Oil, Gas & Energy Law Intelligence

Volume I, issue #02 - March 2003

Managing Political Risk in the Oil and Gas industries

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I. Introduction

In today's increasingly global marketplace every investor has to consider particular risks involved in expanding its operations. Risk is a constantly present factor in business decision making process, and determining appropriate ways to manage and mitigate risks is crucial to the ultimate success of any new investments or expansion of already existing business operations.

Risk management is of paramount importance to the economic consequences of investments in oil and gas industry where such investments can exceed US$1 billion, and many years to complete.[1]

The general types of risk faced by all businesses can be grouped into five broad categories:

1) market risks, such as unexpected changes in interest rates, exchange rates, stock prices, or commodity prices;

2) credit/default risks;

3) operational risks, such as equipment failure, fraud;

4) liquidity risks, such as inability to pay bills, inability to buy or sell commodities at quoted prices; and

5) political risks.[2]

The key test for whether a risk can be covered by political risk insurance is determining whether the occurrence was caused by a government action (a "political" risk) or was the result of a commercial activity. Insurers make a distinction

between these two types of risk because a political risk is presumably not within the control of the investor, and a commercial risk is.[3]

Due to the extreme volatility of energy commodity prices it has long been considered that businesses operating in the petroleum, natural gas, and electricity industries are particularly susceptible to market (price) risks and other commercial risks. However, political risk management in the energy industry plays an increasingly important role since the world's oil and gas production pattern is directly related to the geopolitical location of reserves. As shown in the table below major oil reserves are located in the regions of the world characterized by an unstable political environment.

Middle East	65.7%
Commonwealth of Independent States and Eastern Europe	5.9%
Western Europe	1.6%
Latin America	12.3%
North America	3.9%
Asia and Pacific	4.4%
Africa	6.1%

Table 1. Distribution of oil reserves[4]

It has to be noted that traditional commercial risk management approaches, such as diversification, long-term contracts, inventory maintenance, etc. do not work well, however, for managing political risks. This paper defines the political risks threatening the well-being of the oil and gas industry, provides the description of current political risk management tools and techniques, and determines areas of their practical application.

II. Defining Political Risk in the Oil and Gas Industry

One of the major considerations inherent in any international investment is the political risk represented by the host country. This is particularly true in industries such as the oil and gas or energy industries, which are high profile and often controversial in almost every country in which the energy industry has been privatized or in which private upstream petroleum operations exist. When evaluating

a prospective investment in a foreign country, the investor must also evaluate and manage the potential political risk in addition to the geological and market risks. In other words, an oil company must be able not only to find hydrocarbons, it must also be able to develop and produce those hydrocarbons at a reasonable profit over time. An agreement signed with the host government is likely to have a term that will be for a longer period of time than the current government will remain in office. A future government may be less disposed to western companies and adopt a more nationalist policy for their national resources.

Once the geologists have made their assessment of the geologic potential of a particular area, and the economists have evaluated the fiscal regime that the host country is offering, it is up to company management and their advisors to assess the political risk inherent in a particular new venture and determine if that risk can be managed in an acceptable way, given the returns that are likely to result if the first two assumptions are correct.

Political risk *does not* result from the type of political system in place in the host country. For example, western companies have operated successfully under all types of political systems, be they Marxist, capitalist, nationalist, socialist, monarchy, or democracy. Political risk usually stems from changes to the political and socio-economic conditions of the host country from those that existed at the time the agreements in question were originally entered into. Examples of this are the problems that Belco Petroleum Corp. faced in Peru in the 1980s and that Enron Corp. faced in India in the 1990s. In both cases, a change in the local ruling party resulted in a new government that adopted an anti-foreign investment attitude that differed significantly from that of the predecessor government (or in the case of Enron in India, a regional government that adopted a policy different from that of the national government).

Furthermore, political risk is not confined to the third world. At various times, developed countries such as the UK, France and Italy have raised concerns about nationalization. If you broaden the definition of political risk to include "creeping expropriation" which stems from changes in legislation that affect the industry such as taxes, labor, environmental regulations and other economic measures, the United States itself may be considered to present somewhat of a political risk.

Therefore, the way the political power is exercised in particular country may have considerable effect on the investing firm's financial performance. Sometimes subtle political changes can greatly affect the investment climate. Accordingly, it is very important to identify the types of political risks in order to determine whether a particular government action poses a threat to the investment.

The first distinction that must be made is between ***firm-specific*** political risks and ***country-specific*** political risks. Firm-specific political risks are risks directed at a particular company. The example of firm-specific risks can be the risk that a government will nullify its contract with a given firm or that a terrorist group will target the firm's physical operations. Firm-specific risks, therefore, are by nature discriminatory. By contrast, country-specific political risks are not directed at a firm, but are countrywide. Examples include a government's decision to forbid currency transfers or the outbreak of a civil war within the host country.[5]

Investors may be able to reduce both the likelihood and impact of firm-specific risks by incorporating strong arbitration language into a contract or by enhancing on-site security. However, firms usually have much less control over the impact of country-level political risks on their operations. Sometimes the only sure way to avoid country-level political risks is to stop operating in the country in question.[6]

A second distinction to be made between types of political risk is the distinction between ***government risks*** and ***instability risks***. Government risks are those that arise from the actions of a governmental authority, whether that authority is used legally or not. Instability risks, on the other hand, arise from political power struggles. An example of such risk could be conflicts between members of a government fighting over succession, or mass riots in response to deteriorating social conditions.[7]

The distinctions between different categories of political risks are summarized in the table below.

	Government Risks	**Instability Risks**
Firm Specific Risks	• Discriminatory regulations • "Creeping" expropriation	• Sabotage • Kidnappings

County Level Risks	• Breach of contract • Mass nationalizations • Regulatory changes • Currency inconvertibility	• Firm-specific boycotts • Mass labor strikes • Urban rioting • Civil wars

Table 2. Categories of political risks.[8]

The degree of willingness to accept political risk varies from company to company. What one company finds acceptable, may be too risky for another company. In addition, there is usually a direct correlation between the degree of political risk that a company is prepared to accept, and the degree of geological potential of the proposed contract area.

In assessing[9] the degree of political risk in a particular country, the company will look to many indicators, e.g., the current activity in the host country that is affecting or is likely to affect the stability of the government (insurrection, rebellion, criminal activity), prospect for change of national or local government, past history of nationalizations/expropriations, experience of other companies in the country, political activity and trends in the region, the overall economic condition of the country, etc.

"When assessing political stability, the focus should be on the legitimacy of state authority, the ability of that authority to impose and enforce decrees, the level of corruption that pervades the system of authority, and the degree of political fractionalization that is present. Where economic policy is concerned, the focus would be more along the lines of the degree of government participation in an economy, the government's external debt burden, and the degree to which interest groups can successfully obstruct the decision-making process. ***Effective political risk management requires distinguishing developments that pose true risks—a well-defined threat to corporate performance—from political events that are merely dramatic.***[10]

III. Political Risk Management

It is important to emphasize that the there are a number of ways to protect the investing company against political risks, and the decision regarding the political risk mitigation measure to be taken has to be made after the careful assessment and evaluation of the factors the can potentially influence the company's financial performance in the host country.

Assuming that a petroleum company determines that the geological potential is attractive given the fiscal terms being offered, how does the company manage the political risk? Political risk can be managed in two ways: either through actual political risk insurance, or through what I like to refer to as *de facto* insurance. De facto insurance may be described as the protection that results from strategic partnering and/or planning. Actual political risk insurance is aimed not at preventing a loss, but rather at assuring the investor that compensation will be received for all or part of the investment if a loss does occur. De facto political risk insurance is aimed at trying to prevent a loss from occurring in the first place. Obviously, it is more effective against certain risks such as expropriation or nationalization, and less effective against others, e.g., currency inconvertibility, war risk, etc. These two methods are not mutually exclusive. They complement each other and in many instances are, used in tandem.

IV. Types of Political Risk Insurance

Actual political risk insurance can be obtained either through private companies such as Lloyds, AIG, etc. or through national or multilateral government insurance programs e.g., OPIC or MIGA. Countries offering some form of political risk insurance to their nationals include Australia, Belgium, Canada, Denmark, France, Germany, Japan, the Netherlands, Norway, Sweden, United Kingdom and the United States. The extent and scope of coverages offered will vary by country.

It can be emphasized that unlike multilateral agencies, bilateral agencies (known as Export Credit Agencies, or ECAs) are designed to promote trade or other interests of an organizing country. They are generally nationalistic in purpose and nationalistic and political in operation. Funding for bilateral agencies generally comes from their organizing governments.[11] This distinction is important in making the decision about the type of political risk insurance to be obtained by the investor: many of the projects financed by ECAs have serious social, political, cultural and environmental

impacts and this factor may influence the investment climate in some developing countries.

The two major U.S.-based ECAs are Overseas Private Investment Corporation (OPIC)[12] and Export-Import Bank (USEx-Im).[13]

The United States Overseas Private Investment Corporation ("OPIC"),[14] is probably one of the best known of the national government companies. OPIC is an agency of the executive branch of the U.S. government. It is widely known for its political risk insurance program, in which it covers losses attributable to certain political risks in oil and gas projects such as expropriation including losses caused by material change in project agreements, confiscation of tangible assets and bank accounts, interference with operations. OPIC insurance covers up to $250 million per transaction or project and can be obtained for up to 20 years.[15]

USEx-Im operates as independent U.S. agency. According to its governing statutes it has three guiding principles: support United States exports through financing, attain a reasonable assurance of payment, and provide financing support where commercial finance cannot do so. In addition, the USEx-Im guarantee program provides credit support for private sector loans made to foreign buyers to protect against repayment risks. The host government and USEx-Im must have in place a bilateral agreement. This agreement must give USEX-Im recourse to the government if a political risk event occurs, and results in a default.[16]

In addition to the national companies, which only offer protection to their own citizens (for example, in the case of OPIC, a corporation must be 50% or more owned by United States citizens, or if a foreign corporation, it must be at least 95% owned by a qualified United States entity), the Multilateral Investment Guarantee Agency ("MIGA"), which is an agency of the World Bank, offers protection to corporations which are incorporated and have their principal place of business in a country which is a member country, or which is majority owned by nationals of member countries. Approximately 97 countries have signed the MIGA Convention and of those approximately 71 have ratified the convention. Ratification is required in order to participate in MIGA's programs.

V. Types of Coverage and Measure of Loss

Two of the most important sections of a political risk insurance policy are those which set forth the events that give rise to a loss i.e., what constitutes an event of loss, and the measure of damages in the event a loss occurs. The determination of when an event of loss occurs, and the measure of damages will be a function of the type of coverage that is being purchased. It is important, therefore, to understand the types of political risk insurance coverages that are available.

Political risk insurance coverages generally include expropriation, currency inconvertibility, war and civil disturbance, trade disruption and breach of contract, each of which will be examined more closely.

1. Expropriation coverage protects against partial or total loss of the investment as a result of actions by the host government which may reduce or eliminate the insured's ownership of, control over, or the exercise of its rights with respect to its investment. Coverage can also be obtained against so-called "creeping" expropriations i.e. a series of actions which, over time, have the effect of depriving the investor of its ownership, control or rights to its investment. The amount of the loss is generally the net book value of the insured investment.

The concept of book value appears repeatedly throughout this discussion when discussing the measure of loss under a particular form of coverage. The definition of book value can be very important in determining how much will be recovered in the event of a loss. For example, whose book value is to be utilized, the foreign entity or the parent company? The two can be quite different and produce dramatically different results. If the parent company wants to protect its investment in the foreign entity as reflected on the parent company's balance sheet, it should think very carefully about this question. In the U.S. for example, there are two generally accepted methods of accounting for drilling results. An oil company can either use the successful efforts method of accounting under which dry hole costs are written off in the year incurred, or the full cost method of accounting whereby all drilling costs are capitalized and written off over the economic life of the reserves. The two methods can produce dramatically different results. This was at the core of the dispute that Belco had with its insurers in the case of the Peruvian expropriation.

Therefore, it is important to try and negotiate a definition of net book value that will produce the most favorable financial result for the insured. Particularly, expropriation coverages can take the following forms:

1.1. Confiscation of Fixed Assets and Bank Accounts

Many companies have investments in the form of subsidiaries, or via a joint-venture located overseas. To attract inward foreign direct investment it is likely that the host government would have granted concessions or signed specific agreements with the investing company. In many instances, such contractual agreements or licenses are a fundamental part of the overseas operations. When a change of government occurs at a later date, or a subsequent change is made to investment regulations, the locally held assets are exposed to selective or discriminatory action by the government, which might restrict its operations. Equally equity and/or shareholder loans invested by the banks or companies are at risk of confiscation. Insurance is available to protect the assets and interbank loans.[17]

Expropriation coverage also includes losses caused by material change in project agreements unilaterally imposed by the host government. The following agreements can be mentioned.

a. Drilling Rights

Long term agreements that relate to power purchase, production sharing, exploitation or drilling rights need to contain provision for remedy via external arbitration to protect against future disputes because there is a risk that such rights/licenses may be revoked at a later date. The contract should contain provision to pursue the government for remedy via arbitration, and significantly relies on the quality of the arbitration provision to secure a legal indebtedness through a court award. If such revocation of permits restricts the operations of the foreign enterprise, and is selective and discriminatory, underwriters can be persuaded to deem this an act of expropriation; this would certainly be the case if it causes the permanent and total cessation of the activities of the foreign enterprise.

b. Exploration/Exploitation (Production Sharing Agreements)

Moreover, where overseas governments seek to attract western companies to share in the exploration of a potential field (and import of the related technology), the exploration agreement will embrace the exploitation at the next phase. Thus the production sharing agreement will identify how subsequent oil revenues are split between the government and the exploration company.

In the event of a “dispute” with the host government under any of these agreements, proceeding to arbitration would identify the government indebtedness via the award, and coverage is available on grounds similar to drilling rights.

c. Proven Reserves

In circumstances where future oil revenues derived from an oil field of proven reserves (PDP) are consolidated into the balance sheet, and the underwriters are comfortable with the accounting principles applied, it is possible to include loss of future earnings as part of the overall net asset value lost, in the event of expropriation by the host government.

1.2. Confiscation of Mobile Assets

Contractors who take valuable and often specialized mobile plant and equipment overseas to undertake a project e.g, a drilling rig or a barge, usually intend to re-export their property on completion. Prior to re-exporting the equipment the contractor is required to obtain permits and licenses from the host government. In addition to the potential risk that permits are refused, the contractor remains exposed to a potential loss caused by both confiscation and deprivation i.e., their inability to re-export.

Insurance covers the investor’s equipment that is 'blocked' in an overseas country, or when contractor is forced to abandon the project due to war or other political disturbance. Similarly, insurance can be obtained to cover the loss of stocks of supplies and materials that are maintained in overseas warehouses. Ownership of these goods rests with the manufacturer until payment has been received, often prior to local delivery.[18]

2. Currency inconvertibility coverage protects against losses arising from an investor's inability to convert local currency into the foreign currency specified in the

policy, which is usually United States dollars, or the investor's home currency, for transfer abroad. Specific acts covered usually include excessive delays (usually expressed in terms of a stated time period), adverse changes in local laws or regulations, and an adverse change in the conditions governing the conversion to foreign exchange. Devaluation of the local currency is not a risk that is covered. The investor should, however, be sure that the date of the loss is considered to be the date when the request for transfer of funds was denied, and not the expiration of the stated waiting period, so that the risk of devaluation is on the insurance company and not on the investor. Typically, the investor will be required to pay over the blocked currency to the insurance company in exchange for the foreign currency that is guaranteed under the policy.

3. War and civil disturbance coverage protects against losses resulting from damage, destruction or disappearance of assets as the result of acts of war or civil disturbance in the host country. Covered acts usually include revolution, insurrection, coup d'etats, sabotage and terrorism. There may also be a business interruption feature whereby if the investment becomes a total loss as a direct result of any of the foregoing actions interrupting the conduct of the business, an event of loss will be deemed to have occurred. Thus, the assets need not actually be damaged or destroyed for a claim to be made, but the investment must be considered a total loss. In such event, the measure of the loss will be the investor's net book value of the investment. In the case of damaged or destroyed property, the measure of the loss will be the investor's book value for the assets that have been destroyed, the insurance company may also want to include a provision giving them the option to replace the destroyed item, or in the case of damaged property, the reasonable cost of repairing such damaged item.

4. Breach of contract coverage protects against a host country's breach or repudiation of the investor's contract. A recent example of this type of event is the repudiation of Enron's contract to build a power plant in India. This type of policy will usually require that the investor's contract provide for arbitration or other dispute resolution procedure whereby the investor can obtain an award of damages. Once such an award is final, if it is not paid after a stated period of time, an event of loss

will be deemed to have occurred the investor can then seek payment for the net book value of its investment under the policy. The loss of future profits is not covered, however.

5. Project Finance

The vast majority of infrastructure projects overseas require bank finance, either on a limited or non-recourse basis. The private insurance market now provides coverage for 10-year periods (in some cases 15 years) that specifically protects banks making loans to overseas projects. The project sponsors will almost certainly be seeking finance from the lenders where the assets of the project are assigned as collateral and the cash flows derived used to repay financing. [19]

6. Trade Disruption.

Border closures, blockades and sanctions might not cause a loss of the local investment, however they can significantly interrupt its business activities. A loss of profit and an increase in operating costs are two of the possible consequences for which specific insurance programs can be tailored. [20]

VI. Differences Between the Private and Government Insurers

In deciding whether to choose a private or government (national or multilateral) policy, some of the factors that should be considered are:

1. The private company will not have a nationality requirement other than that the insured not be a citizen of the host country. Furthermore, private political risk insurers provide insurance without regard to such factors as the host country's level of economic development, or the investment's economic effects upon the investor's home country.

2. The private insurer will insure existing as well as new investments, where as the government insurance companies will usually only insure new projects, or the expansion of an existing project. This is because the underlying rationale of the government companies is the promotion of foreign investment. It is important to remember that if you think you might want to consider a government type policy for

a particular project, you should register that project with the government company at an early stage of negotiation.

3. The government companies will usually write a policy for a fifteen or twenty year term, while the private sector will write a shorter term usually on a three year basis which can be renewed at the end of each year for an additional year, so that unless renewal is denied by the carrier, there is always a three year term remaining.

Currently official political risk insurers are able to provide coverage which is bound, at fixed rates, for durations commensurate with the long-term exposures (up to 20 years) attendant to most investment projects. In recent years, the private market has begun to offer coverage for up to 15 years.[21]

4. The cost of government insurance is usually cheaper than that offered by the private sector.[22]

5. With a private company, there is more flexibility and opportunity to negotiate the provisions of the policy. The government companies are usually not willing to alter the provisions of their standard form of policy.

6. Under government policies, the host government is informed of the coverage. Private sector policies often prohibit the investor from disclosing the fact of the coverage. In fact, disclosure can nullify the policy. This dichotomy of approach is an example of the de facto principle at work. The government companies feel that a foreign government will be less likely to take expropriatory action if they know it will lead to a direct claim by and potential conflict with the other government.

For some investors it might be advantageous to use both private and official markets to obtain the political risk insurance that meets their needs in securing investment. Government insurers, such as MIGA and OPIC, encourage the public-private partnerships and obtaining syndicated insurance in cooperation with private underwriters.

VII. De Facto Political Risk Insurance

As noted above, actual political risk insurance is aimed at compensating an investor for a loss once it occurs. If a company wants to achieve a degree of political

protection against expropriation and breach of contract, and does not want to pay the cost of political risk insurance, then one approach that a company may take, is to look at the geopolitical situation of the host country and enter into a joint venture with a local company and/or a strategic investor. The theory is that a particular host country would not expropriate the operations of an investor that is a national of a country with which the host country has close political, economic and/or military ties. This umbrella of protection will then extend to the other investors as well.

Another form of de facto political risk insurance involves having one of the multilateral institutions such as the World Bank (IFC) or Inter-American Development Bank (IIC) become an investor in the project. Obviously, a host country might think twice before nationalizing a company or project in which an agency of the World Bank has a financial interest. As noted above, this reasoning is the basis for disclosing that OPIC or MIGA has written a policy, and is a marketing tool for these companies in selling their insurance policies.

Proper planning is another important component of the political risk mitigation scheme. It includes thorough studying and researching the political, economic, social and legal environment in the country where the company is going to make an investment. Additional time and resources have to be allocated for such an effort, but it can minimize the potential threat resulting from political risk thus enhancing the chance for success. Another components of the political risk management aimed to creating the political risk friendly environment are: developing good relationships with the local workforce, constantly tracking the changes in political situation of the host country, establishing the sound company's reputation and corporate image. [24]

Conclusion

Unless a company follows a strategy of complete risk avoidance and stays solely within its national boundaries, it will be faced with the need to consider political risk when investing outside its home country. The challenge therefore is to manage the political and other risks that are unavoidable in the industry. How well these risks are analyzed and managed will often be key to a project's success. Classic political risk in

the form of expropriation and nationalization remains a threat, although it is not as prevalent as it once was. Remember, that expropriation or nationalization does not in and of itself violate international law, provided there is prompt, fair and adequate compensation to the investor. Risks of contract repudiation such as was experienced by Enron in India, and so-called "creeping nationalization" as evidenced by punitive taxation, burdensome labor and environmental regulations, price and monetary controls, pose a greater and probably more likely risk today.

While political risk can be *managed* through insurance, strategic alliances and partnering, it can also be minimized, by taking some actions, which may seem obvious, but are too often ignored. Effective techniques include keeping a low profile, maintaining close relationships with the host government, anticipating change and working with it, avoiding geographical concentration, being a good corporate citizen and utilizing local suppliers and personnel to the greatest extent possible so as to create an economic link with the host country that establishes a national constituency with a stake in your continued political survival.

One final caveat. No form of political risk insurance can protect a company if it engages in bribery or corruption, or pollutes the environment. Keep in mind that such actions would probably void any political risk insurance that was obtained.

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[1] *See Derivatives and Risk Management in the Petroleum, Natural Gas, and Electricity Industries*, Energy Information Administration Report (October 2002), available at: http://www.eia.doe.gov

[2] Id.

[3] *See* Daniel Wagner, *The Impact of Political Change and How To Protect Your Business Against It*, International Risk Management Institute (April 2000), available at: http:// www.irmi.com.

[4] In the past, when many countries had large excess-producing capacities, the world supply pattern was closely related to the pattern of world consumption. Since these excess-producing capacities have declined the current pattern of world production is more closely determined by the level of reserves and productive capacities of each region. *See* Bisio, A. and Boots, S., *Encyclopedia of Energy Technology and the Environment* 2223 (New York: John Wiley & Sons, 1995).

[5] *See* Daniel Wagner, *Defining Political Risk*, International Risk Management Institute (April 2000), available at: http:// www.irmi.com.

[6] Id.

[7] Id.

[8] Id.

9 Economists use various methodologies such as the expected monetary value theory to quantify political risk. A discussion of these quantification methods, however, is beyond the scope of this paper. For more information on this subject, see Johnston, International Petroleum Fiscal Systems and Production Sharing Contracts, PennWell Books (1994).

[10] *See* Daniel Wagner, *Defining Political Risk*, International Risk Management Institute (April 2000), available at: http:// www.irmi.com.

[11] See Scott L. Hoffman, The Law and Business of International Project Finance 487 (Kluwer Law International, 1998).

[12] Additionally, it provides financing of foreign direct investment projects through direct loans and loan guarantees. More about OPIC see http://www.opic.gov.

[13] More about USEx-Im see http://www.exim.gov.

[14]In addition to OPIC, the EXIM Bank also offers protection for US equipment that is sold abroad.

[15] See http://www.opic.gov.

[16] See http://www.exim.gov.

[17] *See* Marsh Credit & Political Risk Practice, available at: http://www.marshcredit.com

[18] Id.

[19] Id.

[20] Id.

[21] *See* OPIC, Private and Official Sources of Political Risk Insurance, available at: http://www.opic.gov/columns.htm.

[22] The cost of such coverage for an oil and gas project can run between 0.5 and 3% or more of the amount of coverage, depending on the perceived risk associated with project, the type of coverage and the host country.

[23] *See* OPIC, Private and Official Sources of Political Risk Insurance, available at: http://www.opic.gov/columns.htm.

[24] See Daniel Wagner, Defining Political Risk, International Risk Management Institute (April 2000), available at: http:// www.irmi.com.