTERNATIONAL FINANCIAL ISSUES IN THE PACIFIC RIM: GLOBAL IMBALANCES, FINANCIAL LIBERALIZATION, AND EXCHANGE RATE POLICY 241 (Nat'l Bureau of Econ. Research E. Asia Seminar on Econ., Book 17, 2008). See also *OI European Group B.V. v. Bolivarian Republic of Venez.*, ICSID Case No. ARB/11/25, Award, ¶ 780 (Mar. 10, 2015) (comparing Italy and Venezuela).

<sup>4</sup> Louis T. Wells & Eric S. Gleason, *Is Foreign Infrastructure Investment Still Risky?*, HARV. BUS. REV., Sept.–Oct. 1995, at 44–55.

<sup>5</sup> This association is true for financial asset markets. But it is not clear whether the same happens in enterprise performance. Some studies have shown a negative relationship between risk and return. If that is correct, higher returns are associated with lower risk and lower return with higher risk. See Edward H. Bowman, *A Risk/Return Paradox for Strategic Management* 17, 25 (Alfred P. Sloan Sch. of Mgmt., Working Paper, WP 1107-80), <https://archive.org/stream/riskreturnparado00bowm#page/n3/mode/2up> (later published in MIT SLOAN MGMT. REV. Issue 21, Spring 1980).

risk. That higher demand will often reflect in a premium added to a baseline expectation. The premium in itself could take the form of more money (e.g., a higher yield for debt), more collateral, additional assurances from the national and international legal system,<sup>6</sup> or several other alternatives.

Investors need to know how that higher risk is different from that of their home state or other mature economies to evaluate the extent of the additional return and protections demanded. Comparisons will often use the United States or Germany as a risk-free country scenario.

### **A. Concept of Country Risk**

Each state creates a different environment within its borders. Every element of governance controlled by sovereign power will play a role in defining the characteristics of the investment climate. Labor policies, the level of permitted free speech, the cost and time of litigation, and the characteristics of human capital, to name a few, will vary from one host state to the other and could have very significant impacts on the investment conditions. Of course, that is to the extent that a host can pursue independent policies. Global markets and foreign pressure will oftentimes restrict what host states can and cannot do within their borders.

In this context, country risk could be described as the unanticipated downside variability in a key performance indicator or strategic target, resulting from engaging in international business transactions with an inevitable exposure to a host state's policies and performance (other than a home country).<sup>7</sup> Country risk must be unanticipated. Expected changes can never be a source of risk.<sup>8</sup>

Country risk exists as a consequence of national borders and sovereign power. More specifically, country risk will arise from the interaction of the strategies implemented by the investor to deal with the host environment, and the host state's action.<sup>9</sup> In this interaction, the investor might be at a disadvantage.<sup>10</sup>

Asymmetrical information could partially explain the problem foreign investors face. Theoretically, investors within a host state will have more knowledge about the state than those outside. Implementing adequate resources can reduce the information gap at a cost.<sup>11</sup> Investors can also gain additional information by becoming repeat players, thus familiarizing themselves with the relevant market.<sup>12</sup> Risk, however, is not only a matter of ignorance.

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<sup>6</sup> SERGEY RIPINSKY & KEVIN WILLIAMS, DAMAGES IN INTERNATIONAL INVESTMENT LAW 326–28 (2008).

<sup>7</sup> COLIN WHITE & MIAO FAN, RISK AND FOREIGN DIRECT INVESTMENT 147 (2006).

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> ADRIAN BUCKLEY, INTERNATIONAL CAPITAL BUDGETING 114 (1995).

<sup>11</sup> WHITE & FAN, *supra* note 7, at 59.

<sup>12</sup> *Id.*

Country risk can be analyzed as a systematic market risk. In that sense, it affects all members of a defined group, extending to all the enterprises that operate within the jurisdiction of a particular country.<sup>13</sup> Industry risk, on the other hand, affects all those investing in a particular industry. Both country and industry risk are unlike idiosyncratic and non-systematic risks,<sup>14</sup> which are independent of the market behavior and can be managed by diversification of assets.<sup>15</sup>

## **B. Sub-Risks**

Country risk comprises several sub-items. Given their large number, it can be helpful to classify these sub-risks. However, there are at least two problems with classification. First, existing literature usually focuses only on a few elements, ignoring others; scholars only agree partially on which elements should affect the analysis.<sup>16</sup> Second, academic studies, rating agencies,<sup>17</sup> and private companies use different terminology to refer to the same sub-components. While all classifications in this context might give rise to complaints, the most simple and commonly found categorizations in economic literature group items in two sub-components: political and economic.<sup>18</sup> Yet some of those sub-items can be further separated for clarity into four groups: political, economic, financial, and cultural.

Political risk is often at the center of country risk analyses because a host state can use most of its sovereign power inside its own borders (as opposed to economic and financial sub-risks, which might be partially outside a host state's territory in a globalized economy). A traditional definition of political risk describes it as "the exposure to a change in value of an investment or cash position resultant upon government action."<sup>19</sup> Critics of this definition point out its narrowness and suggest that it should include any unanticipated change in the

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<sup>13</sup> IMAD MOOSA, *FOREIGN DIRECT INVESTMENT: THEORY, EVIDENCE AND PRACTICE* 207 (2002).

<sup>14</sup> CHRISTOPHER CULP, *THE RISK MANAGEMENT PROCESS: BUSINESS STRATEGY AND TACTICS* 3–31 (2001).

<sup>15</sup> David Aaker & Robert Jacobson, *The Risk of Marketing: The Role of Systematic, Uncontrollable, and Controllable Unsystematic, and Downside Risk*, in *RISK, STRATEGY AND MANAGEMENT* 137–60 (R. Bettis & H. Thomas eds., 1990).

<sup>16</sup> WHITE & FAN, *supra* note 7, at 152–53 tbl.9.1.

<sup>17</sup> Bank of America World Information Service, Business Environment Risk Intelligence, Control Risk Information Services, Economist Intelligence Unit, Euro-Money Magazine, Institutional Investor Magazine, Moody's Investor Services, Political Risk Services: Coplin-O'Leary Rating System, Political Risk Services: International Country Risk Guide, and Standard & Poor's Rating Group all largely disagree on the included sub-risks. Nevertheless, the first five services are more comprehensive. *See id.* at 154 tbl.9.2.

<sup>18</sup> MOOSA, *supra* note 13, at 131–60.

<sup>19</sup> BUCKLEY, *supra* note 10, at 312.

host state's political environment that has a negative impact in a relevant performance indicator or strategic target.<sup>20</sup>

Yet another alternative definition of political risk sees it as "unexpected changes in future cash flows due to political events in the host country."<sup>21</sup> And it classifies it in macro and micro political risks. The former is country-specific and influences all foreign firms in the host state alike. The latter is exclusive to a certain industry, firm, or project.<sup>22</sup>

The list of the components of political risk often includes: change of government (democratic or otherwise); lack of continuity in government policies; political instability; war, invasions, and other types of foreign conflict; internal conflict (civil war, social unrest, high crime rates); terrorism; nationalism; and dependence on other states or international institutions. Among these, change of government, political instability, nationalism, and policy discontinuity (sometimes combined with economic and financial risks) can give rise to direct or indirect expropriation. For international investment law, such expropriation is the main source of political risk.

Economic risk results from unexpected changes in the economic context of an investment project.<sup>23</sup> The main sub-items of economic risk are: reduction or slowdown of economic growth; deficit in the balance of payments; depreciation of the exchange rate; inflation; interest rate increase; and poor infrastructure.<sup>24</sup> Financial risk refers to unexpected changes in creditworthiness. Among other factors, it comprises of limited ability or complete inability to access international financial markets and low credit ratings.<sup>25</sup> Cultural risk refers to transaction costs and negotiation differences that arise from cultural patterns of behavior when doing business. Corruption, nepotism, and conflicts of language, religion, or race all make up this sub-list.<sup>26</sup>

### **C. Measurement**

#### **1. For Debt**

The oldest and most straightforward measure of country risk is an assessment of the probability of default when lending to the host state's

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<sup>20</sup> WHITE & FAN, *supra* note 7, at 147.

<sup>21</sup> Dorothee J. Feils & Florin M. Şabac, *The Impact of Political Risk on the Foreign Direct Investment Decision: A Capital Budgeting Analysis*, 45 *ENGINEERING ECONOMIST* 129 (2000).

<sup>22</sup> *Id.*

<sup>23</sup> WHITE & FAN, note *supra* 7, at 158.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at 161.

<sup>26</sup> *Id.* at 162.

government.<sup>27</sup> Measurement attempts for sovereign default risk date back to the 19th century.<sup>28</sup> To determine the host state's default risk, the variables to consider are degree of indebtedness, social security costs, government revenues, political risk, and collaterals.<sup>29</sup> The most common assessments of default risk are sovereign ratings and credit default swaps' prices.

That information might not be enough to evaluate country risk in general, though. So a number of companies provide measurement services that go beyond the sovereign bond market and add a partial qualitative analysis. Some select a combination of variables to evaluate political, economic, and financial risks. The result is a score per country.<sup>30</sup> Others survey hundreds of economists to determine a country's score;<sup>31</sup> measure currency risk, sovereign debt, economic structure risk, political risk, banking risk, and overall risk;<sup>32</sup> or evaluate corruption, government effectiveness, political stability, regulatory quality, rule of law, and voice/accountability,<sup>33</sup> among several other options.<sup>34</sup>

## 2. For Equity

Estimating equity risk premiums for a specific country is a different task. How to approach it might depend on available information and which country is in question. One option is to use historical data in each market to estimate an equity risk premium. This first approach suffers from structural and statistical problems in most emerging markets.<sup>35</sup>

A second alternative is to begin the analysis with an equity risk premium for a mature market (e.g., the United States or Germany) and build up to or estimate additional risk premiums for countries carrying more risk. Analysts can ascertain the mature market premium by analyzing either the historical risk

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<sup>27</sup> Aswath Damodaran, *Country Risk*, in INVESTMENT RISK MANAGEMENT, 155, 158–60 (K. Bajer & G. Filbeck eds., 2015) [hereinafter Damodaran, *Country Risk*].

<sup>28</sup> *Id.* at 159.

<sup>29</sup> Aswath Damodaran, *Country Risk: Determinants, Measures and Implications—The 2015 Edition 25–28* (July 14, 2015) (unpublished paper), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2630871](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2630871) [hereinafter Damodaran, *Determinants*].

<sup>30</sup> E.g., *International Country Risk Guide*, PRS GROUP, <https://www.prsgroup.com/about-us/our-two-methodologies/icrg> (last visited Oct. 23, 2016).

<sup>31</sup> *Country Risk survey results Q3 2016: China, Italy, Nigeria mar stabilizing global outlook*, EUROMONEY, <http://www.euromoney.com/Poll/10683/PollsAndAwards/Country-Risk.html> (last visited Oct. 23, 2016).

<sup>32</sup> *Country Risk Service: Sovereign risk ratings and analysis for 128 countries*, ECONOMIST (2014), [www.eiu.com/handlers/PublicDownload.ashx?mode=m&fi=risk-section/country-risk-service.pdf](http://www.eiu.com/handlers/PublicDownload.ashx?mode=m&fi=risk-section/country-risk-service.pdf).

<sup>33</sup> *Worldwide Governance Indicators*, WORLD BANK, <http://data.worldbank.org/data-catalog/worldwide-governance-indicators> (last updated Oct. 16, 2016).

<sup>34</sup> WHITE & FAN, *supra* note 7, at 15.

<sup>35</sup> See Roelof Salomons & Henk Grootveld, *The Equity Risk Premium: Emerging vs Developed Markets*, 4 EMERGING MKTS. REV. 121 (2003).

premium for the United States or the average historical risk premium across dozens of equity markets.<sup>36</sup> For non-mature markets there is a need to measure country risk and convert it into a country risk premium. Analysis can do this by using default spreads (based upon sovereign bonds or ratings) or equity market volatility as an input.<sup>37</sup>

A third possibility is to use the market pricing of equities within each market to back out estimates of an implied equity risk premium. The advantage is that this approach is market-driven and current and does not require any historical data. Thus, it can be used to estimate implied equity premiums in any market, even if the market has a short history.<sup>38</sup>

#### **D. Insurance**

Investors seeking alternatives to secure their foreign investment can resort to political risk insurance. This term encompasses different programs that aim at reducing the investor's exposure to country risk.<sup>39</sup> There are four principal classes of insurance instruments.<sup>40</sup> National or bilateral guarantee programs are where a government owns and operates insurance to its nationals that invest in eligible foreign states.<sup>41</sup> Multilateral guarantee programs, such as that Multilateral Investment Guarantee Agency (MIGA), offer investors from World Bank member states insurance to protect investments placed in developing member states.<sup>42</sup> Some regional development banks also provide insurance to member states,<sup>43</sup> and private insurance companies sell products to anyone.<sup>44</sup>

The policies generally cover three types of political risk. First, currency inconvertibility coverage protects against losses caused by currency transfer restrictions. Typically, it applies to the interruption of interest payments, repatriation of capital or dividends, or similar restrictions caused by the host

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<sup>36</sup> Damodaran, Determinants, *supra* note 29, at 55.

<sup>37</sup> *Id.* at 56.

<sup>38</sup> *Id.* at 67.

<sup>39</sup> KRISTA NADAKAVUKAREN SCHEFER, INTERNATIONAL INVESTMENT LAW 511–12 (2013).

<sup>40</sup> *Id.*

<sup>41</sup> *Id.* at 96–97.

<sup>42</sup> Ibrahim Shihata, *Toward a Greater Depoliticization of Investment Disputes: The Roles of ICSID and MIGA*, in INVESTING WITH CONFIDENCE: UNDERSTANDING POLITICAL RISK MANAGEMENT IN THE 21ST CENTURY, *supra* note 2, at 2, 11–17.

<sup>43</sup> For example, political risk insurance is provided by the Islamic Corporation for Insurance of Investment and Export Credit (member of the Islamic Development Bank Group), the Asian Development Bank, the African Development Bank, and the Inter-American Development Bank, among others.

<sup>44</sup> Political risk insurance is provided by ACE Global Markets, Marsh, and AON, among other companies. See also Kathryn Gordon, *Investment Guarantees and Political Risk Insurance: Institutions, Incentives and Development*, in OECD INVESTMENT POLICY PERSPECTIVES 2008, 103–04 (2009).



state's currency restrictions. Second, confiscation, expropriation, and nationalization coverage protects investors against losses generated by various acts of expropriation. The coverage applies to confiscation of both property and funds. Third, political violence covers losses caused by war, civil disturbance, or terrorism.<sup>45</sup>

While the content of these policies varies from one to the next, there are some typical clauses. Policy duration can be up to 15 years. There, an insured investor has to accept a part of the financial loss, either as a deductible or a co-insurance. More interestingly, policies often include salvage and subrogation clauses. Under the former, the insured may have to forfeit ownership of its insured property. The insurance provider can then sell any of the remaining assets to reduce its loss. Under the latter, the investor has to transfer the legal rights to litigate or settle the dispute to the insurer. This is another opportunity for the insurance to recover the sums paid.<sup>46</sup>

### III. INCORPORATING COUNTRY RISK TO VALUATION

There are several company valuation methods available to determine the quantum of damages. The asset-based approach includes the replacement value, book value, and liquidation value methods.<sup>47</sup> The market-based approach uses the multiples, stock prices, prior transactions, offerings, and comparable sales methods.<sup>48</sup> The income-based approach uses the discounted cash flows method (DCF).<sup>49</sup> Others make reference to amounts invested. And finally there are some hybrid approaches.<sup>50</sup> Whether it is better to use one or another (or a combination of them) depends on the facts of the case. Nevertheless, there are two that investment arbitration tribunals commonly apply, given the prevalence of some repeated fact patterns in investment law dispute resolution: DCF and market approaches (prior transactions and multiples). What follows is a review of how country risk applies to those valuation methods.

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<sup>45</sup> Summary of Findings, Kausar Hamdani, Elise Liebers & George Zanjani, An Overview of Political Risk Insurance, to Federal Reserve Bank of New York 2 (May 2005), <https://www.bis.org/publ/cgfs22fedny3.pdf>.

<sup>46</sup> Feils & Şabac, *supra* note 21, at 131.

<sup>47</sup> RICHARD BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 77–78, 466 (2014); MARK KANTOR, VALUATION FOR ARBITRATION, 8–9, 231–39 (2008).

<sup>48</sup> KANTOR, *supra* note 47, at 8; BREALEY ET AL., *supra* note 47, at 78.

<sup>49</sup> BREALEY ET AL., *supra* note 47, at 93.

<sup>50</sup> David Jenkins, *The Benefits of Hybrid Valuation Models*, CPA J., Jan. 2006, at 48.

### A. Discounted Cash Flows

Many arbitral tribunals have awarded damages using DCF<sup>51</sup>—increasingly so in recent years.<sup>52</sup> This method has the advantage that managers can plan better on how to mitigate risks because of the prior analyzing of specific risks and their impact on value. Another benefit is that companies can customize their forecasts by considering risks that affect them specifically. This improves the valuation's accuracy.<sup>53</sup>

Yet DCF is not without problems. The World Bank has warned that

particular caution should be observed in applying this method as experience shows that investors tend to greatly exaggerate their claims of compensation for lost future profits. Compensation under this method is not appropriate for speculative or indeterminate damage, or for alleged profits which cannot legitimately accrue under the laws and regulations of the host country.<sup>54</sup>

The tendency towards inflating claims (and the complexity of the method)<sup>55</sup> might make investment tribunals sometimes wary of accepting DCF.<sup>56</sup> And when tribunals do use it, they might be more willing to accept higher discount rates, cash flow haircuts, added costs, or other mechanisms to deflate the quantum of damages.<sup>57</sup> Under this scenario, the ball is in the investor's court to claim well-grounded numbers.

#### 1. Discount Rate Premium

A common mechanism to account for country risk in the valuation of a company when using DCF is to build a specific discount rate premium for that

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<sup>51</sup> See *SEDCO, Inc. v. Nat'l Iranian Oil Co.*, 15 Iran-U.S. Cl. Trib. Rep. 23, 104 (1987); *ADC Affiliate Ltd. & ADC & ADMC Mgmt. Ltd. v. Republic of Hung.*, ICSID Case No. ARB/03/16, Award of the Tribunal, (Oct. 2, 2006); *Sempra Energy Int'l v. Argentine Republic*, ICSID Case No. ARB/02/16, Award of the Tribunal, (Sept. 28, 2007).

<sup>52</sup> See cases cited *infra* Part IV.B.a.

<sup>53</sup> Mimi James & Timothy M. Keller, *Valuation in Emerging Markets*, 4 MCKINSEY Q. 83 (2000).

<sup>54</sup> *Report to the Development Committee on the Legal Framework for the Treatment of Foreign Investment*, in LEGAL TREATMENT OF FOREIGN INVESTMENT: THE "WORLD BANK GUIDELINES" 193, 210–11 (Ibrahim Shihata ed., 1993) (citations omitted).

<sup>55</sup> John Gotanda, *Recovering Lost Profits in International Disputes*, 36 GEO. J. INT'L L. 61, 91 (2004).

<sup>56</sup> Jack Coe, Jr. & Noah Rubins, *Regulatory Expropriation and the Tecmed Case: Context and Contributions*, in INTERNATIONAL INVESTMENT LAW AND ARBITRATION 597, 659 (Tod Weiler ed., 2005).

<sup>57</sup> KANTOR, *supra* note 47, at 136–37, 140–41.

country and investment. Usually, analysts use a measure of country risk (e.g., default spreads) and add it to the cost of equity and debt of every company traded in that country. The main variations on this approach come in the measure of country risk selected. A discount rate premium equation might look like this:

$$\text{Cost of equity} = \text{Risk-free rate} + \text{Beta (Mature Market Premium)} + \text{Country Risk Premium}^{58}$$

Some experts criticize the use of a discount rate premium. The arguments' common theme is the same. Discount rate premiums overstate country risk by using an inappropriate proxy (e.g., sovereign default for equity risk);<sup>59</sup> double discount risks already included in reduced cash flows;<sup>60</sup> ignore investment law or BIT's provisions that require using but-for cash flows for investments protected from sovereign risk; or disregard laws that exclude risk of default from damage calculation.<sup>61</sup> Still, arbitration tribunals have often applied a discount rate premium to account for country risk.<sup>62</sup>

## 2. Probabilistic Adjustment

A second alternative is to devise alternative cash flow scenarios that reflect different possible outcomes.<sup>63</sup> Analysts first estimate the likelihood that a risky event will occur and then measure the consequences for cash flows under all scenarios. Possible alternatives might assume that the host state complies with all investment protection standards, lawfully expropriates the investment by timely paying compensation, or illegally expropriates the investment.<sup>64</sup> The final valuation results from averaging the assessed probability of each outcome.<sup>65</sup>

<sup>58</sup> Damodaran, *Determinants*, *supra* note 29, at 72.

<sup>59</sup> See KANTOR, *supra* note 47, at 159; James & Keller, *supra* note 53, at 83.

<sup>60</sup> Florin A. Dorobantu et al., *Country Risk and Damages in Investment Arbitration*, 31 ICSID REV. 219 (2016).

<sup>61</sup> Andrew C. Wright, *Analyzing DCF as a Valuation Method for Calculating Damages in Expropriation Arbitrations*, BUCERIUS/WHU (2009).

<sup>62</sup> See *infra* Part IV.B.

<sup>63</sup> See BREALEY ET AL., *supra* note 47, at 143.

<sup>64</sup> PRICEWATERHOUSECOOPERS, *REWARDING EXPROPRIATION?* 8 (2015), <http://www.pwc.co.uk/assets/pdf/rewarding-expropriation.pdf>

<sup>65</sup> *Id.*

### 3. Cash Flows Haircuts

Analysts can also adjust for country risk by lowering expected cash flows by a specific percentage depending on the host state.<sup>66</sup> The riskier the country, the higher the haircut. This alternative posits several problems. It is arbitrary. It might vary significantly from one financial analyst to the next, and among different investment decisions. Worse, once the haircut is applied, the adjustment is hidden or implicit in the cash flows.<sup>67</sup> Unless the company's financial statements or the parties' experts expressly mention that, the arbitration tribunal might not be aware of the haircut and might apply a second discount.

### 4. Cost of Protection Included in the Cash Flows

Instead of reflecting country risk with a discount rate or alternative cash flow predictions, it is possible to include the cost in the cash flows. Here, country risk would become a cost, as investors must purchase insurance to counteract country risk.<sup>68</sup> In that sense, as long as one can buy protection against the specific country risk's sub-components, part or all of the country risk will reduce the estimated cash flows.<sup>69</sup>

However, because the availability of insurance or guarantees will depend on the investor's state, the host state, and the terms of the policy (e.g. caps to the covered amounts), it might not always be possible to build in the cost of protection. There are several reasons why investors are not purchasing insurance: the high cost (missing markets effect); mismatches between offered products and demand, where policies do not cover all relevant risks (e.g., currency depreciation, terrorism); and low coverage amounts for the relevant industry.<sup>70</sup>

## **B. Market Approach**

The market approach values a company by comparing it with the same or similar companies for which there is price information available.<sup>71</sup> The information taken into account for valuation purposes includes similar businesses, business ownership interests and securities exchanged in the market and any relevant transactions of shares in the same business, prior transactions, or offers

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<sup>66</sup> Aswath Damodaran, *Valuing Country Risk: Pictures of Global Risk Part II, MUSINGS ON MARKETS* (July 29, 2015), <http://aswathdamodaran.blogspot.com/2015/07/valuing-country-risk-pictures-of-global.html>.

<sup>67</sup> *Id.*

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

<sup>70</sup> Gordon, *supra* note 44, at 95–117.

<sup>71</sup> BREALEY ET AL., *supra* note 47, at 78.

for any component of the business.<sup>72</sup> Prior transactions and multiples are among the preferred methods.

Tribunals have resorted to prior transactions data on several occasions.<sup>73</sup> Here, the focus will be on prior transference of the company being valued. The valuator might need to adjust the quantum based on passage of time, changed circumstances in the economy, the industry, and the business.<sup>74</sup> These changes might include an increased expropriation risk.<sup>75</sup> However, unless there is enough information on how much country risk influenced valuation in the prior transaction, a proper adjustment might not be possible.<sup>76</sup>

When lacking this information, tribunals have resorted to comparable transactions or sales.<sup>77</sup> Here, the valuator will identify a sample of transactions or publicly traded companies that are sufficiently similar to the investment being valued. If the transactions or companies originate from the same host state, the comparison might be pertinent. However, whether the original data accounts for the relevant country risk depends on the investments' shared characteristics. If they do not have enough elements in common, re-adjustment might not be possible. This becomes even more difficult if the comparable sales took place in another state.<sup>78</sup>

Using valuation multiples<sup>79</sup> is a third alternative. This rule-of-thumb like approach consists of selecting one variable of the company (usually cash flows, EBIT or EBITDA) and multiplying it by a factor (e.g., the sale of comparable investments).<sup>80</sup> Discounting country risk here might be even more impractical, given the numerous pieces of information and assumptions on the variables of the other companies that might be missing.<sup>81</sup>

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<sup>72</sup> INT'L VALUATION STANDARDS COUNCIL, INTERNATIONAL VALUATION STANDARDS 2013, FRAMEWORK & REQUIREMENTS ¶ 18 (2013), [http://www.valuersinstitute.com.au/docs/professional\\_practice/International%20Valuation%20Standards%202013.pdf](http://www.valuersinstitute.com.au/docs/professional_practice/International%20Valuation%20Standards%202013.pdf) [hereinafter IVSC VALUATION STANDARDS].

<sup>73</sup> Gould Marketing Inc. v. Iran, 6 Iran-U.S. Cl. Trib. Rep. 272, 286 (1984); INA Corp. v. Iran, 8 Iran-U.S. Cl. Trib. Rep. 373, 380 (1985); Phelps Dodge v. Iran, 10 Iran-U.S. Cl. Trib. Rep. 121 (1987).

<sup>74</sup> IVSC VALUATION STANDARDS, *supra* note 72, ¶ 30.

<sup>75</sup> KANTOR, *supra* note 47, at 121.

<sup>76</sup> This is because absent that information, the tribunal will not be able to control for differences, which is one of the steps necessary to use comparable market information for valuation. *See id.* at 121.

<sup>77</sup> Mohtadi v. Iran, 32 Iran-U.S. Cl. Trib. Rep. 124 (1996); Papastavrou v. Greece, 2003-IV Eur. Ct. H.R. 257 (2003).

<sup>78</sup> Dorobantu et al., *supra* note 60.

<sup>79</sup> The valuation multiples approach includes 'enterprise value multiples,' 'equity value multiples,' and other less used alternatives.

<sup>80</sup> *See* Robert W. Holthausen & Mark E. Zmijewski, *Valuation with Market Multiples: How to Avoid Pitfalls When Identifying and Using Comparable Companies*, J. APPLIED CORP. FIN., Sept. 2012, at 26-27.

<sup>81</sup> To learn about other possible problems of this method, see generally BREALEY ET AL., *supra* note 47, at 78.

#### IV. ANALYSIS OF EXISTING AWARDS

Arbitration tribunals have often assessed country risk as part of the calculus to determine the damage's quantum. Often times, tribunals do not analyze the reasons behind the decision to discount country risk, though they have in a few recent cases.<sup>82</sup> Either way, existing awards on the topic lack consistency, as discussed below.

##### A. Allocation of Country Risk

Tribunals have stated on several occasions that general deterioration of a host state's economic situation or of ongoing circumstances must not be compensated to the investor.<sup>83</sup> This means that it is not the host state's duty to make a good general risk assessment of investing and working in a country facing difficult economic conditions, which may have many reasons outside of the control of the investor and the host state.<sup>84</sup> Additionally, it is not the host state's duty to ameliorate the risk of operating in a developing country or region, because such risks might have reasons outside the control of the parties.<sup>85</sup>

International Investment Agreements (IIAs) and investment laws provide for standards of protection for investments but not total indemnity against the risk of placing money abroad, particularly in developing countries. That is, several tribunals have expressed that international law does not protect investors against investment risks<sup>86</sup> and IIAs are not insurance policies.<sup>87</sup> Although IIAs provide

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<sup>82</sup> *Gold Reserve Inc. v. Bolivarian Republic of Venez.*, ICSID Case No. ARB(AF)/09/1, Award, (Sept. 22, 2014); *Venez. Holdings B.V. v. Bolivarian Republic of Venez.*, ICSID Case No. ARB/07/27, Award, (Oct. 9, 2014); *Flughafen Zürich AG & Gestion e Ingeria IDC SA v. Bolivarian Republic of Venez.*, ICSID Case No. ARB/10/19, Award, (Nov. 18, 2014); *OI European Group B.V. v. Bolivarian Republic of Venez.*, ICSID Case No. ARB/11/25, Award, (Mar. 10, 2015); *Tidewater Inc., et al. v. Bolivarian Republic of Venez.*, ICSID Case No. ARB/10/5, Award, (Mar. 13, 2015).

<sup>83</sup> *See, e.g., Ebrahimi Shahin Shaine v. Iran*, 30 Iran-U.S. Cl. Trib. Rep. 170, \*28 (1994); *Sola Tiles Inc. v. Iran*, 14 Iran-U.S. Cl. Trib. Rep. 223, \*11 (1987).

<sup>84</sup> *CME Czech Republic B.V. v. Czech Republic*, Final Award, ¶ 561 (Mar. 14, 2003), 9 ICSID Rep. 264 (2006).

<sup>85</sup> *Id.* ¶¶ 561–62.

<sup>86</sup> *Starrett Housing v. Iran*, 4 Iran-U.S. Cl. Trib. 122, 156 (1983); *AIG v. Iran*, 4 Iran-U.S. Cl. Trib. 96, 107 (1983).

<sup>87</sup> *MTD Equity Sdn. Bhd. & MTD Chile S.A. v. Republic of Chile*, ICSID Case No. ARB/01/7, Award, ¶ 178 (May 25, 2004); *Emilio Agustín Maffezini v. The Kingdom of Spain*, ICSID Case No. ARB/97/7, Award, ¶ 64 (Nov. 13, 2000).

tools to reduce or mitigate risk, investors are still in charge of business risks.<sup>88</sup> When a contract or an IIA does change the risk allocation, making the investment more burdensome for the host state, tribunals have taken into account the additional financial gains of the investor in the quantum of compensation awarded.<sup>89</sup>

## **B. Reduction of Quantum**

### 1. Country Risk in DCF

Arbitral tribunals frequently discount for country risk when using the DCF method. Tribunals often prefer to build an additional premium rate in spite of valuation experts' preference for discounting country risk from cash flows. Sometimes tribunals use discount rates without further analysis.<sup>90</sup> Other times, they expressly take on the issue. For example, in *CMS v. Argentina*, the claimant used the build-up method (risk-free rates plus risk premiums) and arrived at a number close to that the host state used in a prior tariff review.<sup>91</sup> The tribunal accepted the build-up method but increased the discount rate, arguing that at the time of the tariff review the host state had incentives to cite an artificially low rate.<sup>92</sup>

There is also disagreement on whether to use sovereign bond spreads to calculate the additional country premium. In rejecting the idea, the *Sempra v. Argentina* tribunal reasoned that the country risk premium required by an investor in a private company was significantly lower than the government's credit risk premium during the same period.<sup>93</sup> Conversely, in accepting the idea, the *GAI and Rurelec v. Bolivia* tribunal stated that the premium is typically calculated by looking at the spread implicit in the market yield of host state's sovereign bonds traded internationally.<sup>94</sup> But since no such bonds existed the tribunals used an index of emerging market bond as a proxy.<sup>95</sup> The tribunal also rejected the respondent's petition to add a country risk multiplier and a size premium.<sup>96</sup>

<sup>88</sup> *Waste Mgmt., Inc. v. United Mexican States*, ICSID Case No. ARB(AF)/98/2, Award, ¶ 177 (Jun. 2, 2000); *Eudoro Armando Olguin v. Republic of Para.*, ICSID Case No. ARB/98/5, Award, ¶ 65.b (Aug. 3, 2005).

<sup>89</sup> *Himpurna v. PLN*, Final Award, ¶ 294 (May 4, 1999), 25 Y.B. Comm. Arb. 11 (2000).

<sup>90</sup> *See ADC Affiliate Ltd. and ADC & ADMC Mgmt. Ltd. v. Republic of Hung.*, ICSID Case No. ARB/03/16, Award, ¶ 511 (Oct. 2, 2006).

<sup>91</sup> *CMS Gas vs. Arg.*, ICSID Case No. ARB/01/08, Award, ¶ 454 (May 12, 2005).

<sup>92</sup> *Id.* ¶¶ 187, 450–57.

<sup>93</sup> *Sempra Energy Int'l v. Argentine Republic*, ICSID Case No. ARB/02/16, Award, ¶ 433 (Sept. 28, 2007).

<sup>94</sup> *Guaracachi America, Inc. v. Plurinational State of Bol.*, PCA Case No. 2011-17, ¶¶ 558–59 (2014).

<sup>95</sup> *Id.* ¶ 560.

<sup>96</sup> *Id.* ¶¶ 583, 602–03.

Other tribunals have applied a more elaborate country risk premium following specific formulas. In *Lemire v. Ukraine*, the tribunal adopted Professor Damodaran's approach,<sup>97</sup> which included a ten-year average of the mature market premium to calculate the host state's higher country risk.<sup>98</sup>

The *OI European Group B.V. v. Venezuela* tribunal also accepted that formula.<sup>99</sup> The claimant had proposed a country risk premium of 2%, arguing that since the host state controls legal, regulatory, and political risks, the discount rate must exclude them.<sup>100</sup> Furthermore, the claimant argued that accepting the 6% rate resulting from Damodaran's formula would have sent negative messages in the business environment about potential expropriations that the host state would have generated.<sup>101</sup> In rejecting the claimant's arguments, the tribunal said that the claimant had not demonstrated that the negative messages had managed to cause a 4% increase in the host state's country risk premium.<sup>102</sup> Moreover, the award highlighted the calculation bore no relation with the microeconomic policies the host state implemented.<sup>103</sup>

More recently, in *Tidewater v. Venezuela*, the tribunal also rejected the claimant's contention that valuation should exclude most political risks created by the host state, which allegedly allowed them to purchase assets at high discounts.<sup>104</sup> The tribunal found that (i) the applicable bilateral investment treaty (BIT) did not create a legal indemnity against political risks resulting from the host state's breaching investment protection standards; (ii) the BIT allows host states to take assets by paying compensation; and (iii) any hypothetical buyer would factor country risk into its own consideration of the investment's value.<sup>105</sup>

The question of determining the relevant market to set the risk premium rate appeared recently. In *Quiborax v. Bolivia*, the tribunal referred to the host state's country risk premium, and thus declined to use that of target market states.<sup>106</sup> The claimant advocated that *ulexite*<sup>107</sup> markets' country risk (i.e., Brazil, China, India, and the United States) should determine the discount rate.<sup>108</sup>

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<sup>97</sup> See Part III.A.1.

<sup>98</sup> *Lemire v. Ukr.*, ICSID Case No. Arb/06/18, Award, ¶¶ 285–86 (Mar. 28, 2011).

<sup>99</sup> *OI European Group B.V. v. Bolivarian Republic of Venez.*, ICSID Case No. ARB/11/25, Award, ¶¶ 773–74 (Mar. 10, 2015).

<sup>100</sup> *Id.* ¶¶ 775–77.

<sup>101</sup> *Id.* ¶ 781.

<sup>102</sup> *Id.* ¶ 782.

<sup>103</sup> *Id.* ¶¶ 782–83.

<sup>104</sup> *Tidewater Inc., et al. v. Bolivarian Republic of Venez.*, ICSID Case No. ARB/10/5, Award, ¶¶ 183, 188 (Mar. 13, 2015).

<sup>105</sup> *Id.* ¶¶ 182–90.

<sup>106</sup> *Quiborax S.A., Non Metallic Minerals S.A. v. Plurinational State of Bol.*, ICSID Case No. ARB/06/2, Award, ¶ 487 (Sept. 16, 2015).

<sup>107</sup> *Ulexite* is a soft mineral consisting of a hydrous borate of sodium and calcium and usually occurring in loose masses of white fibers. *Ulexite*, MERRIAM-WEBSTER DICTIONARY (2016).

<sup>108</sup> *Quiborax S.A., Non Metallic Minerals S.A. v. Plurinational State of Bol.*, ICSID Case No. ARB/06/2, Award, ¶ 480 (Sept. 16, 2015).



However, the tribunal stated that the relevant risk was that of the host state and used Damodaran's data for the premium.<sup>109</sup>

## 2. Country Risk in Market-Based Methods

While it is more difficult to apply country risk discounts in market-based methods, there are precedents on this strategy. In *CME v. The Czech Republic*, the tribunal valued the investment based on a multiple, which was influenced (i.e., reduced) by the risk of operating broadcasting stations in Eastern Europe.<sup>110</sup> In *Thomas Earl Payne v. Iran*, the Iran-US tribunal rejected the use of a multiple of net average earnings proposed by the claimant.<sup>111</sup> However, the tribunal did award damages by reducing the quantum to approximately 30% of the investment's fair market value, as computed by the claimant.<sup>112</sup>

In *Khosrowshahi v. Iran*, the tribunal based its valuation on the stock exchange's share prices eight months before the expropriation.<sup>113</sup> But the tribunal then reduced the quanta by 25% and 30%, to reflect the Iranian Revolution's economic and political risks.<sup>114</sup> The same risk also caused the tribunal in *Sola Tiles v. Iran* to reduce the compensation amount, originally obtained by reference to a buyer's purchase offering for 45% equity in the investment.<sup>115</sup>

However, tribunals sometimes refused to apply a discount. In *Phelps Dodge v. Iran*, the tribunal awarded compensation by the original amount the investor paid six years before the expropriation.<sup>116</sup> The tribunal refused to reduce the quantum as a consequence of the Iranian Revolution.<sup>117</sup>

## C. Allocation of Expropriation Risk

In *Amoco v. Iran*, the tribunal had to answer the claimant's request to exclude expropriation risk from the valuation's quantum. In rejecting the petition, the tribunal said that the dispute on this point was "surreal" because the risk had already materialized.<sup>118</sup> The tribunal in *Phillips Petroleum v. Iran* took an opposite view.<sup>119</sup> Again at claimant's request, the tribunal excluded the effects of

<sup>109</sup> *Id.* ¶ 487.

<sup>110</sup> *CME Czech Republic B.V. v. Czech Republic*, Final Award, ¶¶ 561–62 (Mar. 14, 2003), 9 ICSID Rep. 264 (2006).

<sup>111</sup> *Thomas Earl Payne v. Iran*, 12 Iran-U.S. Cl. Trib. Rep. 3, ¶¶ 15–16, 35–37 (1986).

<sup>112</sup> *Id.*

<sup>113</sup> *Khosrowshahi v. Iran*, 30 Iran-U.S. Cl. Trib. Rep. 76, ¶¶ 52, 78 (1994).

<sup>114</sup> *Id.*

<sup>115</sup> *See Sola Tiles Inc. v. Iran*, 14 Iran-U.S. Cl. Trib. Rep. 223 (1987).

<sup>116</sup> *Phelps Dodge Corp. v. Iran*, 10 Iran-U.S. Cl. Trib. Rep. 121, ¶¶ 30–31 (1986).

<sup>117</sup> *Id.*

<sup>118</sup> *Amoco Int'l Fin. Corp. v. Iran*, 15 Iran-U.S. Cl. Trib. Rep. 189, ¶ 248 (1987).

<sup>119</sup> *Phillips Petroleum Co. v. Iran*, 21 Iran-U.S. Cl. Trib. Rep. 79, ¶ 136 (1989).

the risk or threats of expropriation and focused on the business risks typical of that particular investment's industry.<sup>120</sup>

More recently, three awards have dealt with the same question reaching three different solutions. *Gold Reserve v. Venezuela* gave investors some hope.<sup>121</sup> There the tribunal excluded expropriation risk from the discount rate in a DCF valuation.<sup>122</sup> The claimant had proposed a discount rate of 8.22%.<sup>123</sup> The respondent suggested a rate between 15% and 23%.<sup>124</sup> These numbers reflected a higher country risk premium to capture the expropriation risk.<sup>125</sup>

The tribunal deemed it inappropriate to increase the country risk premium to reflect the market's perception of the host state's policy to nationalize investments in breach of IIAs.<sup>126</sup> Nevertheless, the tribunal found that the claimant's figure was too low because it failed to include other risks.<sup>127</sup> The tribunal then chose a rate of 10.09%.<sup>128</sup> The Paris Court of Appeal granted Gold Reserve's request for recognition of the award, dismissing the host state's arguments about mistakes in the country risk premium.<sup>129</sup>

Later, host states recovered their breath. In *Venezuela Holdings v. Venezuela*, the tribunal decided that confiscation risk is part of the country risk; thus, the arbitrators considered confiscation risk in determining the discount.<sup>130</sup> The claimants proposed an 8.7% discount rate.<sup>131</sup> They accepted some elements of country risk such as market volatility and civil unrest.<sup>132</sup> However, they argued against confiscation risk's inclusion based on the host state's BIT obligations.<sup>133</sup> The applicable BIT provided for that compensation for expropriation should be the market value of the investment before the measures were taken or became of public knowledge.<sup>134</sup>

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<sup>120</sup> This was a 2 to 1 decision. Arbitrator Khalilian emphatically disagreed with the valuation approach. See *Phillips Petroleum Co. v. Iran*, 21 Iran-U.S. Cl. Trib. Rep. 39, ¶ 136 (1989); see also *Phillips Petroleum Co. v. Iran*, Statement by Judge Khalilian, 21 Iran-U.S. Cl. Trib. Rep. 97 (1989).

<sup>121</sup> *Gold Reserve Inc v. Bolivarian Republic of Venez.*, ICSID Case No. ARB(AF)/09/1, Award, (Sept. 22, 2014).

<sup>122</sup> *Id.* ¶ 841.

<sup>123</sup> *Id.* ¶ 839.

<sup>124</sup> *Id.*

<sup>125</sup> *Id.* ¶ 841.

<sup>126</sup> *Gold Reserve Inc v. Bolivarian Republic of Venez.*, ICSID Case No. ARB(AF)/09/1, Award, ¶ 841 (Sept. 22, 2014).

<sup>127</sup> *Id.*

<sup>128</sup> *Id.* ¶ 842.

<sup>129</sup> See Cour d'appel [CA] [regional court of appeal] Paris, Jan. 29, 2015, 14/21103 (Fr.).

<sup>130</sup> *Venez. Holdings B.V. v. Bolivarian Republic of Venez.*, ICSID Case No. ARB/07/27, Award, ¶ 365 (Oct. 9, 2014).

<sup>131</sup> *Id.* ¶ 361.

<sup>132</sup> *Id.* ¶¶ 322, 364.

<sup>133</sup> *Id.* ¶ 364.

<sup>134</sup> *Id.* ¶ 365.

The tribunal found that the risk of a potential expropriation exists at the time before an expropriation and that hypothetical buyers would take it into account when setting the price they would be willing to pay.<sup>135</sup> Venezuela's experts had calculated the discount rate (expropriation risk included) in the 18.5% to 24% range.<sup>136</sup> The tribunal rejected these numbers and selected a discount rate of 18%, as used by an ICC tribunal in a parallel contract case.<sup>137</sup>

Lastly, the *Flughafen et al. v. Venezuela* tribunal adopted a third position.<sup>138</sup> The tribunal discounted the country risk (including that of expropriation) existing at the time of investment but not the subsequent risk increase derived from the host state's wrongful acts.<sup>139</sup> The award stated that a host state cannot benefit from a wrongful act attributable to it that reduces compensation.<sup>140</sup> But the award limited the excluded risk to that created after the investment was materialized.<sup>141</sup>

## V. SUGGESTED APPROACH

Should country risk be part of the equation to determine the quantum of damage valuation? On the one hand, investors complain that country risk significantly reduces a company's value and argue for the exclusion of some of the country-risk components.<sup>142</sup> More daringly, others sustain that all political, legal, and regulatory risks protected by IIAs should be completely excluded from quantum calculation.<sup>143</sup> The main argument is that host states create and control country risk, and they should not benefit from generating more risk before an expropriation or other breach of investment protection standards.<sup>144</sup>

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<sup>135</sup> *Venez. Holdings B.V. v. Bolivarian Republic of Venez.*, ICSID Case No. ARB/07/27, Award, ¶ 365 (Oct. 9, 2014).

<sup>136</sup> *Id.* ¶ 366.

<sup>137</sup> *Id.* ¶¶ 367–68.

<sup>138</sup> *Flughafen Zürich AG & Gestion e Ingineria IDC SA v. Bolivarian Republic of Venez.*, ICSID Case No. ARB/10/19, Award, (Nov. 18, 2014).

<sup>139</sup> *Id.* ¶¶ 905–07.

<sup>140</sup> *Id.* ¶ 905.

<sup>141</sup> *Id.* ¶ 907.

<sup>142</sup> *See supra* Part IV.C.

<sup>143</sup> *See OI European Group B.V. v. Bolivarian Republic of Venez.*, ICSID Case No. ARB/11/25, Award, ¶¶ 772–83 (Mar. 10, 2015).

<sup>144</sup> *Flughafen Zürich AG & Gestion e Ingineria IDC SA v. Bolivarian Republic of Venez.*, ICSID Case No. ARB/10/19, Award, ¶ 904 (Nov. 18, 2014); *OI European Group B.V. v. Bolivarian Republic of Venez.*, ICSID Case No. ARB/11/25, Award, ¶ 777 (Mar. 10, 2015).

On the other hand, host states sometimes have contradictory positions, depending on the stage of the FDI inflow. Before an investment is made, host states have an incentive to show a low country risk.<sup>145</sup> A high country risk would mean that a state is not a safe place in which to put money. If country risk is high the host state can take the hard route of working to improve the risk's sub-components. If that alternative is not feasible, a host state will have to make more assurances to the foreign investor, offer a higher rate of return, sign IIAs or contracts containing ISDS, obtain funds from a multilateral bank, etc.

After an investment claim has been filed, the host will often need to show a large country risk to reduce the company's valuation—sometimes significantly. Host states often point out that country risk exists independent of their actions, that claimants were aware of the risk at the time of their investment, and that other investors will discount country risk when deciding whether to buy the claimant's investment.<sup>146</sup>

### **A. Accounting for Country Risk Depends Both on Law and Economic Theory**

Whether valuation methods in investor-state arbitration must include country risk depends on legal and economic considerations. Applicable law might implicitly or explicitly provide that valuations must account for country risk, but at the same time, economic theory might require the opposite. Conversely, even if economics supports country risk adjustments, applicable law could exclude all country risk (or certain of its sub-components) from quantum calculation.

#### 1. Legal Considerations

The legal solution to this conundrum is important beyond the quantum. If there were not any legal grounds to support a discount for country risk, under the current prevalent legal trend, the investor would be undercompensated, as it would receive less than the fair market value of their investment. Conversely, if

<sup>145</sup> In *CMS Gas v. Argentine Republic*, the tribunal considered that in 1997 the government was incentivized to cite an artificially low discount rate for two reasons. First, a higher discount rate would have suggested to potential investors that investing in Argentina was risky, and the government wanted to project a positive image of the country as a foreign investment host. Second, a higher discount rate would have meant the government would have to increase tariffs to meet investors' rate of return. See *CMS Gas v. Argentine Republic*, ICSID Case No. ARB/01/08, Award, ¶¶ 130–32 (May 12, 2005).

<sup>146</sup> See *Guaracachi America, Inc. v. Plurinational State of Bol.*, UNCITRAL, PCA Case No. 2011-17, Award, ¶ 561 (Jan. 31, 2014); *Flughafen Zürich AG & Gestion e Ingineria IDC SA v. Bolivarian Republic of Venez.*, ICSID Case No. ARB/10/19, Award, ¶¶ 837–38 (Nov. 18, 2014); *Venezuela Holdings B.V. v. Bolivarian Republic of Venez.*, ICSID Case No. ARB/07/27, Award, ¶ 364 (Oct. 9, 2014); *Tidewater Inc., et al. v. Bolivarian Republic of Venez.*, ICSID Case No. ARB/10/5, Award, ¶¶ 176, 187 (Mar. 13, 2015).

tribunals were required to apply a market risk discount but do not, the investor would receive more compensation than it is entitled to. Under customary international law, such excess is illegal because punitive damages are not permitted.<sup>147</sup> Moreover, if a tribunal awards compensation under domestic investment law, the doctrine of unjust enrichment might also require the investor to return any exceeding payments.<sup>148</sup>

The ILC's Draft Articles on Responsibility of States for Internationally Wrongful Acts obliges any host state responsible for an internationally wrongful act to compensate for the damage caused by covering any financially assessable damage, including loss of profits.<sup>149</sup> Fair market value is the basis to assess this compensation.<sup>150</sup>

IAs and investment laws usually set forth that a host state must pay a fair market price in case of expropriation. The model BITs of the United States, Canada, India, Italy, among others, expressly set forth that just compensation must equal fair market value,<sup>151</sup> so do several BITs currently in force.<sup>152</sup> Other model BITs refer to the genuine<sup>153</sup> or real value.<sup>154</sup>

Investment and expropriation laws use diverse terms such as just compensation (United States and Japan), fair compensation (France), appropriate compensation (China), full and just compensation (Argentina), reasonable

<sup>147</sup> See U.N. Int'l Law Comm'n, Draft Articles on Responsibility of States for Internationally Wrongful Acts 99 n.516 (2001), [http://legal.un.org/ilc/texts/instruments/english/commentaries/9\\_6\\_2001.pdf](http://legal.un.org/ilc/texts/instruments/english/commentaries/9_6_2001.pdf) [hereinafter Draft Articles].

<sup>148</sup> Christina Binder & Christoph Schreuer, *Unjust Enrichment*, in MAX PLANCK ENCYCLOPEDIA OF PUBLIC INTERNATIONAL LAW (2013).

<sup>149</sup> Draft Articles, *supra* note 147, at 99.

<sup>150</sup> *Id.* at 102-03, 102 n.549.

<sup>151</sup> 2012 U.S. MODEL BILATERAL INVESTMENT TREATY § 6.2(b) (amended 2012); 2004 U.S. MODEL BILATERAL INVESTMENT TREATY § 6.2(b); 2004 CANADA MODEL BILATERAL INVESTMENT TREATY § 13.2; 2015 INDIA MODEL BILATERAL INVESTMENT TREATY § 5.6; 2003 ITALY MODEL BILATERAL INVESTMENT TREATY § V.3.

<sup>152</sup> Treaty between the United States of America and the Argentine Republic Concerning the Reciprocal Encouragement and Protection of Investment art. IV.1, Arg.-U.S., Nov. 14, 1991, 31 I.L.M. 128; Agreement on Encouragement and Reciprocal Protection of Investments Between the Government of the People's Republic of China and the Government of the Kingdom of the Netherlands art. 5.1(c), China-Neth., Nov. 26, 2001, 2369 U.N.T.S. 219; Agreement between the Government of Australia and the Government of the United Mexican States on the Promotion and Reciprocal Protection of Investments art. 7.2(b), Austl.-Mex., Aug. 23, 2005, 2483 U.N.T.S. 247; Agreement between the Russian Federation and the Government of the Republic of Venezuela on the Reciprocal Promotion and Protection of Investments art. 5.2, Russ.-Venez., June 2, 2009; Agreement for the Promotion and Protection Mutual Investment between the Republic of Colombia and the Kingdom of Spain art. 4.2, Colom.-Spain, Mar. 31, 2005.

<sup>153</sup> 2008 U.K. MODEL BILATERAL INVESTMENT TREATY § 5.

<sup>154</sup> 2006 FRANCE MODEL BILATERAL INVESTMENT TREATY § 5.2.

compensation (Germany), and due compensation (Macau).<sup>155</sup> Domestic and international tribunals often equate these terms with the “Hull Formula,” which requires prompt, adequate, and effective compensation. In most cases, this materializes through market value, fair market value, or genuine compensation. However, the European Court of Human Rights has disagreed, holding that legitimate objectives of public interest may call for payment of less than full market value in some circumstances.<sup>156</sup> Some domestic laws do exclude loss of future profits.<sup>157</sup> However, in an international conflict, customary international law and IIAs will supersede domestic laws.<sup>158</sup>

The World Bank Guidelines on the Treatment of Foreign Direct Investment define fair market value as the

amount that a willing buyer would normally pay to a willing seller after taking into account the nature of the investment, the circumstances in which it would operate in the future and its specific characteristics, including the period in which it has been in existence, the proportion of tangible assets in the total investment and other relevant factors pertinent to the specific circumstances of each case.<sup>159</sup>

This definition includes a discount of the risks that condition the investments.<sup>160</sup> Because most international investment law rules provide for a market compensation,<sup>161</sup> in most cases tribunals will have to estimate and discount country risk.<sup>162</sup>

An applicable IIA or investment law could establish a valuation standard different from fair market value. Alternatively, it could expressly exclude country risk or some of its sub-risks (broadly or narrowly defined) from the calculus of the

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<sup>155</sup> Wenhua Shan, *The Legal Protection of Foreign Investment*, in GENERAL REPORTS OF THE XVIIITH CONGRESS OF THE INTERNATIONAL ACADEMY OF COMPARATIVE LAW 467, 492 (2012).

<sup>156</sup> *Holy Monasteries v. Greece*, App. No. 13092/87, 13984/88, 301 Eur. H.R. Rep. 71 (1994).

<sup>157</sup> Law No. 21499 § 10, Jan. 21, 1977, [23581] B.O. 1 (Arg.).

<sup>158</sup> JAMES CRAWFORD, *BROWLIE’S PRINCIPLES OF PUBLIC INTERNATIONAL LAW* 51–55 (2012).

<sup>159</sup> World Bank Group [WBG], *World Bank Guidelines on Treatment of Foreign Direct Investment*, at 6, <http://www.italaw.com/documents/WorldBank.pdf> (last visited Oct. 23, 2016).

<sup>160</sup> WHITE & FAN, *supra* note 7, at 191.

<sup>161</sup> In a but-for context in case of an unlawful expropriation.

<sup>162</sup> This point is acknowledged even by those who generally question how investment tribunals deal with country risk. See Abby Cohen Smutny, *Investment Treaty Protections, Political Risk, and Tribunal Decision-Making*, in CONTEMPORARY ISSUES IN INTERNATIONAL ARBITRATION AND MEDIATION: THE FORDHAM PAPERS 2013 47 (Arthur W. Rovine ed., 2013).

damages' quantum. Under that scenario, some or all country risk should not be discounted.

Finally, international investment law is not an insurance against all country risk.<sup>163</sup> IIAs and investment laws set forth investment protection standards<sup>164</sup> and mechanisms that allow investors to file claims against certain acts and conducts attributable to the host state.<sup>165</sup> Investment laws thus distinguish between wrongful and benign conduct.<sup>166</sup> The host state is only liable when its conduct (or lack thereof) caused the breach of investment protection standards.<sup>167</sup>

However, host states do not have full control over most of the country risk's sub-components. Changes of government, social conflict, war, low economic growth, among many other sub-risks will be beyond the host state's sovereign power. These risks are inherent to investing abroad, particularly in developing countries.<sup>168</sup> Investors take the burden of these risks when taking their money overseas. Host states should not face liability if the risks they do not control materialize.

## 2. Economic Considerations

From an economic perspective, the question of whether country risk should be a part of a company's valuation depends on two issues. First, the analysis must consider whether a marginal investor (that is, more likely to trade on equity) can diversify the additional risk of investing in a developing market. If the marginal investor in an open market can invest across markets<sup>169</sup> (that is, the investor has a global portfolio), country risk should not matter.<sup>170</sup> Second, there must be low correlation for returns across the world. If a positive correlation exists across countries, then country risks might have a market component, and the risk is not diversifiable.<sup>171</sup>

These issues require solutions that depend on empirical research. To that extent, a pertinent economic answer to the question of whether a company's valuation should include a country risk premium can change with time, according to new developments in the field. Under the current state of the art, the prevailing

<sup>163</sup> See, e.g., *Ebrahimi Shahin Shaine v. Iran*, 30 Iran-U.S. Cl. Trib. Rep. 170 (1994); *Sola Tiles Inc. v. Iran*, 14 Iran-U.S. Cl. Trib. Rep. 223 (1987).

<sup>164</sup> STEPHAN SCHILL, *THE MULTILATERALIZATION OF INTERNATIONAL INVESTMENT LAW* 74–75 (2009).

<sup>165</sup> Yusuf Caliskan, *Dispute Settlement in International Investment Law*, in *IMPLEMENTING INTERNATIONAL ECONOMIC LAW THROUGH DISPUTE SETTLEMENT MECHANISMS* 123 (Yusuf Aksar ed., 2011).

<sup>166</sup> Draft Articles, *supra* note 147, § 12 cmts. 2–3.

<sup>167</sup> *Id.*

<sup>168</sup> WHITE & FAN, note *supra* 7, at 166.

<sup>169</sup> René M. Stulz, *Globalization, Corporate Finance, and the Cost of Capital*, J. APPLIED CORP. FIN., Sept. 1999.

<sup>170</sup> Damodaran, *Determinants*, *supra* note 29, at 46–47.

<sup>171</sup> *Id.* at 47.

answers seem to be that investors have progressively invested in global portfolios, but that home bias and increased correlation across markets makes it impossible to diversify country risk completely.<sup>172</sup> If country risk is not diversifiable, then it should be part of valuation.

### **B. Under Most Legal Regimens and Current Economic Theory, Arbitral Tribunals Should Account for Country Risk**

The final answer to the country-risk dilemma depends on the right combination of legal and economic answers. Using country risk requires first an applicable legal system that provides for compensation of a fair market value<sup>173</sup> (and does not expressly exclude country risk or its sub-components); and second, that economic theory predominantly agrees that there is sufficient evidence against global diversification of country risk and no positive correlation in returns globally.<sup>174</sup>

Meeting the first condition depends on applicable law. International investment law often requires fair market value compensation. Economic theory and empirical research currently lean towards denying the possibility to eliminate country risk through a global portfolio. Hence, nowadays both conditions are present and arbitral tribunals should use country risk to determine the quantum of compensation.

This statement is contingent and has some caveats.<sup>175</sup> A change in the law or further economic research could reverse this conclusion in the future.

### **C. Arbitral Tribunals Should Exclude Sub-Risks Solely Controlled by the Host State's Government**

#### 1. Obligations Performed Under Debtor's Exclusive Will

Country risk will arise from the interaction of the strategies implemented by the investor to deal with the local environment and from the host state's action, in a two-party bond. Under investment law, there are two parties to the legal relationship: the investor and the host state. The latter owes several legal obligations towards the former, according to customary international law,<sup>176</sup>

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<sup>172</sup> *Id.* at 51.

<sup>173</sup> Or other concept that would normally determine the value of an investment in a specific time and place, where the same investment would change its value in a different host state.

<sup>174</sup> Damodaran, Determinants, *supra* note 29, at 47.

<sup>175</sup> See *supra* Part V.A; see *infra* Part V.C (discussing more of these caveats).

<sup>176</sup> Jean d'Aspremont, *International Customary Investment Law: Story of a Paradox*, in INTERNATIONAL INVESTMENT LAW: SOURCES OF RIGHTS AND OBLIGATION 5 (T. Gazzini & E. De Brabandere eds., 2012).



applicable IIAs,<sup>177</sup> and domestic investment law.<sup>178</sup> They will determine what sub-components of country risk should be included.

The law has specific rules to deal with conditional obligations. Under civil law systems, those obligations whose performance depends exclusively on the debtor's will are null and void (*obligation potestatif*,<sup>179</sup> *obligación potestativa*).<sup>180</sup> Similarly, common law makes unenforceable any promise that is indefinite or lacks mutuality, where only one side must perform (illusory promise).<sup>181</sup>

In the legal bond between an investor (creditor) and a host state (debtor), those obligations that depend exclusively on the host state's will are null and void; some of the country risk's sub-components also have this characteristic. When a host state exercises sovereign power over which it has absolute control, without any other external factors' influence (such as the market, its constituents, foreign governments, international organizations, etc.), that act functions as an *obligation potestative*. There, the host state is promising the investor to refrain from creating a risk (i.e., pay less in compensation), but only if the host state so wishes.<sup>182</sup> The main sub-risk on which the host state has full control is expropriation.<sup>183</sup>

However, in a globalized world, the majority of sub-risks are not in full control of the state. Slowdown of economic growth, low creditworthiness, and war might be issues on which other foreign governments and markets might have more influence than the host state. In other issues that are more local in nature,

<sup>177</sup> Erik Denters, *Preferential Trade and Investment Treaties*, in INTERNATIONAL INVESTMENT LAW: SOURCES OF RIGHTS AND OBLIGATION, *supra* note 176, at 49; Tarcisio Gazzini, *Bilateral Investment Treaties*, in INTERNATIONAL INVESTMENT LAW: SOURCES OF RIGHTS AND OBLIGATION, *supra* note 176, at 99.

<sup>178</sup> Makane Moïse Mbengue, *National Legislation and Unilateral Acts of States*, in INTERNATIONAL INVESTMENT LAW: SOURCES OF RIGHTS AND OBLIGATION, *supra* note 176, at 183.

<sup>179</sup> CODE CIVIL [C. CIV.] [CIVIL CODE] art. 1174 (Fr.).

<sup>180</sup> CÓDIGO CIVIL [CÓD. CIV.] [CIVIL CODE] art. 542 (1871) (Arg.) (approved by Law No. 340); CÓDIGO CIVIL [C.C.] [CIVIL CODE] art. 505 (1975) (Bol.); CÓDIGO CIVIL [C.C.] [CIVIL CODE] art. 1535; CÓDIGO CIVIL [C.C.] [CIVIL CODE] art. 1115 (Spain); CÓDIGO CIVIL [CÓD. CIV.] [CIVIL CODE] art. 1202 (Venez.).

<sup>181</sup> "Consideration would again be illusory where it was alleged to consist of a promise the terms of which left performance entirely to the discretion of the promisor. A person does not provide consideration by promising to do something 'if I feel like it,' or 'unless I change my mind.'" HUGH BEALE, CHITTY ON CONTRACTS 3-025 (2015) (citations omitted). *See also* Wickham & Burton Coal Co. v. Farmer's Lumber Co., 189 Iowa 1183, 179 N.W. 417 (1923) (holding that an agreement to ship as much coal as the other side "might order" was invalid).

<sup>182</sup> This is not the first time the doctrine of illusory promise has been suggested as a useful tool for treaty interpretation. *See* Justin Lowe, *What Would Grotius Do? Methods and Implications of Incorporating the Contract Law Doctrine of Illusory Promises into the Law of Treaty Interpretation*, 6 WASH. U. GLOBAL STUD. L. REV. 703 (2007). Specifically referring to country risks, others argue that host states might not invoke their illegal acts to limit the quantum of compensation. *See* Smutny, *supra* note 162.

<sup>183</sup> Dorobantu et al., *supra* note 60, at 219, 220.

such as religious, ethnic, or racial conflicts, change of government, and cultural risks, the host government might have little control, if any.

## 2. Allocation of Risks

A second argument goes to the allocation of risks. The basic rule in that regard is that a particular risk should be borne by the party most suited to control, influence, and bear the cost. That is the party that should take measures to avoid the risk.

If a country risk's sub-component is under full and sole control of the host state and not the investor, the former will be in the best position to limit the risk. A host state decides whether to enact a law, issue a decree or an executive order, pass a judgment, or perform acts that amount to expropriation. All of these actions depend exclusively on its sovereign power. Unlike war, change of government, or loss of creditworthiness—where global markets and a handful of military powerhouses have more influence on outcomes than most host states—expropriation risk depends only on one state. That state should therefore bear the cost of taking the investor's property.

To this extent, tribunals should not reduce the quantum of damages to account for expropriation risk. The host can avoid them completely if it so desires, and thus it must pay for the reduction in the fair market value of the investment that the host state itself has caused completely.

## D. Time of Measurement

Tribunals calculating due compensation should always assess the damage as seen at the time of expropriation. According to the *Chorzów* case, in case of a lawful expropriation, damages should be limited to what has been lost.<sup>184</sup> And in case of an unlawful expropriation, the valuation must add the damages for what the investor expects at the time of the expropriation, in terms of future profits and expansion. The evaluation of damages takes place in a but-for scenario. Tribunals should not introduce real, post-expropriation data.<sup>185</sup>

Arbitral tribunals should evaluate country risk based on the facts known at the time of the expropriatory act. That is, the country risk's sub-components have to be evaluated at a moment before the host state took the relevant step to expropriate. The compensable damage is that foreseeable as resulting from the governmental act. However, investors cannot reasonably anticipate damages ensuing from other causes, like the fluctuations in the market, as deriving from the host state's acts.<sup>186</sup>

<sup>184</sup> *Factory at Chorzów*, Judgement, 1928 P.C.I.J. (ser.A) No. 17, at 46 (Sept. 13).

<sup>185</sup> *See* *Quiborax S.A. & Non-Metallic Minerals S.A. v. Plurinational State of Bol.*, ICSID Case No. ARB/06/2, Partially Dissenting Opinion, ¶¶ 77–89 (Sept. 16, 2015).

<sup>186</sup> *Id.* ¶ 99.

Using ex-post information will change the evaluation of country risk. This, in turn, will make the quantum of damages granted vary with the date of the award. Once a state has made public its decision to take private property, country risk will very likely increase, almost by definition. If the arbitral tribunal looks at country risk data immediately after expropriation, the risk will probably be higher, to the host state's benefit. However, if a tribunal takes several years to issue an award on damages (as often happens)<sup>187</sup> and the host state's political situation has improved, the risk will be lower and the quantum of damages higher.<sup>188</sup> This variation is inconsistent with the principle of causation<sup>189</sup> and would generate more uncertainty in an already somewhat unpredictable area.

## VI. CONCLUSION

Whether investment arbitration tribunals should use country risk as an element of valuation is both a legal and an economic question. The legal answer in most systems that require paying a fair market price is that country risk must be estimated and used. However, if applicable law expressly excludes country risk or some of its sub-components, then tribunals should not discount some or all country risk.

More importantly, arbitral tribunals should not discount or take into account sub-risks for which the host state has full control, particularly expropriation risk. First, when the existence of a risk depends completely on one side of the legal relationship, that party should bear the risk. Moreover, risks should be allocated to those in better conditions to avoid them. When the only party making the expropriation decision is the host state, then that state is also the only party who can prevent the risk.

The economic answer is that arbitration tribunals should account for country risk. Currently, economic theory deems country risk as non-globally-diversifiable, or at least not entirely diversifiable. And empirical studies have determined that return on income is highly positively correlated at a global level. Thus, the prevailing view is that computing country risk is economically justified.

The final answer to the country risk dilemma depends on the right combination of legal and economic answers. Using country risk requires an applicable legal system that provides for compensation of a fair market value, and does not expressly exclude country risk or its subcomponents. And that state of the art economic research considers that there is enough evidence to support

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<sup>187</sup> For example, "the 19 ICSID Convention awards issued in 2012 came after an average of nearly five years of proceedings." Adam Raviv, *A Few Steps to a Faster ICSID*, GLOBAL ARB. REV., Oct. 17, 2013, at 23.

<sup>188</sup> *Quiborax S.A. & Non-Metallic Minerals S.A. v. Plurinational State of Bol.*, ICSID Case No. ARB/06/2, Partially Dissenting Opinion, ¶ 101 (Sept. 16, 2015).

<sup>189</sup> *Id.* ¶¶ 87, 99–100.

country risk premiums. In the absence of either condition, arbitral tribunals should disregard country risk—but we are not there now.<sup>190</sup>



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<sup>190</sup> Other references for this paper include: Jose Alberro & Sharon B. Johnson, *Controversial Topics in Damage Valuation: Complex Issues Require Sophisticated Analytical Methods*, in INTERNATIONAL COMPARATIVE LEGAL GUIDE TO: INTERNATIONAL ARBITRATION 2015 35 (Global Legal Group, 2015). IRMGARD MARBOE, CALCULATION OF COMPENSATION AND DAMAGES IN INTERNATIONAL INVESTMENT LAW (2009). Q.C. MCLACHLAN, LAURENCE SHORE CAMPBELL & MATTHEW WEINIGER, INTERNATIONAL INVESTMENT ARBITRATION (2007). Jason Pan, *Valuation Standards for Calculating ICSID Awards*, 14 PEPP. DISP. RESOL. L.J. 355 (2014). BORZU SABAHİ, COMPENSATION AND RESTITUTION IN INVESTOR-STATE ARBITRATION (2011). James Searby, *The Country Risk Premium in International Arbitration*, in THE EUROPEAN AND MIDDLE EASTERN ARBITRATION REVIEW 19 (2011). T.W. Wälde & B. Sabahi, *Compensation, Damages and Valuation in International Investment Law*, 5 TRANSNAT'L DISP. MGMT 1 (2006). HERFRIED WÖSS ET AL., DAMAGES IN INTERNATIONAL ARBITRATION UNDER COMPLEX LONG-TERM CONTRACTS (2014).