Rewarding expropriation?

Our perspective on valuing compensation for expropriation

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Rewarding expropriation?

Recent ICSID awards[1] have led to debate as to the correct approach to compensation in cases of expropriation. This article aims to contribute to that discussion from the perspective of practitioners involved in assessing the value of compensation.

First of all, let's set the premise. Compensation for expropriation typically involves assessing the value of the company, assets or other rights that have been expropriated. The recent ICSID awards (all involving Venezuela) highlight uncertainty over whether the compensation in cases of expropriation should reflect the decrease in market value that would result from a pattern of expropriative behaviour by a state leading up to the date of expropriation. This depletion in value might be seen, for example, if a government were to make pronouncements about the benefits of nationalising an investor's industry, then to make this a reality by nationalising first one, then two, of its competitors.

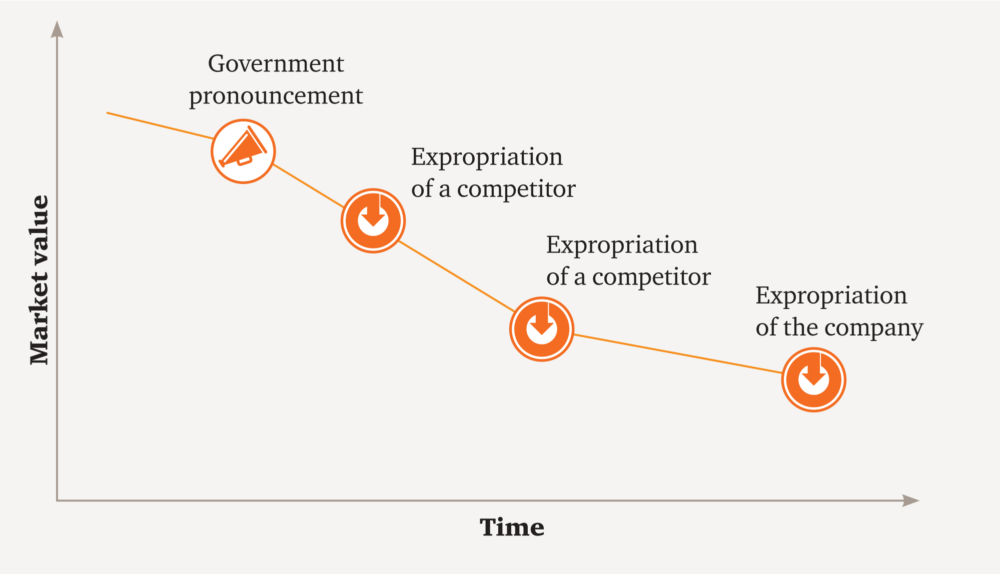
The issue we are interested in arises if the company is then the third to be nationalised. Should the decrease in value from this pattern of behaviour be borne by the investor or by the state? And if the latter, what value other than market value at the date of expropriation should be attributed to the third company?

In the remainder of this article we explore this issue further by considering:

What do we mean by 'expropriation risk'?

In the context of valuing an investment, 'expropriation risk' could perhaps be described as the likelihood of an investment being expropriated by the host state, without the investor receiving adequate compensation in return. This is perhaps more likely to happen in the context of an unlawful expropriation – for which any compensation is subject to successfully gaining (and enforcing) an arbitration award – than lawful expropriation, for which the investor is typically expected to receive 'fair and adequate' compensation from the expropriating state.

For ease of reference, in this article we refer to the risk of inadequately compensated expropriation, whether lawful or unlawful, as the 'expropriation risk'.



- What do we mean by 'expropriation risk'?
- How is expropriation risk captured in a valuation?
- What do the recent Venezuela awards tell us about the legal framework?
- How are country risk premia calculated?
  - What can be done when country risk premia do not adequately capture expropriation risk?
  - How can expropriation risk be removed?

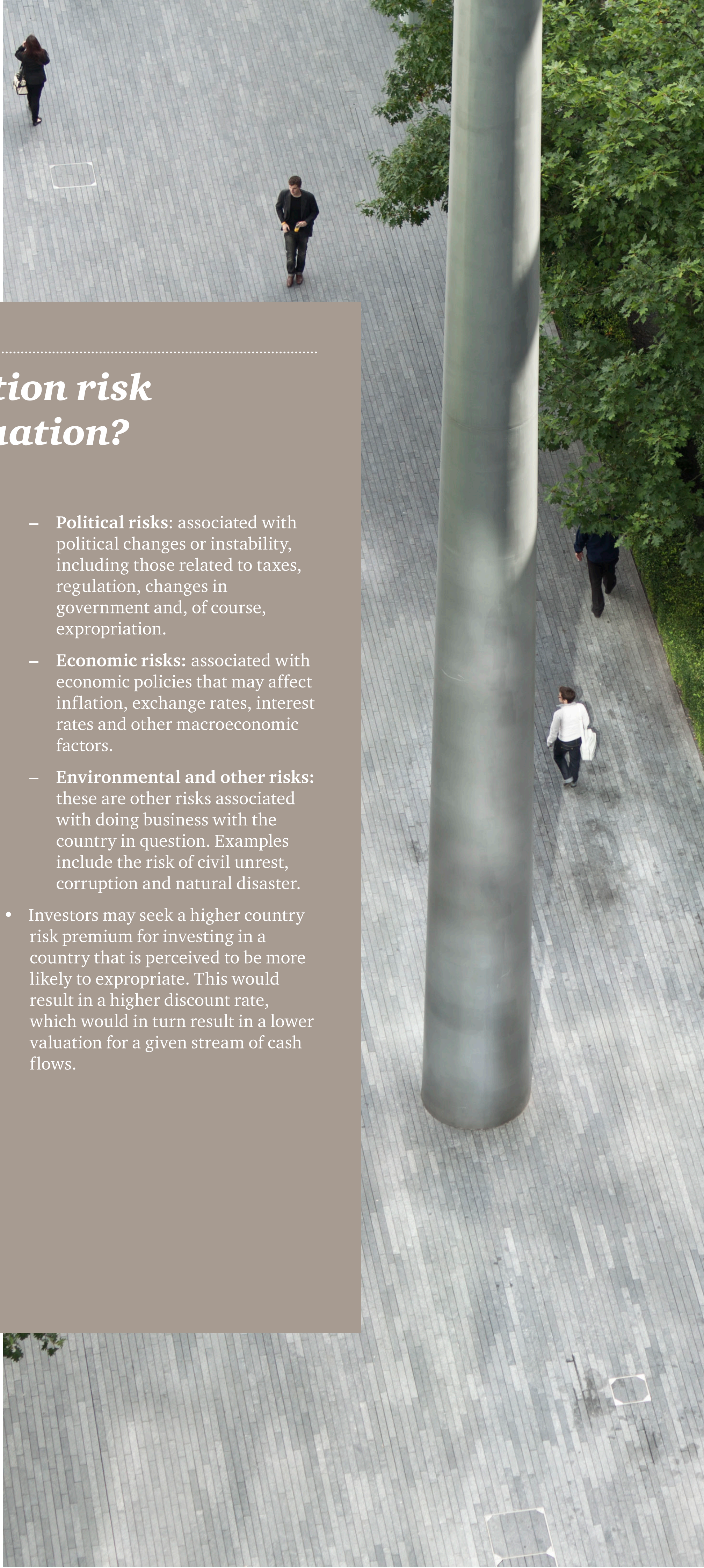
[1] (a) Gold Reserve Inc. vs. Bolivarian Republic of Venezuela, 22 September 2014, ICSID case no. ARB(AF)/09/1;
(b) Venezuela Holdings B.V., Mobil Cerro Negro Holding Ltd and others vs. Bolivarian Republic of Venezuela, 9 October 2014, ICSID case no. ARB/07/27;
(c) Tidewater Investment SRL and Tidewater Caribe C.A. vs. Bolivarian Republic of Venezuela, 13 March 2015, ICSID case no. ARB/10/5.

How is expropriation risk captured in a valuation?

The awards in the recent Venezuela cases were all based on the discounted cash flow ('DCF') valuation methodology and it is that approach we focus on in this article. Before exploring the issues further it is useful to explain how expropriation risk would be captured in a DCF valuation in normal circumstances.

The diagrams opposite explain some of the following basic concepts:

- The DCF approach derives the valuation of an investment (which could be a company, asset or other rights) based on its expected future cash flows, discounted to a present value using an appropriate discount rate.
- A discount rate is often calculated as the weighted average between the cost of debt and the cost of equity. When valuing an investment in a developing country it is common practice to include a premium to the cost of equity (and sometimes the cost of debt) to reflect country risk.
- The country risk premium reflects a wide basket of risks which may affect investors' returns. Country risks can be grouped as follows:
    - **Political risks**: associated with political changes or instability, including those related to taxes, regulation, changes in government and, of course, expropriation.
    - **Economic risks:** associated with economic policies that may affect inflation, exchange rates, interest rates and other macroeconomic factors.
    - **Environmental and other risks:** these are other risks associated with doing business with the country in question. Examples include the risk of civil unrest, corruption and natural disaster.
- Investors may seek a higher country risk premium for investing in a country that is perceived to be more likely to expropriate. This would result in a higher discount rate, which would in turn result in a lower valuation for a given stream of cash flows.



The **net present value of cash flows** is calculated by applying the **discount rate** to the annual cash flows:

Year 1 cash flow | Year 2 cash flow | Year 3 cash flow | Year 4 cash flow

Discount rate %

Present value of cash flows

The **discount rate** is typically the weighted average of:

Cost of debt % | Cost of equity %

When calculated using the capital asset pricing methodology, the **cost of equity** typically has the following components:

Risk free rate | Beta | Equity market risk premium | Country risk premium

The **country risk premium** is a proxy for a wide variety of risks including:

Political risks
- expropriation risk
- taxation and duties
- regulatory
- repatriation of profits
- change in government

Macroeconomic risks
- inflation
- interest rates
- currency
- fiscal deficits

Environmental risks
- war and civil unrest
- natural disaster
- corruption
- labour
- power and infrastructure

What do the recent Venezuela awards tell us about the legal framework?

Normal commercial practice would be to reflect in a valuation the risks that exist at the valuation date. However, this approach is not necessarily applicable when valuing an investment for the purpose of compensation for expropriation, particularly in relation to the treatment of expropriation risk. The potential approaches are as follows:

1. Include the expropriation risk that existed at the date of expropriation;
2. Exclude the expropriation risk that existed at the date of expropriation in full;
3. Exclude the elevated degree of expropriation risk associated with a developing pattern of expropriative behaviour.

We explain these approaches in the context of the recent Venezuela cases below.

Lawful expropriation: Venezuela Holdings and others vs. Venezuela[2]; Tidewater vs. Venezuela[3]

In both of these cases the Tribunals determined that the expropriation was lawful and that compensation should therefore be based, pursuant to the relevant investment treaties, on the market value of the investment at the point immediately prior to the expropriation.

The Tribunals both determined that the market value should reflect the expropriation risk that existed at the point immediately prior to the expropriation. In each case this resulted in the Tribunal applying a high country risk premium and discount rate (as shown in the table below) and consequently reduced the market value. The precise impact that this had on the market value depends on the timing of cash flows; it could easily have reduced the market value (and so compensation) by a third as compared to the claimants' positions. The impact would be greatest if, as is common, cash in-flows were expected to increase in the later years.

Taking this approach meant, of course, that the claimants suffered the effect of any depletion in market value that resulted from any developing pattern of expropriative behaviour up to the valuation date.

	Venezuela Holdings			*Tidewater*			*Gold Reserve*		
	Claimant	Respondent	Tribunal	Claimant	Respondent	Tribunal	Claimant	Respondent	Tribunal
Discount rate	8.7%	19.8%	18%	6.96%	24.57%	n/a	8.22%	16.5% – 23.8%	10.09%
CRP	n/a	n/a	n/a	1.50%	14.76%	14.76%	1.5%	6.7% – 16.4%	4%
Treatment of expropriation risk	Excluded	Included	Included	Excluded	Included	Included	Excluded	Included	Excluded in part/in full

The table shows that, in each case, the claimant's expert excluded expropriation risk and the respondent's expert included expropriation risk. As the jurisprudence around this issue develops it is more likely that experts will be provided with legal instructions on whether to include or exclude expropriation risk. It is, after all, primarily a legal question. That in turn will allow for more focused debate between experts over the economic issues, such as how expropriation risk can best be captured or, if necessary, how it can be isolated and removed. We explore the economic issues further in the later sections of this article.

[2] See paragraphs 360 to 368 of the Tribunal's Award for Venezuela Holdings and others vs. Venezuela, dated 9 October 2014.
[3] See paragraphs 73d, 76d, and 182 to 190 of the Tribunal's Award for Tidewater vs. Venezuela, dated 13 March 2015.

Unlawful expropriation: Gold Reserve vs. Venezuela

In cases of unlawful expropriation, it is common for Tribunals to be guided by the principle for compensation established in the Chorzow factory case that "*reparation must, as far as possible, wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if that act had not been committed*".[4]

As explained above, a developing pattern of expropriative behaviour may lead to a depletion in market value. Where that is the case, the following two approaches may help to apply the Chorzow principle for compensation:

- Exclude all expropriation risk at the date of expropriation.
  - This appears to have been the approach taken by the claimants' experts in each of the recent Venezuela cases and it may seem like an attractive approach – after all, is it fair that a claimant's compensation sum is reduced on account of the *risk that the property might be expropriated later without the compensation required by the Treaty*?[5]
  - In practice, however, any investor would reasonably be expected to factor the perceived expropriation risk into its original investment decision, with higher returns demanded in countries with a higher perceived risk of expropriation. It may therefore be reasonable to expect compensation to be reduced on account of expropriation risk, at least to the extent that the investor would reasonably have been expected to factor such a risk of expropriation into its original investment decision.
- Exclude the elevated degree of unlawful expropriation risk associated with a developing pattern of behaviour.
  - The attraction of this approach is that it would avoid penalising the investor for any depletion in market value associated with a pattern of expropriative behaviour that developed after the investment was made.
  - It would also avoid unjustly rewarding the investor for the realisation of risks it should reasonably have taken into account when making its original investment decision.

It is not immediately clear which of these approaches the Tribunal in Gold Reserve vs. Venezuela was intending when it explained that its country risk premium of 4% *appropriately considers political risks, together with other risks, but has not been over-inflated on account of expropriation risks*.[6]

[4] Case concerning The Factory at Chorzow (Claim For Indemnity) (Merits), Collection of Judgments of the Permanent Court of International Justice, Series A., No. 17, Judgment no. 13., p. 47.
[5] This argument was put forward by the Claimant's expert in Gold Reserve vs. Venezuela. See paragraph 364 of the Tribunal's Award dated 22 September 2014.
[6] As explained by the Tribunal for Gold Reserve vs. Venezuela at paragraph 842 of its Award dated 22 September 2014.

How are country risk premia calculated?

As noted earlier, in normal circumstances the expropriation risk would be captured in a valuation through the country risk premium applied to the discount rate. The approaches most commonly used in practice to calculate the country risk premium include:

- **Sovereign debt method –** This measures country risk by comparing the spread on sovereign debt yields between the country in question and a developed country such as the US. The country risk premia published by PwC each quarter follow this approach.
- **Equity risk method –** This measures country risk by reference to the relative volatility of equity market returns between the country in question and a developed country.

Neither of these approaches is perfect and both have circumstances in which they may be more or less applicable. Judgement is required to ensure the approach selected is well suited to the circumstances of a particular valuation.

The examples below illustrate this point:

- In situations where a country is perceived to be in danger of defaulting on its sovereign debts, as has been the case in recent times in Southern Europe, sovereign debt yields would increase exponentially. In such circumstances, the spread on sovereign debt yields may not be a useful proxy for the risks faced by private investors in the country[7].
- The equity risk method may be less applicable in circumstances where a country has a limited number of publically traded equities, particularly if those equities are spread across a narrow range of industries.

What can be done when country risk premia do not adequately capture expropriation risk?

As the name suggests, country risk premia aim to capture risks associated with a country as a whole. They are not company or industry specific. If a particular company or industry is at particular risk of expropriation (as in the case of a developing pattern of expropriative behaviour) this would not be directly captured by the conventional approaches to calculating country risk described above. The alternative approaches to directly capture the expropriation risk of a particular investment include:

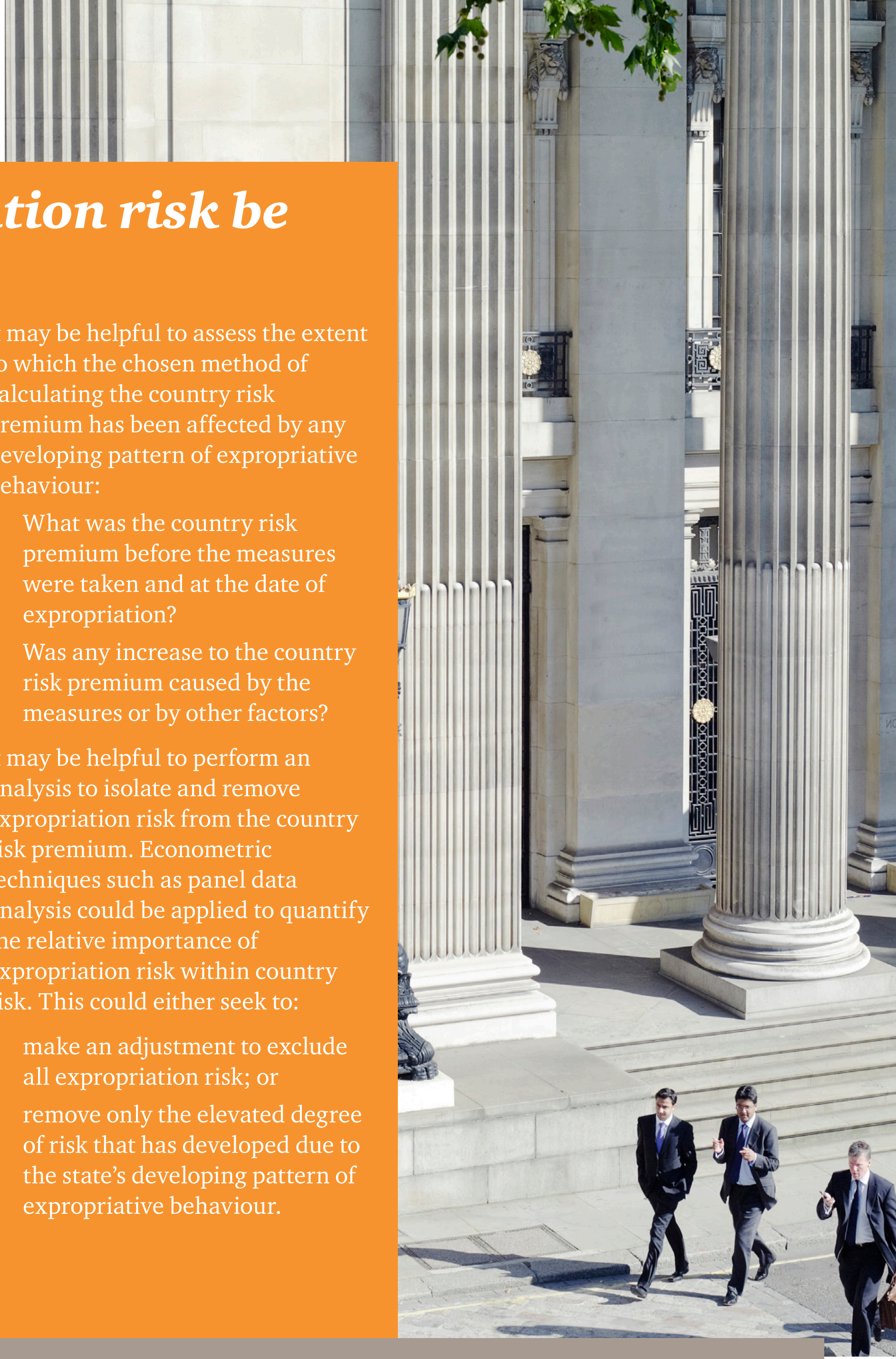
- **Alternative cash flow scenarios** – The theoretically superior method for capturing expropriation risk is to devise alternative cash flow scenarios that reflect the different possible outcomes. These scenarios might assume, for example, that the business continues as normal, is lawfully expropriated (with fair compensation paid at the date of expropriation) or is unlawfully expropriated (with any compensation subject to the outcome of arbitration proceedings). The scenarios can be averaged to produce a single valuation, based on the assessed probability of each outcome.

  The benefit of this approach is that it allows for transparency as to the expected probability and impact of an expropriation. The challenge is, of course, getting enough evidence to make an objective assessment of each of these factors and the associated cash flows.
- **Premium to the discount rate/ discount to the value –** An alternative approach is to add a percentage premium to the discount rate (or the country risk premium within the discount rate) to reflect the perceived risk of expropriation, or to simply make a discount to the valuation amount. Both have the same effect, to reduce the valuation to account for the perceived expropriation risk. This approach is simpler and more pragmatic, if not as pure theoretically.

Each of these approaches ultimately requires an assessment to be made of the expected probability and impact of an expropriation on the specific investment in question. Various tools and techniques could be considered for such an exercise, from econometric analysis of expropriation risk to the subjective assessment of the valuer. The reality, of course, is that there is no magic formula and the Tribunal may be best assisted by an approach that is transparent in identifying the key areas of judgment.

Tribunals are often persuaded by an approach which uses contemporaneous evidence where possible. This may be found, for example, in company level investment papers or industry analyst valuation reports.

[7] This was the situation in EDF and others vs. Argentina (ICSID case no. ARB/03/23) leading the Tribunal to use an alternative method based on relative volatility of equity markets (see paragraph 1264 of the Award dated 11 June 2012).



How can expropriation risk be removed?

If the exercise of including expropriation risk is a challenge for valuation practioners, what hope is there for removing it? Again, it is not an exact science. However, perhaps some of the challenges in fully capturing expropriation risk make it easier to exclude from a valuation.

The first and most important step would be to exclude from the assessment any alternative cash flow scenarios, premium to the discount rate or discount to the value (as just described) that seek to directly account for expropriation risk. This would remove the company/industry specific risk associated with an investment perceived to be at heightened risk of expropriation.

The next question would be how to deal with the expropriation risk captured within the country risk premium. A few points to consider:

- Excluding the expropriation risk does not mean excluding the country risk premium altogether. Doing so would ignore other important political, economic and environmental risks that should be accounted for in a valuation.
- Country risk premia do not directly calculate the component risks and accumulate them into a single figure. Data does not exist for such a calculation to be performed. This makes isolating the component of country risk that is attributable to expropriation risk a more challenging exercise.
- It may be helpful to assess the extent to which the chosen method of calculating the country risk premium has been affected by any developing pattern of expropriative behaviour:
  - What was the country risk premium before the measures were taken and at the date of expropriation?
  - Was any increase to the country risk premium caused by the measures or by other factors?
- It may be helpful to perform an analysis to isolate and remove expropriation risk from the country risk premium. Econometric techniques such as panel data analysis could be applied to quantify the relative importance of expropriation risk within country risk. This could either seek to:
  - make an adjustment to exclude all expropriation risk; or
  - remove only the elevated degree of risk that has developed due to the state's developing pattern of expropriative behaviour.

Concluding statements

A key challenge for experts in cases of expropriation is to ensure they understand the applicable legal framework and adapt their valuation approach accordingly. Any differing instructions provided to the experts on the applicable legal framework should be made clear to the Tribunal, perhaps through the experts' joint statement.

This article should also highlight why circumstances of elevated expropriation risk become key areas of contention between experts. Conventional approaches capture the risk at the level of the country, rather than at an industry or company specific level. The alternative approaches available to capture expropriation risk at a company or industry specific level each have their own strengths and weaknesses. No single approach can lay claim to being superior in all circumstances.

Tribunals should be aware that any attempt to directly capture expropriation risk would require a significant degree of judgment by the valuer. A greater complexity in approach would not necessarily lead to a more accurate result.

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Our country risk premia quarterly update

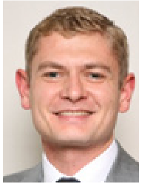
Our country risk service can help companies to quantify and manage country risks in order to make better business decisions. We calculate country risk premia for 187 sovereign nations using an economic model that we have developed since 1998. Our model uses a range of inputs in generating CRPs, including reliable sources of credit and risk ratings and sovereign bond information. See our website for more details.

http://www.pwc.co.uk/the-economy/issues/country-risk-premia-quarterly-update.jhtml

Authors of the article

Tim Ogier
Partner, Economics and Policy
+44 (0) 20 7804 5207
tim.ogier@uk.pwc.com

Gerry Lagerberg
Partner, Forensic Services
+44(0) 20 7213 5912
gerry.j.lagerberg@uk.pwc.com



Matthew Fritzsche
Director, Forensic Services
+44 (0) 20 7804 3063
matthew.t.fritzsche@uk.pwc.com

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