COUNTRY RISK ANALYSIS AND INVESTOR-STATE DISPUTE SETTLEMENT: A NEW APPROACH

ROBERT GINSBURG*

ABSTRACT

The condition of a host country's investment climate is a significant factor in determining liability and the amount of damages in investor-state disputes. Conflicting assessment methods can create differences amounting to hundreds of millions of dollars in the final award. Existing methods are insufficient and fail to identify and account for political, economic, legal and regulatory differences among nations. Country risk assessments can help tribunals and investors understand nuances of a host country's investment climate and lead to more equitable outcomes. This is the first article that identifies and demonstrates the ways in which country risk methods can help tribunals and parties to the dispute make more informed decisions during both phases of the arbitral dispute. With a step-by-step demonstration of tailored risk assessments, this paper provides a framework for integrating country risk analysis into international arbitration.

I. INTRODUCTION

What is an emerging market? Currently, there is no universal definition of this term. According to the Morgan Stanley Capital Index (MSCI) equity index, there are twenty-six emerging market (EM) countries. On the other hand, the International Monetary Fund's (IMF) index comprises 155 EM countries based on measures of social and economic development.[1] Regardless of the number, there is a thread that runs through common understandings of such countries: they possess markets with endemic graft, underdeveloped infrastructure, and economic dependence on the developed world. Even the most sophisticated analyst relies on the assumptions that are associated with a country's emerging status and the dichotomous breakdown between developed and developing countries. The global narrative focuses on a bifurcated world economy comprised of developed, core countries that manufacture products with raw materials that are provided by the developing, peripheral countries.[2] This two-dimensional background is obsolete: one need not look far to find data that not only challenges these assumptions but derails them. Portugal's debt as a percentage of Gross Domestic Product (GDP) is five times as much Chile's, while Japan's debt as a percentage of GDP is more than Poland and India's combined. Myriad examples abound of analysts and economists using the developing markets grouping to suggest equivalence among countries where there is none.[3] While the creation of the term "emerging markets" in the eighties transformed "underdeveloped" nations into "aspirational" economies, the term has outrun its usefulness.[4]

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* Robert Ginsburg (rbg32@georgetown.edu) manages a legal and consulting firm named RBG Global. Prior to starting RBG Global, Robert worked as the Foreign Direct Investment Manager for the State of Illinois and as an attorney for Freshfields Bruckhaus Deringer. He also is a Professor of Practice at Southern Illinois University. The author is grateful to Tom Ginsburg, Don Wallace, and Tim Samples for their helpful peer reviews.

[1] Will Kenton, *International Monetary Fund – IMF*, INVESTOPEDIA, https://www.investopedia.com/terms/i/imf.asp (last updated Dec.19, 2017). The MSCI World Index also lists 32 frontier markets based on social and economic development indicators.

[2] https://www.weforum.org/agenda/2014/07/raw-material-value-wealth-ricardo-hausmann/

[3] James Kynge & Jonathan Wheatley, *Emerging Markets: Redrawing the World Map*, FINANCIAL TIMES, (Aug. 3, 2015), Global Finance Magazine, Debt as a % of GDP https://www.ft.com/content/4a915716-39dc-11e5-8613-07d16aad2152, https://www.gfmag.com/global-data/economic-data/public-debt-percentage-gdp

[4] In fact, "the number of socio-economic dissimilarities among such countries often exceeds the similarities."

In the context of investor-state dispute settlement (ISDS), assumptions about a host country's investment climate based on its "emerging or developing status" influence decisions about liability and drastically alter the amount of damages awarded to claimants. For example, an arbitrator might consider the context in which a claimant makes an investment to determine whether or not the company should have anticipated host government interference with its foreign direct investment (FDI) project.[5] More specifically, arbitrators will look at the investment climate in a host country to verify whether or not there were precursors to regulatory instability at the inception of the investment.[6] This inquiry helps arbitrator determine whether or not there has been a breach of the relevant investment treaty. In other cases, the condition of an investment climate at the time that a company's project is confiscated is an important part of their effort to determine the value of the confiscated investment.[7] An examination of socio-economic/investment climate conditions often helps arbitrators understand the risk exposure of the relevant investment at the time of the loss.[8] Consequently, this examination becomes an essential part of the arbitrator's efforts to determine the amount of damages owed to the claimant. A review of myriad award decisions in such cases reveals that arbitrators often rely on ambiguous country categorizations such as "emerging markets" to determine liability and damages amounts. For example, arbitrators often use an "emerging markets sovereign bond index" to measure the risk exposures of a host country that is "developing."[9] When arbitrators rely on inaccurate categorizations of investment climates, they are less likely to retroactively determine which of the investor's expectations are realistic and the real value of a claimant's assets. When decisions are based on cursory assessment of investment climates, arbitrators are more vulnerable to making questionable decisions about liability and the amount of damages that a respondent should pay in the quantum phase. Whether arbitrators rely on methods that fail to account for variations among investment climates in different countries or apply the same risk exposure to all investments in a given nation, the current approaches to measuring risk are insufficient. This is the first article to demonstrate the specific ways in which country risk assessments (CRA) can provide arbitrators with a framework for understanding the host country's investment climate at the inception of an inbound investment. Rather than relying on assumptions based on obsolete categorizations to determine liability and amount of damages, arbitrators should use bespoke CRA to identify relevant aspects of a host state's investment climate that determine outcomes. CRA are the most accurate measure of investment climate because they evaluate the quantitative and qualitative value of the political, economic, social, and

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[5] *See* Michele Potesta, *Legitimate Expectations in Investment Treaty Law: Understanding the Roots and the Limits of a Controversial Concept* (2013) 28 ICSID Review 88; Meg Kinnear, *The Continuing Development of the Fair and Equitable Treatment Standard* in Andrea K Bjorklund, Ian A Laird, and Sergey Ripinsky (eds), INVESTMENT TREATY LAW: CURRENT ISSUES III (British Institute of International and Comparative Law 2009).

[6] *See* Toto Construzioni Generali S.p.A. v. Lebanon, ICSID Case No. ARB/07/12, Award, ¶ 245 (June 7, 2012); Bayindir Insaat Turizm Ticaret Ve Sanayi A.!. v. Pakistan, ICSID Case No. ARB/03/29,Award, ¶ 195 (Aug. 27, 2009); Duke Energy Electroquil Partners & Electroquil SA v. Ecuador, ICSID Case No. ARB/04/19, Award, 340 (2008).

[7] Marcos D. Dominguez, *Calculating Damages in Investment Arbitration: Should Tribunals Take Country Risk into Account?* 34 ARIZ. J. INT'L& COMP. L. 95, 109 (2016);

[8] Dominguez pg. 108

[9]*See, e.g.*, Guaracachi America, Inc. v. Plurinational State of Bol., PCA Case No. 2011-17 ¶¶ 558-59 (2014).

business risks of doing business in a country.[10] Thorough examinations of institutions in an investment climate can reveal potential government acts that account for country and project specific aspects of the inbound investment. While the existing body of literature recognizes the usefulness of CRA and sub-risk analysis, this approach has not been widely adopted by the ISDS community. One potential reason for the reluctance to implement CRA is a lack of experience and knowledge about the process and the product. In order to explain how bespoke CRA can help arbitrations, this article: 1) explains why the emerging market and related categorizations are misleading; 2) identifies how reliance on the emerging markets term and the cursory assessments of investment climates negatively influence decisions about liability during the merits phase of ISDS cases, 3) explains how cursory assessments of investment climates negatively influence decisions during the quantum phase of ISDS cases, 4) presents a primer on CRA, and 5) demonstrates how a tailored CRA can help tribunals make more informed decisions during both phases of the arbitral dispute.

II. THE TERM "EMERGING MARKETS" AND HOW IT IS MISLEADING

"Emerging markets" and related terms form the organizing principles that are the starting point for those people who seek to understand the socio-economic, environmental and political factor that give shape to the world. While the term was created as a marketing tool to explain peripheral countries that were on the rise, it does not have any set of specific criteria on which it is based. Examples of the assumptions associated with emerging markets include: unstable political and economic climates, underdeveloped markets and institutions, and rampant corruption.[11] Based on these stereotypes, political pundits and economists draw inaccurate conclusions about the corporate governance and financial well-being of myriad countries in Latin America, Africa, and Southern Asia. Whether the collective label of emerging countries includes "former Soviet countries," "newly independent states," "underdeveloped economies," or "countries in transition," the current global order requires analysts and lay people to stop making assumptions about countries based on inaccurate and inadequate groupings. Furthermore, current economic hierarchy, which places emerging nations at the periphery and developed markets at the core of world affairs, does not accurately describe a world in which EM countries contribute a larger share to global gross domestic product than their developed counterparts, when measured by purchasing power parity."[12] In fact, a review of rule of law rankings reveals many outcomes that contradict the existing understanding of a developing and developed world. For example, the World Justice Project's (WJP) annual report on rule of law reveals many surprising outcomes. Uruguay ranks as number eighteen in the absence of corruption ranking, receiving better scores than the United States, Japan, and Italy.[13] In the WJP's overall ranking of "rule of law", Korea receives a better score than the United Kingdom, Spain and Portugal.[14] As these

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[10] Brian Perry, *Evaluating Country Risk for International Investing*, INVESTOPEDIA,
https://www.investopedia.com/articles/stocks/08/country-risk-for-international-investing.asp (last updated May 31,2018).

[11] https://www.temit.co.uk/content-common/market-perspective/en_GB/local-GB/archive-2017/debunking-emerging-market-myth-misconceptions.pdf (Franklin Templeton Investments

[12] Kynge & Wheatley, *supra* note 2.

[13] *Id.* In the component scores for openness of government, the WJP places Costa Rica (an emerging market according to MSCI), as the country that has the 15th strongest institutions, ranking ahead of the United States, Japan, Spain, Singapore, and Italy

[14] *Id.*

facts show, each country comprises a unique unit of social, political, economic, financial, and regulatory factors that influence investment decisions and the ability of the multinational enterprises (MNE) to succeed in FDI projects. The global order now requires interested parties to examine investment climates in specific host countries where they plan to do business. The availability of country-specific data and analytics should compel decision makers to look at the host country individually rather than rely on assumptions about it based on its association with other countries that often share no similarities.

In the context of ISDS, the condition of the investment climate is a very important part of the decisions on merits and damages.[15] Similar to the impact that cursory categorizations under emerging markets have in other contexts, arbitrators also suffer from drawing important conclusions based on cursory consideration of investment climates and the tendency to lump countries together under different headings. When examining the investment climate of a given country, ISDS tribunals must refrain from relying on commonly accepted generalizations. As the following demonstrates, tailored CRAs can help arbitrators determine the legitimacy of expectations in the merits phase and risk exposures of a claimant's assets at any given point in time.

III. CURSORY ASSESSMENTS OF INVESTMENT CLIMATE IN MERITS PHASES

The merits phase of arbitration determines whether or not the respondent breached its commitments under an investment treaty. In the event that a respondent is ruled to be liable for such a breach, the arbitrators commence the damages phase of the arbitration.[16] The following explains both phases of arbitration and provides examples of how arbitrators' reliance on overly simplistic understandings of a host country's investment climate negatively impact important arbitral decisions.

A. The Merits Phase

Treaties generally contain both general and specific protections. Whereas general protections relate to all aspects of a foreign investment in a host country, specific treatment standards protect investors from certain types of action or inaction, including safeguards against expropriation, the free exchange and transfer of currency, and full protection and security against acts of political violence.[17] General protections provide foreign investors with promises to adhere to basic standards of non-discriminatory treatment. The most fundamental principle of non-discrimination, which is comprised of the most-favored nation principle (MFN) and national treatment (NT) principle, form the basis of the international trading system.[18] MFN requires that if a member state provides a benefit to another member state, this same advantage must also be extended equally to all other parties to the treaty.[19] Similarly, NT requires that non-nationals be

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[15] Marcos D. Dominguez, *Calculating Damages in Investment Arbitration: Should Tribunals Take Country Risk into Account?* 34 ARIZ. J. INT'L& COMP. L. 95, 96 (2016); Tiago Duarte-Silva, Charles River Associates, *Country Risk*, GLOBAL ARBITRATION REVIEW, https://globalarbitrationreview.com/chapter/1151515/country-risk.

[16] BORZU SABAHI ET AL, INVESTOR-STATE ARBITRATION 567 (reprint ed. 2011).

[17] SABAHI ET AL, INVESTOR STATE, *supra* note 10, at 398. In this phase, both sides argue about the proper valuation of the investment that determines the amount of money owed to the claimant.

[18] OECD, *Most-Favoured-Nation Treatment in International Investment Law* (OECD, Working Papers on International Investment No. 2004/2), https://www.oecd.org/daf/inv/investment-policy/WP-2004_2.pdf

[19] SABAHI ET AL, INVESTOR STATE, *supra* note 10, at 414; Perry, *supra* note 6.

treated no less favorably than nationals.[20] This principle can also be extended to include the goods, investments or services of "non-nationals", which must be treated no less favorably than the member's own domestic goods, investors, or service providers.[21]

While regulations can be challenged under the specific and general protections of international investment treaties, one of the broadest and most utilized challenges to government measures are filed under the Fair and Equitable Treatment clause (FET).[22] The FET clause is a key element in international investment agreements (IIAs), that has emerged as the most relied upon and successful basis for IIA claims by investors. Claimants use the FET standard as their primary mechanism for challenging government measures that negatively impact their investments. Arbitrators use the standard as a multi-purpose umbrella principle that allows them to invoke and apply a wealth of sub-principles.[23] The broad scope of the FET enables tribunals to consider a wider range of factors than is possible under the relevant test for direct and indirect expropriations. Whereas the FET provides protections against a variety of host government actions deemed to be "unfair" or "inequitable", the expropriation clauses often focuses exclusively on the taking of an investor's investment or property. For this reason, the FET clause is broader in scope than the expropriation clauses of IIAs.

B. *Legitimate Expectations and Examples of Assessments in ISDS Cases*

Several tribunals use the doctrine of legitimate expectations to review claims arising out of FET clauses. In reviewing the claims that a host government's implementation of a regulation has breached the FET clause of the treaty, tribunals ask whether or not the claimant could reasonably expect a stable regulatory framework.[24] As part of the analysis of the legitimacy of expectations, many tribunals consider the condition of the investment climate in the host country at the time of the investment. More specifically, the tribunals attempt to examine social, political, and economic conditions in the host country to see if there were glaring precursors to changes in regulatory frameworks.[25]

However, in determining the legitimacy of an investor's expectations, tribunals often use broad-brush reviews of a host country's investment climate that fail to look for actual precursors to unstable regulatory frameworks. For instance, while the tribunal in *Duke v. Ecuador* envisaged a comprehensive review of such conditions that consider many facets of the investment climate in a given country, it did not implement a thorough assessment.[26] The *Duke* tribunal and others have performed cursory examinations of the investment climate when

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[20] Bilateral Investment Treaties 1995-2006, Trends in Investment Rulemaking
https://unctad.org/en/Docs/iteiia20065_en.pdf (page 22)

[21] SABAHI ET AL, INVESTOR STATE, *supra* note 10, at 398; OECD, *supra* note 12.

[22] SABAHI ET AL, INVESTOR STATE, *supra* note 10, at 493.

[23] ALEC STONE SWEET AND FLORIAN GRISEL, TRANSNATIONAL INVESTMENT ARBITRATION: FROM DELEGATION TO CONSTITUTIONALIZATION IN HUMAN RIGHTS IN INTERNATIONAL INVESTMENT LAW AND ARBITRATION 130 **edited by P. M. Dupuy, Pierre-Marie Dupuy, Francesco Francioni, Ernst-Ulrich Petersmann**

[24] This article assumes that tribunals will continue to apply this doctrine and does not explore or engage in the debate about whether or not claimant's legitimate expectations should be relevant to FET claims. Rather, this article aims to demonstrate and suggest innovative ways in which to refine and improve the interpretations of the doctrine.

[25] Michele Potesta, *Legitimate Expectations in Investment Treaty Law: Understanding the Roots and the Limits of a Controversial Concept*, 28 ICSID Rev. 88 (2013); *see* Parkerings-Compagniet AS v Republic of Lithuania ICSID Case No ARB05/08, Award, 355 (2007) (Parkerings-Compagniet).

[26] *See* Duke Energy Electroquil Partners, ICSID Case No ARB/04/19.

considering conditions in the host country.[27]

Similarly, in *Parkerings v. Lithuania*, the claimant alleged that the city of Vilnius' rejection of its application for a permit to build a parking facility in a historical part of town breached its legitimate expectation of a stable regulatory framework.[28] Ultimately, the tribunal rejected Parkerings' claims based in part on a perfunctory review of conditions in the host country that provided an incomplete and an inaccurate assessment of conditions at the time of the investment.[29] Without explaining the progress or the actual status of reforms of this former member of the Soviet Union, the tribunal concluded that the claimant's expectations for a stable regulatory environment were not reasonable because the host country was "in transition."[30] As the tribunal explained, "[t]he political environment in Lithuania was characteristic of a country in transition from its past being part of the Soviet Union to a candidate for the European Union ("EU") membership."[31]

The tribunal's complete rejection of investors' expectations of a stable regulatory environment would not comply with the commitments undertaken by many states in the preambles of relevant IIAs. Moreover, a more substantive review that examines actual political and economic conditions at the time of the investment reveals that the investment outlook for inbound investors was far less bleak than the *Parkerings* tribunal made it out to be. In fact, at the inception of the investment, Lithuania was almost eight years into a reformation process that was prescribed by the EU.[32] In order to receive approval for entry into the EU, Lithuania and other eastern European states were required to adopt the new neoliberal reforms that promoted stability and encouraged foreign direct investment.[33] While Lithuania was a Soviet republic with autocratic political institutions and a command economy in 1991, it had transformed itself by 1997. According to the EU's status report of Lithuania in 1998, "Lithuania demonstrate[d] the characteristics of a democracy, with stable institutions guaranteeing the rule of law, human rights and respect for and protection of minorities."[34]

Not only does a more comprehensive review reveal that Lithuania's political system was relatively stable, it also demonstrates that Lithuania had been committed to implementing and maintaining investor-friendly reforms.[35] Such a historical review helps investors understand the country more holistically, more than just the political-economic situation at an isolated point in time. Third-party reports with positive prognoses for the political and legal framework (based on democratic principles) demonstrate that the situation was not as dire as the tribunal's assessment suggested.[36] Conversely, the reports of the situation in "similarly situated" former Soviet republics were not as positive. In fact, the EU report on Slovakia (1999) in the same year stated that:

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[27] Duke Energy Electroquil Partners, ICSID Case No ARB/04/19.

[28] http://isdsblog.com/2015/08/18/case-summary-no-8/

[29] Parkerings-Compagniet, ICSID Case No ARB05/08 (335).

[30] Alex Genin, Eastern Credit Limited, Inc. & A.S. Baltoil v. Republic of Estonia, ICSID Case No ARB/99/02, Award, 348 (2001) (Genin); Parkerings-Compagniet, ICSID Case No ARB05/08.

[31] Id.

[32] European Commission, *Regular Report from the Commission on Lithuania's Progress Towards Accession* 7 (1998) (Lithuania Progress Report).

[33] *Id.*

[34] *Id.*

[35] *Id.* at 12.

[36] *Id.* at 13

Slovakia does not fulfill in a satisfying manner the political conditions set out by during the period July 1997 to end September 1998. There has been a lack of stability in the institutions guaranteeing democracy, the rule of law and protection of human rights, as reflected by the inability to elect a President, the controversial use of the transferred presidential powers, the unsatisfactory functioning of the parliamentary committees and the disregard for the Constitutional Court rulings.[37]

The *Parkerings* tribunal's review assumes that investment climates among all states were identical. The limited scope of the *Parkerings* tribunal's review failed to account for differences between political and ecoTnomic conditions in Lithuania and other post-Soviet states, such as Slovakia. Consequently, the tribunal suggested that an investor's expectations of an investment climate in a country making progress should be the same as those of an investor in a country that is undergoing regression.

Moreover, contrary to the tribunal's assertion, the fact that Lithuania was in transition from a Soviet state toward a EU state could bolster, rather than diminish, an investor's legitimate expectations of a favorable investment climate in the host country. Throughout the application process, the EU tracks the progress of applicants' reforms to make sure that the applicant is moving toward open markets in their financial system and democratic policies in their political system.[38] The EU's ongoing oversight of the reformation process would confirm Lithuania's commitment to accelerate and deepen reforms that were friendly to investors. From an investor's perspective, a review of Lithuania's specific transition to EU membership would not only reveal stable political institutions at the time of the investment, but also suggest that the host government would move in the right direction in subsequent years.

Seven years earlier, a tribunal hearing denied the FET claim of foreign investors based in part on a similarly ambiguous assessment of conditions in the host country.[39] The dispute concerned the cancellation by the Central Bank of Estonia of an operating license held by Innovation Bank, a financial institution incorporated under the laws of Estonia in which the claimants were shareholders.[40] The claimant argued that the cancellation of the license was a breach of its legitimate expectation that the license would remain active throughout the course of the investment.[41] In *Genin v. Estonia*, the tribunal determined that the claimant could not legitimately expect a stable regulatory framework in the host country because the host state was: "[a] renascent independent state, coming rapidly to grips with the reality of modern, financial commercial and banking practices and the emergence of state institutions responsible for overseeing and regulating areas of activity perhaps previously unknown."[42] The tribunal's explanation of the state of affairs in Estonia also describes circumstances in many developing countries at the time of the investment. It explains basic components of financial sector

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[37] European Commission, *Regular Report from the Commission on Slovakia's Progress Towards Accessio*n 13 (1998).
[38] See e.g., European Commission, 'Regular report from the Commission on Slovakia's progress towards accession' (1998) 13.
[39] Genin, ICSID Case No ARB/99/02
[40] *Id.*
[41] Genin, ICSID Case No ARB/99/02, at 348.
[42] *Id.*

privatization that were prevalent across four continents in the years following the Cold War.[43] As the years and the process progressed, privatization efforts experienced different degrees of success, which often have a significant impact on the viability of cross-border transactions and the expectations of their investors.[44]

IV. CURSORY ASSESSMENTS IN THE DAMAGES PHASE

Simplistic assessments of investment climates also have a negative impact on the damages phase of arbitral disputes. In the damages phase, arbitrators determine the amount of money owed to the claimant to compensate it for its loss. According to Article 31 of the International Law Commission, the respondent state in an arbitration is under an obligation to make full reparation for the injury caused by the internationally wrongful act.[45] The first step in making a claimant whole from the respondent's breach requires a valuation of the relevant investments. It follows logically that arbitrators would need to know the value of the investment that has been the target of host government's interference or expropriation. There are three primary ways in which to perform this valuation. The following section explains the three primary methods of valuations employed by arbitrators, the different ways in which tribunals have used these methods and measures of country risk, and the problems associated with them. Each one of these methods incorporates a country risk measurement that reduces the value of each project that takes place in a developing host country. Known as "the country risk premium," this factor is a contentious topic in the international arbitration arena.[46]

A. Valuation Methods

In order to determine the amount of damages that makes a party "whole," the tribunals usually focus on one of the three options: 1) the income-based approach using the discounted cash flows (DCF) method to determine an equitable quantum of damages; 2) the asset-based approach; or 3) the market-based approach using multiples, stock prices, and prior transactions. While some arbitrators favor a hybrid approach or asset-based methods, most tribunals employ the DCF and market-based approach. [47]

1. Income-Based Approach: The DCF

Discounted cash is a method used to estimate the value of an investment based on its future cash flow.[48] DCF analysis estimates the present value of expected future cash flows using a discounted rate.[49] A present value estimate is then used to evaluate a potential investment. A common mechanism to account for country risk in the valuation of a company when using DCF

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[43] https://en.wikipedia.org/wiki/Post%E2%80%93Cold_War_era, A Tale of Two Worlds: Core and Periphery in the Post-Cold War Era - CDDRL". Cddrl.stanford.edu. Retrieved 2013-09-21

[44] Privatization Successes and Failures, Joseph Stiglitz (https://kelley.iu.edu/nagupta/gupta_surveychapter.pdf

[45] BORZU SABAHI, COMPENSATION AND RESTITUTION IN INVESTOR-STATE ARBITRATION 43 (2011). The International Law Commission (ILC) is one of the most prominent authorities on international law and is often cited by scholars and practitioners involved in cross-border projects

[46] *See generally* Dominguez, *supra* note 9; Duarte-Silva, *supra* note 9.

[47] Dominguez, *supra* note 9, at 109; Duarte-Silva, *supra* note 9.

[48] Dominguez, *supra* note 9, at 104-05; Duarte-Silva, *supra* note 9; Perry, *supra* note 6.

[49] Dominguez, *supra* note 9, at 104.

is to build a specific discount rate premium for that country and investment.[50] Frequently, analysts use a measure of country risk (for example, spreads between sovereign default rates) and add it to the cost of equity and debt of every company trading in that country.[51] The main differences in this approach are found in the measure of the country risk selected.[52]

While the first DCF approach estimates a specific amount of future cash flow, the second DCF approach, the probabilistic adjustment method, considers several cash flow scenarios to account for multiple possible outcomes.[53] In this second approach, country risk analysts identify the likelihood that a sub-risk event will take place.[54] Next, the analyst measures the potential impact on cash flows from each scenario.[55] For example, analysis might determine what the country risk number will be in the event that a host government implements an illegal expropriation.[56] The final valuation results from averaging the assessed probability of each outcome.[57]

2. Asset-Based Method

An asset-based valuation of an investment follows a simple formula to determine the value: the investment's total assets are subtracted from total assets minus its total liabilities.[58] Whereas the income-based approach focuses on future cash flows and the market-based method, explained below focuses on the value of similarly situated companies, this approach focuses on the value of the tangible assets that the company owns.

3. Market-Based Method

The market-based approach values a company by comparing similarly situated companies for which there is sufficient price information.[59] Examples of the type of information that valuators use include ownership interests, securities exchanges, and prior transactions.[60] The two most prominent methods focus on multiples and prior transactions.[61] For the former method, valuators will select one variable of the company (usually Earning before interest, tax, depreciation, and amortization (EBITDA)) and multiply it by a factor (e.g. sale of comparable investments).[62] For the latter method, the tribunal focuses on prior transference of the company that is valued.[63] After identifying a transaction that involved a similar company, valuators apply the same rate to

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[50] *Id.* at 105.

[51] *Id.*

[52] *Id.*

[53] *Id*

[54]

[55] *Id.*

[56] Dominguez, pg. 111

[57] Dominguez, *supra* note 9, at 105; Price Waterhouse Coopers, REWARDING EXPROPRIATION? 8 (2015), http://www. pwc.co.uk/assets/pdf/rewarding-expropriation.pdf.

[58] Dominguez, *supra* note 9, at 106.

[59] RICHARD BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 77-78, 466 (2014); MARK KANTOR, VALUATION FOR ARBITRATION, 8-9, 231-39 (2008); Dominguez, *supra* note 9, at 106-07; Duarte-Silva, *supra* note 9.

[60] Dominguez, *supra* note 9, at 103

[61] *Id.*

[62] *Id.* at 107

[63] *Id.*

the existing investment that has been interfered with by host government officials.[64]

B. *Arbitral Valuation Methods and Country Risk Measurements*

In addition to considering the three options for measuring the value of the investments, arbitrators and expert witnesses must also consider the methods for measuring the component that is the country's risk. There are three principal ways in which to measure country risk premium: 1) sovereign bond default measure, 2) volatility of equity and debt markets, and 3) country risk measurements. The following section explains the different ways in which country risk has been measured in previous cases. This section also identifies several flaws in these measurements, which often create differences amounting to tens of millions of dollars in the final award.

1. Sovereign Default Spread

The sovereign default spread is the difference in yield between two bonds.[65] The first bond is a government bond in the relevant host country and is denominated in the currency of a developed country that serves as a reference point.[66] The second yield comes from a Treasury bond yield that has a similar maturity in the developed country.[67] This is the most basic way of using default risk as a proxy for country risk. For example, Country X's C-bond that is denominated in Euros is widely traded and both the price and yield indicate market views of this country. In August 2002, the 10-year C-bond was priced to yield 10.15%. When comparing this yield to the British equivalent, which was C- at the same time, the yield is 4.8%, and produces a default spread of 6.5%. In this case, the country risk premium would be 6.5%.

This approach provides analysts with a more objective alternative than other methods because there is no debate about what metric to use. More specifically, there is one source for determining the sovereign bond yield. Conversely, the more tailored methods that are explained below select data from multiple sources and have many different finished products. While the sovereign bond approach is more objective than others, it has two major flaws. First, this approach merely reflects the spread at a given point in time. In this case that point in time was December 2003. A review of historical spreads reveals that Country X's yields have been very volatile. For example, Country X's spread just six weeks later was 8%. When yields are volatile, the measurement obtained at an isolated point in time does not reflect the actual default risk exposure over time. Therefore, such measurements can be more than random than predictive.

To address the limitations of methods that rely on an isolated time point, other measures use spreads between developed and developing countries over a ten-year period.[68] For example, rather than focusing on sovereign spread at a isolated point in time the tribunal in *Lemire vs. Ukraine* used a ten-year average yield of each individual bond they were comparing.[69]

[64] *Id.* While the market method can be effective, it will be useless in situations where the valuators and arbitrators cannot determine how much country risk considerations factored into the original valuation.

[65] James Chen, *Yield Spread*, INVESTOPEDIA, https://www.investopedia.com/terms/y/yieldspread.asp, (updated Feb. 5, 2018); Duarte-Silva, *supra* note 9.

[66] *Id.*

[67] *Id.*

[68] *Id.* at 110

[69] Lemire v. Ukr., ICSID Case No. Arb/06/18, Award, ¶¶ 285-86 (Mar. 28, 2011).

Ultimately, with reservation, the *Lemire* tribunal used this method and based the premium on a more accurate and reasonable reflection of a country's default rate over time.[70]

While this approach provides a remedy to the isolated time point problem, there is no remedy for the primary critiques of using sovereign yield spreads. The claimants in the *Sempra v. Argentina* case successfully presented this argument. In this case, the respondent's calculations of damages utilized the sovereign yield spread to make its arguments for a high country risk premium based on the likelihood of default.[71] In arguing against Argentina's calculation, the claimants claimed that that the country risk premium should be lower as the political risk exposure of a private company like Sempra was significantly lower than the government's credit risk during that same period.[72] More specifically**,** the claimant stated that a host government's likelihood of default on a sovereign debt is fundamentally different from the risk of government interference with a foreign direct investment project.[73] In the Sempra case, the disputed acts of government interference concerned the host government's decision to prevent the energy company (Sempra) from adjusting its rates after the local currency had been devaluated.[74] This government measure, which did not exist at the time that Sempra made its investment, decimated the company's investment because it was charging electricity rates in the local currency.[75]

Another problem associated with the method used in the *Lemire* disputes is that many host countries that are involved in ISDS cases have not issued bonds that can be part of a sovereign spread analysis.[76] In such cases, tribunals who want to use the default spread must rely on an emerging market bond index instead.[77] This strategy falls prey to the pitfalls associated with the misleading assumptions of lumping countries together whose corporate governance and types of economies have no similarities. For example, the conflicting definitions of the term emerging markets calls into question whether or not the host country is even an emerging market in the first place. Use of the index assumes that the host country will have a similar likelihood of default as the countries selected for the index because they all have developing economies and unstable political frameworks. The ambiguity of this term that allegedly ties these countries together thwarts this assumption. More specifically, the conflicting definitions of this term challenge the notion that either the host country or the group of countries that comprise the index meet the definition of the term that is supposed link them to one another.

2. Relative Volatility of Equity and Debt Markets

To address criticisms about the disconnect between default rates and the ways that host governments interfere with private investments, some experts use an approach that focuses on the relative volatility of equity markets in the host country. The most frequently observed application of this measure is to calculate the ratio between the volatility of the local market and

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[70] *Id.*

[71] Sempra Energy Int'l v. Argentine Republic, ICSID Case No. ARB/02/16, Award, ¶ 133 (Sept. 28, 2007).

[72] Dominguez (p. 109)

[73] *Id.* at ¶ 134.

[74] Sempra Energy Int'l v. Argentine Republic, ICSID Case No. ARB/02/16, Award, ¶ 133 (Sept. 28, 2007). (page 30)

[75] Id. at 30.

[76] Id. at 109

[77] A **bond index** or **bond** market **index** is a method of measuring the value of a section of the **bond**market. It is computed from the prices of selected **bonds https://en.wikipedia.org/wiki/Bond_market_index**

the volatility of the reference market, and then apply that ratio as a multiplier to the market risk premium component of the discount rate.[78]

While this alternative is a decent measure of an investor's risk exposure, it has other problems that hamper its effectiveness. For example, some countries do not have an equity or debt market, and consequently, rely on an emerging market index.[79] In these cases, the host country's risk exposure is lumped together with the myriad other countries whose investment climates are developing.

3. Country Risk and Sub-Risk Ratings

Most articles on the measurement of country risk management focus on sovereign bond spreads and the volatility of equity markets. However, authors still refer to the use of political sub-risks such as change of government and political instability.[80] While most articles recognize that value of using sub-risks, they also give short shrift to the idea of using them in a retroactive calculation of country risk premium.[81] Although ample data for measuring these variables are available, tribunals and scholars have not adopted the usage of these tools.[82] Citing the different sub-risks that experts associate with similar projects, critics argue that the subjectivity and inconsistency of this approach should preclude its usage in ISDS cases.[83] Despite these claims, the use of CRA of sub-risks provides the only measurement options that accounts for country- and project-specific factors on the direct investment. Whereas the other methods focus on macroeconomic variables that apply generally to all investments in a given country, the selection of sub-risks based on a given investment's project profile capture the nuances of different exposures among different projects in the same country. For example, the CRA model would consider the different country risk exposures of an oil and gas project and a t-shirt manufacturer. The former would have a significant expropriation risk while the latter would be more exposed to labor strikes and other risks that focus on manufacturing. The model in Section VI explains this concept in greater detail.

C. *Problems with Valuation and Measurements*

There are three additional problems with the most common methods of valuation discussed above. First, these methods assume that every company in a given country shares the same level of exposure to risk. Second, the first and second methods fall victim to the stereotypical myths of the two-dimensional global economy. Third, they all misunderstand the role of instability in the manifestation of political perils.

1. Failure to Consider Micro-Risk

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[78] *Id.* at 115

[79] *See, e.g.*, Guaracachi America, Inc. v. Plurinational State of Bol., PCA Case No. 2011-17 ¶¶ 558-59 (2014), Dominguez (p.109)

[80] *See* Dominguez, *supra* note 9, at 99. These include: 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).

[81] *Id.* at 99

[82] *Id.*

[83] Dominguez, *supra* note 9, at 99.

The velocity of equity and debt markets and the sovereign spread assume that every company in a given country shares the same exposure to country risk. The failure to consider the project-specific difference distorts the overall risk premium because there are significant differences among each project's exposure to host government interference and political violence. A breakdown of two different investments in different industries with two different business models demonstrates why the consideration of micro-transactional risk is a necessary component of country risk calculations.

A company that is outsourcing labor to the host country and exporting its products will have a very different risk exposure than a company that sells its services or products within the host country and using local currency. For the latter, the manifestation of devaluation risk could significantly reduce or decimate margins while it would help the former increase its margins, because the relative costs of labor would be significantly reduced. In the context of calculation of damages, the devaluations of a currency would decrease the value of the company selling its services in the local currency, and consequently, increase the country risk premium calculation. Conversely, the devaluation would increase the value of a company's investment that focuses on domestic labor and exportation of the finished product, and consequently, decrease the country risk premium. Whereas the former would work in favor of a claimant in the damages phase, the latter would favor a respondent. In any event, country risk measurements that do not examine the project profile specific to a given investment fail to account for differences among inbound FDI projects. As a result, companies with significantly different risk exposures receive an equal percentage of deductions from the valuation of their assets.

2. The Developing and Developed Global Order

Both the sovereign default spread and the equity risk model are based on the foundational principles of the bifurcated global economy. For example, the formula for measuring defaults requires the comparison of a "developing" country's bond yields with that of a "developed" country.[84] While the bond yield requires a subtraction, the stock market compares the host country's index with that of a mature-reference market.[85] The fundamental problem with this approach is that it assumes that all developing countries have the same (or similar) investment climates and risk profiles. It also assumes that all developed countries have the same investment climates and risk profile. Ultimately, it fails to consider the unique profiles of each host country and municipalities therein.

3. Country Risk, Economic Instability, and the IMF

All three approaches to valuation rely on one major assumption: host governments are more likely to default on loans and interfere with foreign investments during times of political and economic instability. When the use of country risk ratings in the context of damages calculations by analysts is explained, it usually measures the likelihood of instability in a given

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[84] Dominguez, *supra* note 9 at 101, Aswath Damodaran, Country Risk: Determinants, Measures and Implications 55 (July 23, 2018) (unpublished) (on file with the Stern School of Business).

[85] Footnote: Bond default spread: Godfrey and Espinosa (1996), and many others, such as Damodaran (2011) and Porras (2011), Stephen Godfrey & Ramon Espinoza, *A Practical Approach to Calculating Costs of Equity for Investments in Emerging Markets*, J. Applied Corp. Finance, Fall 1996, at 24.

host country and the ability of institutions in that country to sustain economic and political order during such times.[86]

There is one major flaw with this argument: it fails to account for the influence of the IMF on sovereign countries who rely on its assistance during times of financial instability and crisis. Many countries that are on the verge of default and economic collapse seek the assistance of the IMF via rescue loan packages.[87] The IMF is a strong proponent of open and liberalized markets that encourage foreign direct and portfolio investment as a vehicle to global economic growth.[88] For these reasons, many host governments are reluctant to default on their bonds and interfere with investments during times of political and economic instability.[89] Host governments that seek bail out packages from the IMF will likely not receive them if they interfere with foreign investments.[90] This factor calls into question the connection among economic instability, bond defaults, and host government interference with private foreign investments during such times of instability.

V. A PRIMER ON CRA

A review of the ways in which arbitral tribunals measure the legitimacy of investor expectations and the impact of investment climates on the value of an investment reveals many inconsistencies and inaccuracies. While there is no perfect tool for executing this analysis, there is an underexplored alternative that is a significant improvement to existing methods. The CRA examines the political, economic, social, and business risks of doing business in a particular country. More specifically, this method measures each country as an individual unit, considers its impact on the relevant project by identifying the primary factors that comprise its unique risk exposure, and selects the most objective data to measure them. Through this process, CRA can provide a more lucid and objective lens through which to consider the impact of a host country's investment climate regarding questions of liability and quantum in ISDS. The following section explains the CRA process.

CRA examines all aspects of a host country's investment climate, such as political and economic landscape, labor regulations, and supply chain factors. Although each customized assessment is different, all tailored assessments include two primary forms of analysis: micro- and macro-level examinations of the host country. While the micro-stage considers factors that are unique to the specific investment, the macro-stage evaluates factors that impact all

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[86] See e.g. Dominguez *supra* note 9 at 99, Duarte-Silva, *supra* note 9.

[87] International Monetary Fund, *What the IMF Does*, https://www.imf.org/external/work.htm; Nurith Aizenman, *A Debt Crisis Seems to Have Come Out of Nowhere,* NPR (Apr. 20, 2018), https://www.npr.org/sections/goatsandsoda/2018/04/20/604169277/a-debt-crisis-seems-to-have-come-out-of-nowhere.

[88] *See, e.g.*, Letter from Henri-Marie Dondra, Minister of Finance and Budget, Central African Republic to Christine Lagarde, Managing Director, International Monetary Fund (Dec. 6, 2018), https://www.imf.org/external/np/loi/2018/caf/120618.pdf.

[89] Kenneth Rogoff & Jeromin Zettelmeyer, *Banruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001*, 49 IMF STAFF PAPERS 470, 477 (2002), Ali J. Al-Sadiq, *The Impact of IMF-Supported Programs on FDI in Low-income Countries* 5 (IMF Finance Department, Working Paper, (2015). https://www.imf.org/External/Pubs/FT/staffp/2002/03/pdf/rogoff.pdf.

[90] Larry Li ∗, Malick Sy, Adela McMurray, *Insights into the IMF bailout debate: A review and research agenda*, Journal of Policy Modeling (2015), https://ac.els-cdn.com/S0161893815001003/1-s2.0-S0161893815001003-main.pdf?_tid=732f083a-893f-40b9-8147 eb8b009f32ef&acdnat=1551642712_9379679d4e640ef4e7b70db51520993f

investors.[91] Ultimately, the review of micro-related data will determine which aspects of the investment climate are most relevant to an inbound investment project.

A. *Micro-Analysis*

Micro assessments identify the project profile of the investment.[92] By considering the industry, method of entry, and risk mitigations strategies, this phase identifies the sub-risks that are most likely to disrupt the project.

1. Industry and Type of Project

The nature of the business activity will have a significant impact on its risk exposure. A meatpacking corporation will face significantly different risks and regulations than a bank. While regulations will vary by country and by state, certain industries are always more exposed to regulatory risks than others. Natural resources projects and others that are immobile carry increased exposure to political risk because investors cannot easily move the project to another country in the event of problems with the host government.[93] Realizing that certain inbound projects cannot leave once they have started, host governments often seek to renegotiate the terms of the contract with the MNE.[94] More specifically, the host country uses its leverage over investors to impose higher taxes or other regulations that diminish the profits of FDI projects. As Feils and Sabac explain, "[t]he implication is that a firm, once heavily invested in a host country, has little leverage to do anything except move its production elsewhere. . . . The move will not be a rational, cost-effective decision until the cost of discrimination exceeds the cost of moving."[95]

Conversely, relatively flexible operations enable some manufacturers to change their business model when problems arise in certain host countries. For example, in the event that a host government imposes windfall taxes on a widget manufacturer that has a nimble business model, the investor can circumvent punitive taxes on the sale by shifting to a model that exports its products from, rather than sells them in, the host country. For these reasons, manufacturers with agile operations retain bargaining power over host governments for much longer than extractive companies.[96]

2. Method of Entry

The method of entry, which is the strategy for penetrating new markets, determines the extent of local participation on a given project. Examples of these modes include wholly owned subsidiaries, joint ventures, franchises, and licensing projects. Whereas a joint venture will

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[91] 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).

[92] https://www.investopedia.com/terms/m/microrisk.asp

[93] Tokosz Tokosz, supra (Guide to Country Risk Book), pages 214, 218-220

[94] Feils and Sabac, *supra* note 84, at 129

[95] *Id.*

[96] Extractive industries are also more vulnerable to regulatory takings because they profit from resources that are attached to the host country's geographical history. Natural resources are highly politicized because they are linked to the territorial integrity of nations. Because companies in the extractive industries are often targets of discriminatory regulations/policies, their expectations about the stability of a host country's framework would differ from other companies in industries that are less exposed to political risk.

usually comprise a partnership between the inbound investor and a company that is headquartered in the host country, the wholly owned subsidiary does not have any local ownerships interests.[97] The risk of host government interference diminishes in a joint venture because local ownership often has relationships with government officials.[98] With ties to the local government, the joint venture links its best interests with those of the government officials and mitigates the likelihood of expropriation and other country risks.[99]

3. Risk mitigation strategies

There are several ways in which foreign investors can mitigate the likelihood that host governments will disrupt a project. First, foreign investors who link the interests of the project to the interests of the host community and its elected officials minimize the likelihood of government interference.[100] Foreign investors can also discourage host governments from discriminating against their investments by employing large numbers of local workers, financing social programs for local communities, and receive loans from multilateral lending institutions. Projects that create a significant number of jobs and social programs for local communities attach the interests of regional constituents to those of the investors. As a result, host governments that interfere with FDI projects are more likely to confront consequences from constituents who are negatively affected by the discriminatory measures imposed against foreign investors.[101] Host governments are also less likely to interfere with projects on which multilateral lenders participate because these institutions have more leverage over host governments than individual companies and private lenders.[102]

B. *Macro-Analysis*

Macro-level political risk assessments look at the investment climate in a host country to determine whether social, economic, political, and financial institutions provide significant checks against instability and government interference.[103] While macro risks affect all participants in any given country, the extent of the exposure to the risk will vary by project.[104] The primary types of risks comprise government currency actions, regulatory instability, sovereign credit defaults, corruption, political violence, and government changes.[105] In order to assess the likelihood that a sub-risk will manifest into a loss, the analyst will look at data that related to the host country.[106] For example, in assessing exposure to currency controls in Country

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[97] MINA TOKSOZ, GUIDE TO COUNTRY RISK, 219 (2014)

[98] *Id.*

[99] IAN BREMMER & PRESTON KEAT, THE FAT TAIL 294 (2009); Perry, *supra* note 6. Other common risk mitigation techniques include risk transfer mechanisms. For example, many FDI projects secure political risk insurance before starting a project in a foreign country. In the event that the host government commits an act of interference that is covered within the insurance policy, the insurance company will indemnify the insured for the loss. When performing a CRA, the analyst will review the risk management strategies of MNEs to identify the type and degree of exposures related to the specific project.

[100] MINA TOKSOZ, *supra* note 90.

[101] *Id.*

[102] Perry, *supra* note 6.

[103] MINA TOKSOZ, *supra* note 90, at 115.

[104] Feils & Şabac, *supra* note 48.

[105] [105] MINA TOKSOZ, *supra* note 90, at 125.

[106] Dominguez, page 99.

X, the analyst will look at historical data explaining how many times and when the host government implemented restrictions on transfer of funds over the past five years. Moreover, they will evaluate the host government's macro-economic policies related to conversion and transfer of currency from the host country to the home country.[107] This data is publicly available and applies to all inbound investors that seek to repatriate capital.

VI. HOW TO REAP THE BENEFITS OF TAILORED CRA IN THE MERITS PHASE

Regulatory expropriations are often orchestrated by executive or legislative officials who curry favor with constituents that compete with inbound investors.[108] For this reason, one of the most common issues related to legitimate expectations focuses on regulatory stability.[109] Expectations are beliefs about the future. To be reasonable, these beliefs must be based on information/factors that help forecast the future. Because of the inherent volatility associated with political and economic cycles, snapshots of stability at the time of the investment do not help investors establish reasonable expectations. However, CRA accounts for ongoing exposure to political risks by measuring variables that reflect a host government's commitment to maintaining a favorable investment climate over time. More specifically, the analysis focuses on whether the host government will change its regulations and make it difficult for investors to succeed. Host governments with strong democratic institutions demonstrate a strong commitment to implementing and maintaining investor-friendly regulations because they encourage FDI and promote policy stability.[110]

Based on this theoretical foundation, a tribunal or a party could develop a model that examines micro- and macro-related factors that measure a host country's institutions. In order to identify the likelihood of regulatory interference with inbound investments, CRA would look for two primary factors: a host government's *willingness* to interfere and its *ability* to interfere through regulation. The following provides a hypothetical case study based on common business operations in the automotive industry and explains a hypothetical model based on tenets of political science and economics.

A. *The Case Study*

The case study in this paper focuses on a hypothetical company named Autoworld and its direct investment in Callao, Peru. Autoworld built a manufacturing facility in Callao to assemble new sedans and SUVs that it sells to consumers in Peru and neighboring Andean and Mercosur countries. In order to assemble these two types of vehicles, Autoworld's wholly owned subsidiary imports component parts from three countries in the Western Hemisphere. The project employs 650 workers who are residents of the local province. In 2006, construction of the facility was completed, and the facility has been manufacturing cars for three years.

B. *The Model*

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[107] [107] MINA TOKSOZ, *supra* note 90, at 126.

[108] BREMMER & KEAT, *supra* note 51, at 213, Perry, *supra* note 6.

[109] Ginsburg, LEGITIMIZING EXPECTATIONS IN ARBITRATION THROUGH POLITICAL RISK ANALYSIS IN YEARBOOK OF INTERNATIONAL INVESTMENT LAW PG. 215.

[110] NATHAN M. JENSEN, NATION-STATES AND MULTINATIONAL CORPORATION: A POLITICAL ECONOMY OF FOREIGN DIRECT INVESTMENT (2006); BREMMER & KEAT, *supra* note 48, at 213 (EM breakdown)

As mentioned above, regulatory interference against foreign investors requires a *willingness* by government officials to disrupt inbound investment projects and an *ability* to elicit support for the regulation from other officials. The following model measures these two components.

1. Willingness to Implement Regulatory Expropriation (60 Points)

The willingness to implement regulations that have a serious impact on an investment can be measured by looking at a host country's record of *discriminating* against foreign investors and its tendency to implement regulations that are both *overbroad* and *irrational*. Whereas the former measures the likelihood that a host government would target an inbound investor with unfair treatment practices, the latter demonstrates the willingness to use regulations as its vehicle of discrimination.

a. *Regulatory Quality (30 points)*

The World Bank's Regulatory Quality Index measures the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.[111] In combining the data from many sources, this indicator considers a host government's proclivity to discriminate and its willingness to "over-regulate" businesses.[112] Among other variables, the ones that focus on these criteria are explained below:

Discriminatory Tendencies
- Unfair competitive practices: regulations that favor local investors or foreign investors
- Discriminatory tariffs: taxes on imports from specific countries that are implemented to favor domestic competitors
- Discriminatory taxes: taxes on foreign investor that are imposed on similarly situated domestic companies

Overbroad and Irrational Regulations
- Government burden: This includes regulatory compliance and bureaucratic inefficiency and/or opacity.
- Extent of taxation: the willingness of restrict business with taxes

CRA Model Integrating World Bank Regulatory Quality Index

The CRA model adopts the World Bank Foundation's scores into the framework for assessing the attitude of the host country toward inbound investors. Based on its review of the data, the World Bank assigns a score to each country's regulatory framework. Countries with investor friendly frameworks receive scores closer to one hundred while those with less friendly frameworks receive a score that is closer to zero. This paper demonstrates a legitimate expectations model that translates the World Bank score into a scale of zero to thirty and is explained below:

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[111] World Bank Group, Regulatory Quality https://info.worldbank.org/governance/wgi/pdf/rq.pdf.
[112] *Id.*

World Bank Score	CRA Score
100-90 points	30 points
89-80 points	25 points
79-70 points	20 points
69-60 points	15 points
59-50 points	10 points

Case study example

Peru's score with the World Bank's index for investment freedom is 75/100 and earns a score of 25 points in the CRA.

b. *Project Profile (30 points)*

The second component of the expectations assessment focuses on aspects that are unique to the specific project. A review of the investment's industry, its method of entry into the host country, and the existence and influence of competitors comprises a project profile. Altogether these factors determine the extent to which a given project is vulnerable to host government interference.

(1)   Industry (10 points)

As mentioned above, different industries have different exposures to political risks based on the agility of the business model in the industry and the nature of the business product. Companies that are dependent on natural resources and have no mobility are assigned the lowest score of three points. Medium intensity manufacturing companies that have some flexibility and do not rely on the territorial integrity of the host country are assigned six points. Lastly, low-intensity manufacturing processes and services companies that have nimble business models are assigned a score of ten points.

Case study example

Auto manufacturing is a middle risk industry that does not rely on the natural resources of the host country. Rather, it is a medium intensity manufacturing process with a business model that can be adapted. However, this effort would require significant financial expenditure to adapt to significant changes in the investment climate. Therefore, Autoworld's industry score is five points.

(2)   Method of Entry (10 points)

As mentioned above, the extent to which the success of IDFI projects are linked to the satisfaction of local interests will determine its score and risk exposure in this category. Whereas

a joint venture receives ten points and franchises are five points, the lack of local participation in a wholly owned subsidiary earns a score of three points.[113]

Case study example:

Autoworld is a joint venture with a local auto manufacturer and receives a ten-point score.

(3)   Local Competitors (10 points)

The inbound investor cannot control everything. Even if it successfully integrates local participation, the political influence of local competitors can often expose foreign investors to government discrimination.[114] Whereas exclusive arrangements with host governments to sell products with no actual presence of local competitors earns a score of ten points, an investment with a possibility of facing competitors in the future receives a score of five points. Companies that have active competitors at the time of the assessment received the lowest score at two points.

Case study example

While there is no existing competitor selling cars at the same price point as Autoworld, it is likely that such competition will emerge over the next five years. For these reasons, the score in this category is five points. Autoworld's project profile score is fifteen points. The total score for willingness prong is thirty-five points.

2. Ability of Government to Regulatory Expropriate (40 points)

Host governments with strong democratic institutions maintain FDI reforms through strong checks and balances that include the judicial and legislative systems and regulatory agencies that operate independently of each other and the host country's executive branch.[115] By making it difficult to pass anti-investor laws and regulations through the system, checks and balances promote the stability of various policies over the course of an investment.[116] Whereas the previous section focuses on government officials' desire/willingness to interfere with investors, this section examines the *ability* of such officials to pass discriminatory regulations through the legislative process.

a. *Host Country's Institutions: Rule of Law*

In countries with strong democratic institutions, executive and legislative officials are not

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[113] Josh Levy and Eunsang Yoon, Methods of Country Risk Assessment for International Market-Entry Decision, University of Massachusetts Lowell, page 1
http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.202.2796&rep=rep1&type=pd
[114] Wilford Mawanza, volume 6 issue 3 International Journal of Business and Social Science, An Assessment of the Political Risk Management Strategies by Multinational Corporations (MNCs) operating in Zimbabwe, 2015 page 122 http://ijbssnet.com/journals/Vol_6_No_3_March_2015/13.pdf

[115] Jensen, https://worldjusticeproject.org/our-work/wjp-rule-law-index/wjp-rule-law-index-2017%E2%80%932018/factors-rule-law/constraints-government
[116] Jensen, https://worldjusticeproject.org/our-work/wjp-rule-law-index/wjp-rule-law-index-2017%E2%80%932018/factors-rule-law/constraints-government

empowered to implement policies that promote special interests of the powerful elite.[117] This facilitates policy stability and provides MNCs with greater assurances that the conditions that promoted entry into the market in the first place will persist.[118] Because acts of regulatory discrimination are often spearheaded by executive officials who are elected officials, political risk analysts look to data that ranks the host country's institutions that provide checks against executives officials who would directly benefit from a regulatory taking of inbound investments interests.[119] The primary component examines the strength of the judicial backstop mechanism in different countries. This factor examines the extent to which the host country's judiciary makes decisions based on the merits. More specifically, in countries where judges are not vulnerable to either the influence of elected officials and/or civilians with specific financial interests, the judiciary is inclined to overturn regulations that are overly broad and linked to political objectives.[120] When courts uphold discriminatory regulations, they empower legislators to favor special interests in the instant case and set a precedent for other lawmakers that such regulations will also be supported in the future. For this reason, countries with weak judicial branches receive lower scores while those with independent judiciaries receive higher scores.

(1)   CRA Model Integrating World Justice Project's Rule of Law Rankings

Using a 0.0-1.0 scale, the World Justice Project (WJP) examines the degree to which the legislative and judicial branches serve as an effective check against executives and other private interests that might have ulterior motives.[121] The WJP scale uses a scoring range of 0 to 1.0.[122] The CRM model adapts this scoring system into one that is scored on a thirty-point scale. Higher scores represent host countries with investor-friendly regulations while lower scores represent host countries that have a willingness and/or ability to interfere.

WJP Score	CRA Score
1.0-.80 points	40 points
.79-.60 points	30 points
.59-.50 points	15 points
.49-.40 points	0 points

[117] Bremmer (213) ,WJP https://worldjusticeproject.org/our-work/wjp-rule-law-index/wjp-rule-law-index-2017%E2%80%932018/factors-rule-law/constraints-government In addition to maintaining investor-friendly reforms, policy stability enables MNCs to more accurately forecast budgeting needs according to future macroeconomic conditions and tax schedules, to hedge against currency risks, and to make managerial decisions in response to the predicted macroeconomic environment.

[118] JENSEN, *supra* note 55; *Constraints on Government Powers (Factor 1)*, WORLD JUSTICE PROJECT, https://worldjusticeproject.org/our-work/wjp-rule-law-index/wjp-rule-law-index-2017%E2%80%932018/factors-rule-law/constraints-government

[119] Tokosz, supra (Guide to Country Risk Book), pages 116-119

[120] JENSEN, SUPRA note 55; *Constraints on Government Powers (Factor 1)*, WORLD JUSTICE PROJECT, https://worldjusticeproject.org/our-work/wjp-rule-law-index/wjp-rule-law-index-2017%E2%80%932018/factors-rule-law/constraints-government

[121] *Id.*

[122] https://worldjusticeproject.org/sites/default/files/files/tables_methodology.pdf

<div align="center">Case study example</div>

Peru's combined score on government checks from WJP is 0.65 and receives a score of 25 points on the CRA.

<div align="center">3. Willingness and Ability to Regulatory Discriminate (30 points)</div>

Whereas the first two sections focus on one of the two components for measuring country risk interference, the final section combines the two scores for a final calculation. If a score determines a significantly low willingness or ability to interfere, the investor will have legitimate expectations of regulatory stability. When combining the scores assigned to both willingness and ability, the following chart explains the breakdown of expectations.

Autoworld's Project Profile	20/30 points
Willingness to Interfere	20/30 points
Ability to Interfere	30/40 points
Total : Ability and Willingness	**70/100 points**

Score Scale

85-100: High Expectations of regulatory stability

70-85: Reasonable Expectations of regulatory stability

60-69: Doubtful Expectations of regulatory stability

59 and under: No expectations of regulatory stability

To pass laws and regulations that discriminate against foreign investors, government officials must be willing to disappoint foreign investors and able to persuade their counterparts to support them. Willingness is reflected in the World Bank's Regulatory Quality index, which includes data that measures a host government's discriminatory practices and its tendency to over-regulate. Government officials must also have the ability to pass such regulations through the political system and ensure that judges will not overturn them. The relative ability to implement them is reflected in the relative strength of the institutions of a host government. The CRA model examines relevant data to demonstrate the willingness and ability of officials to push such regulations through the system. In scenarios where the assessment reveals scores that reinforce the willingness and ability, expectations for a stable regulatory framework will not be legitimate. In situations where the assessment reveals a lack of willingness or ability, expectations for a stable regulatory climate will be legitimate.[123]

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[123] The framework for determining the ability and willingness of government officials to interfere with investments merely recommends one way in which arbitrators can determine whether or not an investor could legitimately expect regulatory frameworks to remain stable. There are certainly other methods using similar variables to

VII. How to Reap the Benefits of Tailored CRA in the Damages Phase

A review of existing approaches for calculating country risk premium revealed the use of methods and data that fail to account for different risk exposures of companies within the same host country. The failure to look at the ways in which a given project profile alters an investor's exposure to risks related to a country's institutional framework distorts the valuation of investments in ISDS cases. CRA solves these problems by combining micro- and macro-level risks to provide tailored valuations. Below is a six-step process for determining a realistic premium that reflects the actual country risk exposure of a given investment in any given nation.

Step 1: Identify the Project's Business Model

Review the company's objectives related to its foreign investment and the business model it uses to accomplish these objectives in the host country. In the example cited above, company A's business model comprises three primary components:
- Component 1: Autoworld **manufacturers cars** in Peru using local labor and paying them in local currency.
- Component 2: Autoworld **sells its cars in local currency to domestic Peruvian market and exports the cars** to Colombia, Argentina, and Bolivia. Seventy-five percent of cash flows are from domestic sales and 25% come from export sales in South America.
- Component 3: Company A frequently **converts and transfers** revenues back to its bank in its home country to deposit there and pay off existing loan to international lender.
-

Step 2: The Indicators that Impact Ability to Execute Business Model

After reviewing the primary components of the business model, this step identifies the factors of the investment climate that significantly and directly impact the company's ability to execute its business model. The following identifies the most relevant indicators and examines/measures them.
- Component 1: The quality of labor and the ability to **hire and fire employees** is very important to executing the business model. For this reason, this component looks at the rankings of the **labor market**, which specifically determine the likelihood that a host governments labor laws and regulations will disrupt business operations
- Component 2: The ability to do business in local currency and repatriate profits is a significant part of Autoworld's business model. Host countries often block a foreign investor's right to convert profits generated in local currency to the home country's currency. For this reason, currency inconvertibility is a significant risk to Autoworld.
- Component 3: The ability to freely **exports cars** and **imports parts** of the manufacturing process. For these reasons, this component looks at export **restrictions** and **tariff barriers** for imports.

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measure similar outcomes. Through these examples, this demonstrate that tribunals have access to data that can help them measure predictive project and country specific variables that impact the relative stability of regulatory frameworks.

As explained in Section IV(B), the sub-risk measurement approach and tailored assessments are not prevalent in ISDS cases because of the subjectivity associated with identifying which perils should be measured. By reviewing the business model in step 1 and linking the investment climate factors that impede or facilitate its implementation, step 2 provides an alternative that will help parties identify the most relevant sub-risks to examine.

Step 3: Select the Data to Measure Indicators

Identify the data and measurements of such indicators in the host country and calibrate the value of each indicator in the risk calculations.
- Component 1: Labor market (Economist Intelligence Unit, World Bank)[124]
- Component 2: Export restrictions and tariff barriers and other trade barriers (Economist Intelligence Unit)[125]
- Component 3: Convertibility and transfer restrictions (A &M Best)[126]
-

Step 4: Assign and Calibrate Weights to Each Indicator Based on Potential Impact

We can achieve this result by applying the mathematical definition of an *expected value.* An expected value is a predicted value of a variable, calculated as the sum of all possible values each multiplied by the probability of its occurrence.[127] We apply this definition to our case study by taking the components we identified earlier that would impact Autoworld's ability to execute its business model and assigning weights to those components in order of their importance. The end result will be achieved by assigning the score of an individual component on a scale of one to five and then multiplying that score by its weight, which will be based on the potential impact of the manifested risk on the specific investment. The sum of all these products will give us a final score of one to five.

For example, because seventy-five percent of Autoworld's sales take place in Peru, and sales to Colombia and Chile account for only twenty-five percent, the repatriation of profits from the Peruvian bank to a bank in the home country would have a stronger weight than the export restrictions. The quality of the labor and the ability to sustain an efficient and productive labor pool is an essential part of the production process. Without quality labor at a reasonable wage, there is no impetus for locating to Peru. Finally, fifty percent of Autoworld's production relies on parts that are imported from other countries. While significant tariffs on imports would have a serious impact on Autoworld's margins, there are suppliers in third party countries that may not have tariffs linked to them. For this reason, the tariff barrier is a less significant risk than labor risks but is more important than export restrictions, which only apply to markets that qualify as twenty-five percent of the sales revenue.

The breakdown of the risks for Autoworld's subsidiary in Peru is:
- Currency Inconvertibility: 35%
- Labor Restrictiveness: 35%

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[124] https://store.eiu.com/product/country-report

[125] https://store.eiu.com/product/country-report

[126] AM BestMeasuring Transfer and convertibility risk, October 13, 2017
http://www3.ambest.com/ambv/ratingmethodology/OpenPDF.aspx?rc=197701,
https://store.eiu.com/article.aspx?productid=60000206&articleid=1843138368

[127] https://en.wikipedia.org/wiki/Expected_value

- Tariff Barriers on Imports of Parts: 20%
- Export Restrictions: 10%
-

Step 5: Align the Scores to the Same Scale and Multiply Each One by Its Weight

The first three indicators are all provided by the Economist Intelligence Unit and use a scale of one to five, but the export restrictions data source uses a range of one to one hindered. For this reason, the model must divide the export scores by twenty to provide a scalable measure. After making the data sources scalable, multiply the weight by the score. For example, if currency inconvertibility scores a four out of five and the weight is thirty-five percent, the value of this factor would be the product of 4 X .35. After multiplying the score by the weight, the model requires adding up the four outcomes and the sum will be your final score on the one to five range. The sum of all products for this case study is 3.8.

Step 6: Fit the Model to the Existing Range of Discount Rates in Historical Cases

Once we obtain a score of one to five using the expected value model that assigns a weight to each indicator based on the potential impact of the manifested risk on the specific investment, we can then take that value and convert it to a score that fits into the previously established range of premia of one percent to twelve percent. We can make this conversion using the information that is explained in Appendix A.

The six-step model aims to answer the primary question facing arbitration tribunals: What is the investment country's risk exposure at any-point in time? This requires analysts to examine the project profile and identify the most pronounced sub-risks for the project in a country. Next, it uses qualitative and quantitative data to measure the host country's governmental institutions and the extent to which precursors to the realization of such risks existed at any point in time.

In sharp contrast to the existing alternatives for measuring country risk premia, the CRA/sub-risk approach is tailored to the host country's investment climate and the project profile. Whereas the sovereign bond approach assigns the same premium to all companies in any given country, the CRA approach adjusts the rate based on industry and specific business model. Although the market-based approach considers industry specific components of the project, it often fails to account for other aspects of the project profile and the investment climate of the specific host country.

VIII. CONCLUSION

The investment climate in a host country is a very important part of answering questions on the merits and damages phases of arbitral disputes. Existing attempts to measure the investment climate are insufficient and subjective and fail to consider core concepts in political science and economics. For example, the risks related to the repatriation of capital to the home country are not linked to credit risks associated with a given country's issuance of sovereign bonds. Rather, they are linked to the specific regulations and procedures for converting and transferring funds. While the existing body of literature recognizes the availability of data that measures the most relevant sub-risks of a given project, it does not consider how the data can actually be applied to enhance decision-making in arbitral disputes. The models in this paper aim

to demonstrate a more objective way in which arbitral tribunals can use the data to make more informed and nuanced decisions. It does not pretend to resolve every controversial issue related to identifying the rationality of expectations in measuring the country risk premium.[128] Rather it seeks to provide readers with a specific demonstration of how country risk management can fill an empirical void in the merits and damages process of ISDS. While critics will argue that the reliance on such data includes a subjective approach, the usage of multiple data points does reduce the degree of subjectivity. Moreover, the benefits of using data which account for project and country specific components of an inbound investment outweigh any negative effects associated with relying on qualitative and subjective data. There are multiple ways to use this data and measure the sub-risks to which a given project is exposed. Simply put, the usage of these models will help arbitrators make sound decisions that are more reasonable than rando.

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[128] For example, it does not consider the questions about the relevant date of loss or whether or not host countries should benefit from added risk associated with their investment climates.

Appendix A

These mathematical equations demonstrate how the model transforms the score within a 1-5 range into the ISDS country risk premium range of 1.0% to 12.0%. In this case, the 3.8 score is changed into 8.7% country risk premium.

- $h = Value\ on\ the\ 1-5\ scale\ of\ expected\ risk.$
- $h_1 = Lower\ bound\ of\ the\ range\ of\ h.\ (h_1 = 1)$
- $h_2 = Upper\ bound\ of\ the\ range\ of\ h.\ h_2 = 5)$
- $i = Value\ on\ the\ 1-12\ scale\ based\ on\ previous\ arbitrations$
- $i_1 = Lower\ bound\ of\ the\ range\ of\ i.\ (i_1 = 1)$
- $i_2 = Upper\ bound\ of\ the\ range\ of\ i.\ (i_2 = 12)$

Equation that transforms our value of 1-5 into a risk premium from 1-12%

$$1 + \left[(h_2 - h_1) \left(\frac{(x - h_1)}{(h_2 - h_1)} \right) \right] \left(\frac{(i_2 - i_1)}{(h_2 - h_1)} \right) = Risk\ Premium$$

This simplifies to

$$1 + (x - 1) \left(\frac{11}{4} \right) = Risk\ Premium$$
$$...where\ x = the\ value\ from\ 1-5\ that\ we\ are\ transforming.$$

In other words, if our model gives us a score of 3.8, we can plug that number x into our equation above to achieve the following result.

1+(3.8-1)(11/4)=Risk Premia
8.7%=Risk Premia