Different Political Risk Mitigation Methods and Analyses of their Practicability

Goksu Gok

Supervisor: Robert Lee

Student Number: 080039781

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Chapter 1

Introduction

"Political risk has to be actively managed. You can minimise it, but never fully eliminate it... You have to go beyond what you see on the surface."[1]

Investors face variety of risks when they are investing in foreign countries. One of those risks is political risk. Political risk however is not the right terminology that should be used. The reason is that the concept of risk generally refers to a possibility of an occurrence of a situation. Unlike other type of risks in a project, political risk usually cannot be measured precisely since the factors of this risk are interrelated to many variables (political decisions, economic factors). Political risk is a phenomenon that is formed through the evolution of the countries. The explanation of this concept is possible through other positive science areas such as political science. Political risk is determined through previous political events thus it is evolving by experience.[2] Mitigation of risks is of a great importance to project companies considering the amount of investment they've made. The achievement of a project heavily depends on the allocation of risks.[3] The mitigation of project risks is generally managed through contracts between the participants of the project. These contracts enable the project company or other participants to pursue their remedies upon an occurrence of one of the project risks. However political risks and the mitigation methods of political risks are different phenomenon thus should be analysed separately from the other risks. Apart from the uncertainty factor which cannot be measured through scientific estimations. Political risks, similar to other project risks can be mitigated through contractual provisions and other arrangements, having the host government as a party to the contractual arrangements which makes the whole process much more complicated in comparison with the other risk mitigation methods. Since a state is a sovereign being and not an individual nor a private entity, it cannot be considered in the same category with other participants of the project, it should be dealt separately.

The aim of this paper is to provide the reader with the explanation of certain political risks, methods of mitigation of these risks and the problems associated with these methods. As it will be seen throughout the work, at the end, all of the methods explained, indicate that political risks can be minimised to a certain level however they cannot be completely eliminated. In addition to it, the cases discussed, demonstrate that the proper consideration given by the project company to the management of political risks might not turn out to be sufficient for protection from those risks. An investor that fully analyses the factors contribute to political risks, cooperates with the host government, hires political risk services for data and inserts provisions that would protect the investment or structures the project in a way that would prevent the governmental actions from turning into reality will still be exposed to a certain degree of risk. With all these methods applied, still, the investor wouldn't be in a political risk free environment. It should be borne in mind that the measures that an investor can take against the political risks are limited. Moreover these methods are not perfect and the application of them can create new risks along with the benefits.

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[1] W.J. Henisz, B. A. Zelner, 'Political Risk Management: A Strategic Perspective', *International Political Risk Management: The Brave New World*, Theodore Moran, The World Bank, Washington D.C., 2003, pp. 167

[2] I., A., Moosa, *Foreign Direct Investment: Theory, Evidence, and Practice*,Palgrave, New York, 2002, pp. 150-151

[3] S. L. Hoffman, *Law and Business of International Project Finance*, Cambridge University Press, New York, 2008, pp. 27

The first part introducing the concept of political risk and the relationship between political uncertainty and political risk is followed by the second chapter which explains the project financing as a method to mitigate political risks. In this chapter, the means (deterrence, stake reduction, terms clarification) that an exposure of political risks, can be managed through the use of project financing are analysed. The chapter continues with the analysis of relevant cases that demonstrates the defects of these risk reduction methods.

The second chapter concerns the use of concession agreements and explanation of political risks in detail. Concession agreements are significant in the point that they contain the basic permissions to commence a project in the host government. The withdrawal of these basic permits granted in concession agreements and the legal status of these agreements create uncertainty for the investor to the extent that the host government might revoke the concession agreement.

The third chapter concerns the implementation agreements which diminish the political risks by obliging the host government to act in certain ways or prohibiting the host government from taking certain actions. The implementation agreement contains stabilisation, damages, dispute resolution clauses which aim to decrease the possible undesirable situations for the project. Further discussion is made about the legal effects and enforcement of these clauses which indicates the project company is not yet fully protected despite the presence of the clauses.

The fourth chapter explains political risk insurance, which offers coverage for political risks. MIGA and OPIC are described briefly with further description of the types of political risks that are covered under their insurance programmes. The pros and cons of political risk insurance are presented including the discussion on conditions to the payment of compensation by these insurers. The emphasis on this chapter is on those conditions which might position the project company in a situation where no compensation is paid by the insurer simply because the conditions to the coverage of the risks are not met.

The fifth chapter is on the methods to mitigate political risks and protect foreign investment under international law. The options that the project company has under international law and the preventative effects of international law are discussed. Most important of all, the remedies that the project company is granted under international law due to the breach of contract by the host government are discussed along with some problems on the enforcement of international law to the host governments.

The paper explains all the available methods to an investor for reducing political risks by the analyses of the disadvantages of those methods that might give rise to new problems including the failure of mitigation of political risks. However this is not necessarily the case such as Shell's investment in Nigeria.

Political Risks

Political risk is not a clearly defined term although it is used frequently. Comeaux and Kinsella explain political risk as the intervention conducted by the government which damages the foreign investment. The amount of exposure to political risk depends on the stability of the regime and on the existence of an autonomous judicial system.[4] The foreign investment is subject to the sovereign rules of the host government. The protection of the foreign investment can be managed through guarantees, investment laws and favourable tax treatments by the host government. However the same government can also introduce legislation that is detrimental to the operation of the utility.

One of the most significant features of political risk is that human judgement plays an important role in the analysis of it.[5] This can be considered as a downside however research, flow of information and experience reduce the subjectivity factor of human assessment.

Political risk and country risks are confused as to be the same type of risks but they have some key differences. Country risk results in financial losses to an investor due to the fiscal situation of a country whereas political risk refers to the combination of variables such as political uncertainty and instability. Political instability is regarded as unforeseen events causing changes in governmental structures whereas political uncertainty arises out of lack of information about the political situation. Compared to these concepts political risk is often regarded as a more objective term which is measured through the amount of uncertain factors. Political instability is a determinant in political risks in which the likelihood of the occurrence of political events is measured.[6] Political uncertainty discourages many investors of investing in particular countries. Political risks are certain assumptions that might occur in a country. Identification of political risks is the first step to form a strategic plan of reducing them. Thus a situation of uncertainty would be considered as a less favourable to a situation where political risks existed. Uncertainty is a combination of a lack of information and unpredictability of the political conditions in a country. On the other hand long term projects need a predictable environment for its development. In case of political risks, an investor has the advantage of knowing what might happen as a result the investor chooses the proper methods for the allocation of those risks whereas political uncertainty does not allow the investor to mitigate the situation for the situation cannot be identified. An investor will invest in a country that contains highly rated political risks but it would not invest in country where certain facts significant to such investments are unknown.[7]

An investor before initiating a project in a foreign country would conduct a detailed analysis of political risk. No specific method of protection for investors exists against the losses occurred due to political events. For that reason, a project company should assess political risks on the very circumstances of each case (the type of investment, country conditions etc.) and it should use every possible way to mitigate those risks. To reduce these risks a company should constitute a series of policies that would discourage the host government from taking actions. The methods that the investor is following for a specific risk, may not always turn out to be convenient for other risks that the project is exposed to. For instance an investor might trigger a specific event by just taking preventative measures for the other situation. It is important for the investor to maintain the bigger picture including all the other factors in managing the political risks.[8] Investors often disregard the existence of the political factors

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[4] P. E. Comeaux, N. S. Kinsella, 'Reducing Political Risk In Developing Countries: Bilateral Investment Treaties, Stabilization Clauses, and MIGA & OPIC Investment Insurance', *New York Law School Journal of International and Comparative Law*, vol. 15, 1994, pp. 4

[5] C., H., Brink, *Measuring Political Risk: Risks to Foreign Investments*, Ashgate Publishing Limited, England, 2004,pp. 2

[6] Ibid. p. 19-20

[7] Ibid. p. 3

[8] H. L. Lax, *Political Risk in the International Oil and Gas Industry*, International Human Resources Development Corporation, Boston, 1983, p. 12

until they come as threat to the investor. The high rate of occurrence of such events might lead one to think that the political risk analysis would be an extremely sophisticated area however it is not. The difficulty that the investors are facing is that the area does not consist of facts it is rather based on political events and cases. Investors face emerging political risks in the changing world. Political risks are interrelated to many circumstances such as socio economic aspects. Since these circumstances also depend on many factors and change rapidly, emergence of sudden risks is inevitable.[9]

A well structured political risk assessment would improve the relationship between the host government and the investor by helping the investor to understand the actions of the government.

Elements of Political Risks

The existence of contracts between investor's home state and the host government is of essential significance. The basic aspects of political risks consist of fiscal regime, political policies and historical origins. It is important to consider the historical aspects of the country regarding the political actions. It might be beneficial for the project company to observe the political attitude of the government towards the similar industrial areas that the project company is operating. In addition to this, investors should also consider the structure of the legal system of country. A weak and an undeveloped legal system might endanger the project as the legislation is likely to change.[10] Many states have laws that concern the prohibition of political action and grant the right to compensate the damages to the investor in specific cases. However, the existence of these laws shouldn't be seen as an ultimate protection since the interpretation and application of these laws are significant as much as the content of it. At the end these are local commitment methods by the government not on the international level. Therefore the assistance of local analysts, political risks experts and local lawyers carry utter importance in the viability of a project.[11] In particular, the use of political risks services has increased overall in the years. Political risks services report the investor the latest conditions in the country that the investment is made. Effective mitigation of political risks is a result of integrating the information given by the political risks services and the consultation to the local staff.

Identification of Political Risks

The distinction of political risks from other risks is a rather complicated issue. The consequences of an identification of the type of a risk determine the compensation methods available for that particular risk. Generally it is tricky to clarify whether a risk is commercial or political. Such a case would be a government owned entity breaching its obligations under the output contract as an output purchaser of a privately held project. It would be difficult to identify whether there were political incentives for the government's entity's breach of its obligations. The importance of this distinction can be seen through on the ways that each risk is compensated. If the government entity had failed to comply with its obligations due to a politically motivated action political risk insurance programmes would compensate the losses occurred. However if the entity breached its obligations under the contract due to the lack of sufficient amount of funds, the risk would not be covered by insurance programmes since it is of commercial character.

[9] Brink, op. cit., p.9

[10] P. Comeaux, S. Kinsella, *Protecting Foreign Investment Under International Law: Legal Aspects of Political Risk*, Oceana Publications, New York, 1997, p.19

[11] Ibid. p. 21

Yet not every situation can be this clear to sort out as sometimes the action could be of both commercial and political character. For instance, if the failure to perform under the contract arises due to the reduced output caused by the government policy changes, the risk could be a political one. However the same situation can be interpreted as the failure by the project company to take necessary precautions for an anticipated reduction in the revenues. If the latter interpretation is taken as a basis then the risk would be of a commercial character. As it is seen, a situation could be interpreted in both ways that can lead to different results which changes the methods of compensation. [12] The identification of the type of the risk also carries importance regarding the compensation methods in international law. A state could be deemed as immune to be subject under certain jurisdiction if the action is of a political nature. However if the action is a commercial one this might not be the case.[13]

Chapter 2

Project Financing as a Way of Political Risk Mitigation

Project financing can be used as a method to diminish the exposure to political risks. One of the features of project financing is that, it is structured in a way that every participant (including lenders, constructors and so on) is affected by the unilateral alterations made by the host government in the contract. These participants would react heavily to the actions taken by the government that impede the operation of the project. For instance, involvement of main international organisations such as World Bank as a lender would reduce the probability of occurrence of governmental actions, for, the government would not desire a future ban on the access to the loans granted by the World Bank.[14]

Project financing as a method of reducing the political risks was first introduced after the nationalisations that many developing countries conducted between years 1970-1973.[15] The project companies, investing in those countries had to find a solution to possible interventions by the host governments. In this manner, project financing has three key features for the solution of these problems; stake reduction, terms clarification and deterrence. Stake reduction is possible through project financing by non-recourse funding which means the funding of the investment is based on the revenues of the project once it is completed. In this situation, evidently the project company's losses would be limited to a certain amount if expropriation or confiscation occurs.[16] Since the project company did not fund the project by its own assets. The project company would be in a stronger bargaining place during the negotiations of the concession contract. Since the project company invested with a less amount than before, it has now less to lose.

Deterrence, differs from stake reduction; it deters the government from taking certain actions by involving, economically and politically strong international organisations, whereas stake reduction is merely about limiting the loss of the investor. The host government is deterred from altering the terms of the contract due to the fear of losing future loans and investments that might be granted from those international organisations.

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[12] Hoffman, op. cit.p. 57
[13] See the discussion under Waiver of sovereign immunity at p.
[14] S. V. Arbogast, 'Project Financing & Political Risk Mitigation: The Singular Case of the Chad-Cameroon Pipeline', *Texas Journal of Oil, Gas, and Energy Law,* vol. 4, no. 2, 2009, p. 270
[15] D., Yergin, *The Prize: The Epic Quest for Oil, Money & Power,* Free Press, 1993, p. 646
[16] Arbogast, op. cit., p. 273

Lenders, on the other hand do not enjoy this “limited loss” status of the sponsors. They are more concerned about the issues regarding the repayment of debt and accrued interest. The interest rate is fixed since the loan is granted for the long term. For that reason, shortfalls on payment or delayed payments can ruin the financial plans of a lender. Therefore lenders mainly insist upon the clarification of the terms in the contract for the occurrence of possible unforeseeable events, regarding the level of approval of the host government to the project. These financial concerns that lenders have, are also the same political risk situations that the project company is also concerned about. Thus the terms clarification by the lenders also turns out to be useful for the investor, for, the lender ensures that the fundamental terms concerning the project are clarified.[17]

Esso Production Malaysia Inc. founded by Exxon, aimed to invest in Malaysia in 1978 applied these risk mitigation methods except terms clarification. In this project, three large scaled investment banks were involved as lenders: J.P. Morgan, Citibank and Chase; in addition with the involvement of the three largest banks of Malaysia. This created a powerful structure that the Malaysian government would not dare to ruin. Even, upon an occurrence of a worst case scenario, this structure of banks would engage in diplomatic negotiations which would enforce the government to restore the situation back to normal.[18] However this perfect plan of Exxon did not go well. The Iranian Revolution caused the oil prices to go high, thus causing the Malaysian government to reconsider the deal which now became too favourable for Exxon. The government demanded an alteration on the terms of the deal, despite presence of discouraging factors that would normally prevent such a demand. The threat posed by the government alarmed the syndication of lenders that led to negotiations with the host government officials. As it turned out, the lenders were more focused in ensuring the repayment of their loans rather than the provisions that concern Exxon. As a result, while the lenders ensured that their deals were not affected at the end, Exxon faced a higher tax treatment than before, imposed by the Malaysian government.[19] This incident shows a failure to deter unilateral changes by the host government of the provisions in the contract to the detriment of Exxon. This case decreased the number of project financings for a specific period of time. However after 1990s this method of financing reappeared.

Similarly in Chad-Cameroon Oil Pipeline case, involvement of the World Bank contributed to the stability of the terms of the contract. Even though, Chad altered its legislation and reallocated the reserves of oil production, this crisis was solved at the end via intensive negotiations between the government and the World Bank and at some point with the involvement of Kofi Annan (General Secretary of UN at that time) as being the mediator in the issue.[20] The main point is that for a long period of time, the terms of the deal were preserved. However, after some time, unilateral action of Chad government indicates that the participation of the World Bank didn’t deter the Chad government from altering the contract. More innovative approaches can be taken after this case, by other foreign investors. A strategic approach that can be taken by an investor is to put the participating lenders in a position that would expose them to the losses in cases of intervention, in the first place. This would ensure that the project company, in case of a unilateral change or intervention by the host government, would benefit from the diplomatic negotiations and restoration of the terms that are instigated by the intense efforts of the lender in order to avoid its losses.[21]

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[17] Ibid., p. 274
[18] Ibid.
[19] Ibid., p.275
[20] Ibid., p.288
[21] Ibid. p. 292

Political Turmoil and Succession

A change of power in the host government might endanger the completion of the project. The new government might retrieve the rights that the previous government had granted via concessions. The mitigation of this risk should be the subject of strategic planning by the project company rather than arranging it by the contract, management of this risk through contract is not an effective solution since the new government might always wipe out the previous government's arrangements. It is often suggested that the investor should also obtain other political actors' support alongside with the support of the current government.[22]

For foreign investors, one of the main fears is the rearrangement of a project with the government which already consists of a complex structure of contracts that is of catenulate character. The likelihood of alterations in the context of main agreements is an unfavourable situation due to the fact that projects need stability and certainty in future actions. A reference should be given to the case of Enron and Indian government regarding this matter. In 1995, a U.S. company Enron had faced this difficulty with the new Indian government who claimed Enron was exploiting the State of India by excessively profiting from the Power Purchase Agreement. Enron and the previous government had negotiated a power purchase agreement which distributed a 16 percent of the profits of the investment to Enron. The new government demanded a renegotiation on the basis that the power purchase agreement was an unfair arrangement for India. This decision is however mostly politically motivated. Upon the repudiation of the power purchase agreement by the Indian government, Enron initiated the arbitration process, the arbitral tribunal made its decision on the issue to be resolved by a renegotiation of the contract between Enron and the government. After the renegotiations Enron had to reduce the price in power purchase agreement. Unilateral repudiation of the power purchase agreement by India would be an infringement under general principles of international law; however the allegations claimed by Indian government, if proved to be true, would have justified the non performance of the government. Enron, by accepting the price adjustment, avoided a lengthy course of action to resolve this dispute and also it implied that Enron was receiving an excessive amount of profit from the power purchase agreement. This case demonstrates the situation a large company like Enron had to face due to poor planning of the energy policies by the government. The main problem of the Enron crisis arouse out of a lack of a bidding programme before the initiation of the project. After the problem materialised Enron submitted a bid giving sufficient assurance to the government that the new offer was fair and that they would not get any better deal even if a competitive bid were held. Some scholars anticipated that Enron's response would create instabilities in other project contracts suggesting that foreign investors exploit developing countries' economies.[23] However Hoffman[24] claims Enron's reassessment of the risks regarding the project by adjusting the prices and its response to government's inability to arrange fair and transparent bids was an intelligent action.

This case revealed the weak points of a project in that the contract provisions should clearly have indicated the conditions of cancellation the project and the obligations of the purchaser including the duty to buy the output. In addition, the inclusion of the stabilisation clauses that prohibit the unilateral repudiation of the agreement by the government, providing some equity return on the project to the government and making it certain that the project is granted

[22] R. Tinsley, *Advanced Project Financing: Structuring Risk*, Euromoney Books, London, 2000, p. 214
[23] D. Mazzini, 'Stable International Contracts In Emerging Markets an Endangered Species', *Boston University International Law Journal*, vol .15,1997, p. 360
[24] Hoffman, op. cit., p. 220

by a transparent and fair process to the project company is a key issue that an investor has to ensure in the beginning of the project.[25]

Methods of Managing the Political Risks

The various methods of managing political risks can be classified as;

Diversification of political risk is possible by the including a variety of investors and international development banks. This ensures that, including the return on the shares, exposure to political risks is distributed among the project participants.

Insurance against political risks covers the risks including change of rules in monetary policies and exchange controls.

Protection from the risk: This method is a mostly strategic method that prevents political risks by political, economic and legal interaction between governments, i.e. bilateral treaties between governments.[26]

Management of political risks by manoeuvres of investor i.e. regarding the degree of the relationship between the investors and politically significant actors, besides ensuring the deal is fair for both parties. An unfair deal might cause later problems for the investor such as unilateral changes by the host government.

Provisional management of political risks, that includes stabilisation clauses and alternative dispute resolution methods in which the investor would benefit with the judgement of neutral forum.[27]

Chapter 3

Concession Agreements

The relevant licences, permits and other rights regarding the use of land in the construction and the operation of a project are usually granted through concession agreements which are concluded between host governments and project companies.[28] Concession agreements address the rights of the investor on import and export with governmental restrictions, the amount of capital the project company is allowed to use, terms for the cancellation of the permits, terms regarding the renewal of the concession. Concession agreements are said to comprise a dual character by having a governmental character and being a contractual document. A concession agreement is a detailed overview of the project with the requirements that project company has to fulfil alongside with government's promises on providing certain consents including the dispute resolution methods.[29]

As mentioned above, loans from international organizations provide a certain level of security for the project. The host government in this case would reconsider the decision of nationalisation or expropriation. Breaching the agreement with an international organization

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[25] Ibid., p. 221
[26] T. W., Waelde, G. Ndi, 'Stabilizing International Investment Commitments: International Law Versus Contract Interpretation', *Texas International Law Journal*, vol. 31, 1996, p. 233
[27] Ibid. p. 234
[28] J., L., Guasch 'Granting and Renegotiating Infrastructures Concessions-Getting it Right', *World Bank Studies* 2004, p. 27
[29] Hoffman, op. cit., p. 145

might cause a loss of financial source for the government, which would be highly undesirable.[30]

In addition loans that are given by banks in major countries such as the USA and Japan, would influence the host government's decision on expropriation of the project. Especially if the host government is a developing country, it would not risk its political and financial relations with major powers of the world.

If the project is financed by a joint venture of international banks, the cross default clauses stipulates that a default of one of the loans would trigger a chain of defaults on loans from the other banks. This chain reaction would mean a deterioration of political and financial relationships between the host government and the countries in which the banks are located. Again the government would avoid conducting an expropriation or nationalisation.

Nationals of the government who invest in the project or lend to the project reduce the risk of expropriation. It is a well known fact that governments are under the pressure from national investors in these cases.[31] Moreover international development banks' investment can create a balance between the local investors and the project company. The agreement is arranged in such a way that the development bank has majority of voting rights on strategic decisions.

A syndicated loan together with a loan from World Bank or other international institutional banks will create an association in the same project. Cross default clauses in these instances ensure that the syndicated loan is treated in the same way as the loan from World Bank is treated. These clauses indicate that a default on a syndicated loan would result in a default on the loan from World Bank. Sometimes a loan from area development banks can be partially transferred to commercial banks as a syndicated loan. Similarly the partially sold loan is still treated as if it is a loan from area development bank. Again in this case commercial banks and area development banks are not differentiated.

Types of Political Risks

1) Expropriation

Expropriation is a means of action taken by the host country in a project which results an arbitrary change of the ownership of the project. Although it is considered as an act of government it can consist of a series of actions. At that point, it turns into creeping expropriation; the collection of events by which government seizes the assets of the projects slowly. Creeping expropriation is one of the most undesirable situations in a project. Creeping expropriation may occur as a result of changes in tax and changes in the policy of the country. In the USA and Europe, policies have led the project companies to sell the securities at undervalued amounts thus resulting in creeping expropriation. Setting a high amount of tax on the revenues of a project is a way of raising finance for the government on its pursuance of other popular social acts for the country. The UK, as an example, increased the tax on revenues of the oil production in North Sea.

In international law it is widely accepted that countries can nationalise anything if they abide by the basic rules. Mostly compensation is paid by the host government otherwise it would be a breach of basic concepts of international law. However, the concept of compensation differs in each jurisdiction and gradually adapts to today's world.[32] Likelihood of an expropriation in

[30] P. K. Nevitt, F. J. Fabozzi, *Project Financing*, Euromoney Books, London, 2000, p.317
[31] Ibid., p. 319
[32] Hoffman, op. cit., p. 48

a country can be assessed with regards to many factors: historical complexion, geographical and political place of the country. Project companies deal with these risks in a variety of ways including concession agreements. There might be a chain of agreements involving central bank and government authorities which are in charge of development.[33] Yet these agreements are not considered as binding in their nature; they are more akin to letters of intent. Expropriation risk can also be reduced when many investors from different countries are affiliated with the project. It is usually reasonable for an investor to create a consortium of other foreign investors when investing in a developing country. In particular, obtaining loans from variety of banks in different countries and tying these loans with a loan from one of the international organizations such as World Bank would lessen the expropriation risk on a large scale.[34] The host country would be unwilling to ruin its reputation globally.[35]

2) Currency Related Risks

Due to the complex and chainlike nature of the contracts in project finance, risks concerning currency are likely to occur.[36] To begin with, the different currencies between the contracts should be addressed. Revenues of the project are usually in host country's currency whereas payment of the debt and other contractual undertakings may be met in another currency. This risk can be categorized in three main titles, a lack of sufficient foreign currency, problems associated with the transfer of the exchange to another country and a decline in the value of the money of the host country.

3) Non-Convertibility of Currency

This category of currency risk, reflects the lack of sufficient foreign exchange in the host country which would impede the process of payment of the debt and other contractual undertakings in the foreign currency. To identify this risk properly, the project company should conduct a detailed investigation about the country's current position regarding the status of the foreign currency. In this manner the host country's policy concerning allocation of the foreign currency within the country should be examined. As a result of this investigation, it may be determined whether the project company would get sufficient foreign currency. Major payments of the government in a developing country in a foreign currency include: the obligation to pay its loans taken from international development banks; interest accruing on international debts; and expenses for imports that are fundamental for the government. After these payments are made a project company will compete with other companies to get the rest of the currency. The problem regarding the availability of foreign currency is mostly associated with enormous amount of debt that the host country is obligated to pay to financial institutions. Various ways to deal with the risk of currency exist. The contracts which concern revenue payments can be subject to hard currency.[37] In addition, if the government is the party obliged to make the payments under the contract, that would be sufficient assurance for the project company.

[33] Nevitt, op. cit., p. 21

[34] Ibid. 22

[35] However involvement of World Bank does not necessarily the government from introducing legislation that would affect the investment as it happened in Chad Pipeline.

[36] Nevitt, op. cit., p. 40

[37] According to Oxford Dictionary of Economics "hard currency" is *A currency which is convertible into other currencies, and whose price in terms of other currencies is expected to remain stable or rise. This is contrasted with a soft currency, which is not convertible into other currencies, or whose price in terms of other currencies is expected to fall. Hard currencies are attractive to hold as private stores of wealth or national foreign exchange reserves.*

Another way to mitigate the inconvertibility risk is to “countertrade” which is a longer method to convert the local currency into foreign currency. This mechanism works by involving another local entity whose products can be traded off with foreign currency. The project company exchanges its revenues with the local company’s products that generate foreign currency. Although it seems as a useful solution for inconvertibility, the mechanism involves complications to operate smoothly, in some cases. A currency that fluctuates frequently would hinder the operation of this mechanism causing one side to lose money.

The project company could get into an agreement with the host government in which the host government guarantees sufficient amount of foreign currency to the project company. This agreement can be a part of a series of agreements included in the sovereign guarantee.

Currency swap is another way to secure that there is adequate amount of foreign currency for the use of project. Nevertheless it is considered to be a highly costly method and cumbersome in some states.

An inclusion of a provision against the risk of inconvertibility of currency might provide adequate protection for the investor. This provision will assure the investor that it will have the necessary rights to convert its profits and revenues into hard currency.[38]

4) Currency Transfer Problems

This type of risk occurs in situations where the project company is unable to transfer the currency to another country. Exchange control policies are the main causes of this risk. The host government in its own interests controls the traffic of the currencies between the host government and the other states. A typical example of this risk is where a central bank refuses to transfer the foreign currency to another country although it exchanged it into the foreign currency. Mostly, developing countries grant limited access to foreign currency, in these cases the host government offers conversion to another currency or the project company will have to accept a deficit. [39] Mitigation methods for this risk are the same as in currency inconvertibility risk.

Every state has different exchange control rules; however some basic common features of exchange control rules, can be identified. Those common rules can be classified as: controlling the exchange rate; restrictions on borrowing in foreign currency; borrowing as non-residents; borrowing from abroad- all are examples of exchange control rules in countries. In these situations apparently the project company should negotiate with the host government and obtain specific permissions. As an exchange control method it may be mandatory for project companies to convert the foreign currency into local currency. This cumbersome process is mostly done by the central bank of the host government. Host governments sometimes apply different exchange rates, in this the case project company may choose one of them. Some governments prohibit maintaining a foreign bank account or maintaining a local account in foreign currency. However diplomats, multinational organizations and accounts pending for permission or conversion are excluded from these prohibitions.

Project contracts that violate exchange control rules are treated as unenforceable in host countries. Local courts would not regard such contracts as valid. However this might differ in the international arena. Countries that are parties to International Monetary Fund agreements

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[38] Comeaux, *Protecting Foreign Investment Under International Law: Legal Aspects of Political Risk*, p. 147

[39] Hoffman, op. cit., p. 42

indicate any contract that concerns the currency of a member state (member of IMF agreement), which is in conflict with the exchange control rules of that country, is deemed as unenforceable in any other member state. Although the article is clear, court decisions show inconsistency regarding this matter.[40]

The project company should ensure that it has the right to exchange local currency into foreign currency according to local regulations. Usually countries require registration to central bank for contracts concerning international loans. The rights related to the exchange of local currency are granted after the registration of the loan.

Dilution of negative effects of exchange control is possible by several means. In earlier stages of the project, the approvals regarding exchange control can be inserted as conditions precedent to the contract. It is crucial to include as many exchange control demands as the project company can in the agreement.

5) Devaluation Risk as a Non Political Risk

Apart from conversion or transfer risk of currency one of the other problematic issues is devaluation of the currency. This type of risk arises in cases where the project company receives the revenue in a currency other than the currency in which the other contract payments would be made. Projects located in developing countries are usually faced with devaluation risk where sponsor borrows in foreign currency and is required to exchange the revenue in local currency into foreign currency in order to make the payments. Since there is usually a long period of time before the project starts to produce cash flows, there might be fluctuations in the market especially when the project is in a developing country. The project company at this point will have difficulty with the conversion rate, it will not have the sufficient cash flow in the local currency to convert it into the required amount in foreign currency. Devaluation can alter the whole planning of the project creating a massive difference between the value of the revenues and cost of input. Depreciation in the value of local currency would carry significance in contracts that concern constructors or lenders. Political risk insurances do not cover this risk, the options for protection against this risk are limited. Foreseeing this possibility and arranging input prices in contracts in accordance with it would reduce the negative effects of currency fluctuations.[41] In addition the revenues can be received in hard currency which would protect the project against the depreciation in the value of the money. Borrowing from local lenders is another form of mitigation of this risk. However there might be limited an amount of capital that is available in the host country. Adjustment options of the input price, after the incidence of depreciation in the value of the local currency, should be negotiated in the contract with the foreign supplier.[42]

6) Offshore Accounts

The project company might demand that the host government make the payments to an offshore account in another currency. In this way the project company by choosing another state to keep its assets, lessens the exposure to the risk of nationalisation of the project by the host government.[43]

7) Approvals, Concessions and Licence Risks

[40] Ibid. p. 43
[41] L., Wynant, 'Essential Elements of Project Financing', *Harvard Business Review,* 1980, May-June, p. 168
[42] Hoffman, op. cit., p. 44
[43] Comeaux, *Protecting Foreign Investment Under International Law: Legal Aspects of Political Risk*, p. 147

Achievement of construction and operation of a project depends on the obtainment of the relevant approvals and permits from the host government. Especially in projects where an exploitation of a natural resource takes place, obtaining specific approvals carries importance. Failure to obtain a significant approval might result in a delay on the operation of the project which might cause additional costs and interests on the late payment of the debts. This might cause default in some important contracts of the project such as off-take purchase agreements and loan agreements. It triggers a chain of events. Host governments can withdraw their supports for many reasons; delaying the grant of certain permits or rejecting specific permits may indicate the host government is withholding its support. Project companies, to avoid this risk, engage in implementation agreements with host governments. Implementation agreements ensure that projects will be granted with certain rights and the project company will claim for compensation where government delays in granting those approvals. Sometimes the implementation agreements may contain underlie a list of already granted permits.[44] The implementation agreements also foresee that the risk of cancellation of permits might arise after the permit is given. Although the host government grants the permit, it might act in a discriminatory manner or expropriate the project indirectly. This is not the case where the project company is controlling the situation.

The debate about the implementation agreements is whether the host government agencies are authorized to grant specific exemption. For that reason, to determine the validity of the permits, the law of the host country should be investigated.

The rights to build and operate a project are sometimes arranged by concession agreements or licences. Build-own-transfer projects mainly use concession agreements with the host government. The characteristic of a BOT project is that the project company builds, owns and operates the facility for a specific period; at the end of this period the project company transfers the rights regarding use and ownership of the project to the host government.[45] In a concession agreement besides granting the rights for building and operating the facility, the details of such a structure are arranged. Moreover the host government may guarantee certain things to the extent that it supports the project. Such an example would be an assurance by the host government for the purchase of the products. However concession agreements do not just involve rights granted to the project company, but also involves the host government retaining control to some degree over the project. Maintaining the facility at a certain performance level will ensure the value of the project will not decline until the time it is transferred to the host government. The host government's right to rescind the concession upon the occurrence of certain situations including lapses in the construction schedule, which assures completion at a certain date, are indicated in the concession to protect the host government's interests. On the other hand host government may issue licences or concessions involving granting labour visas, rights regarding the land and guarantees of the availability of sufficient raw material upon the request of project lenders or sponsors.[46] The validity of concession agreement might depend on the achievement of financial targets. Failure to achieve those financial targets might annul the concession. Due to some circumstances those financial targets might not be achieved on the anticipated date, the occurrence of these events might be related to the type of financing method of the project. Host government realising this situation in the concession agreement might ease the situation. The concession agreement might lay out the possible scenarios whereby lender takes over the project upon the default by

[44] Hoffman, op. cit., p. 47
[45] M., Frilet, 'Some Universal Issues in BOT Projects for Public Infrastructures', *International Construction Law Review,* 1997, p. 499
[46] Hoffman, op. cit., p. 48

the project company. These terms usually lay out the permits and rights granted to lenders by the host government.

The inclusion of all the terms above would make a perfect and risk free concession agreement; however getting all of these terms is not easy. Governments granting the consents may have concerns regarding the possible infringements on the Constitution caused by the concessions. As it seems, the project company and lenders should bear a degree of risk which still can be mitigated through arrangements with the government to a certain point.

8) Change of Law Risk

One of the political risks that a project might face is the amendments in the legal or administrative rules. The outcome might affect the profitability of the project and may cause difficulties in the payment of the debt. These changes might occur in the form of tax obligations or import and export limitations. The important issue is that a government has the right to change its law or other regulatory rules. This is not an illegal risk, nor an infringement of international law; therefore political risk insurance does not cover this risk. However agreements with the host government might ensure that there will not be any significant changes in law that would affect the project. In these cases the insurers would insure the risk of termination of the contract with the host government. It will insure against the risk that the host government might infringe the agreement.

i) Import Risk

Import restrictions might interfere with the progress of the project in a significant way. The construction of a project might require raw materials which are to be imported. The host country might not have sufficient amount of raw materials nor the specific raw material to be used in the construction. The construction costs might increase dramatically as a result of restrictions on import tariffs. Thus the project company should ensure that it has necessary approvals from the host government that concern import and export. In addition a contract with the host government might protect against government actions in the future.[47]

ii) Export Risk

Export restrictions, similar to import restrictions, affect the sale of the project products abroad. Failure to export the output of the project might halt the preventative actions taken by the project company to reduce foreseeable losses occurring due to political or economical conditions of the country. Likewise a contract with the host government might reduce the future uncertainty regarding this risk.

iii) Changes in Production or Consumption Controls

Governments due to their public or economical policies sometimes restrict the use of natural resources to a limited amount.

iv) Taxes

Governments can impose taxes on projects either to terminate the project or to rearrange the terms about the project. In addition the host government would be interested in developing its financial conditions with the help of the taxes imposed on the project or the industry of the project. Tax obligations might severely change the situation of the financing of the project.

[47] Ibid., p. 49

Rather than the imposition of new taxes a project might receive tax exclusions or reductions from the host government. However the project company also faces the risk of termination of favourable tax deals.

There are no current insurance programmes for the potential tax risks in the host government.[48]

Chapter 4

Minimising political risks through Investor-State Contracts

Structuring Contracts to Minimise Political Risks

The developers of the project would structure the project in a way that would minimize the political risk. Consultation of local lawyers is important in structuring the investment. One of the general rules that an investor should bear in mind is to reduce the amount of the assets hold in the host state.

Developing countries with considerable amount of oil resources form state companies to search for and generate oil. Sometimes these state companies associate with other foreign investors either under direct or indirect agreements. In these structures four types of contracts are differentiated depending upon the amount of control that is granted to the project company. In concession agreements host governments grant set of rights to the project company such as right to seek, generate and sell oil in the specified period.[49] In a “production sharing agreement” the state company allows the project company to search and produce oil in exchange for a certain portion of the output. The host government and the project company form a joint venture for the project in the form a participation agreement. Participation agreements combine the powerful attributes of each party as the state offers the land and the project company offers its experience and technology. Service contracts grant the right to produce oil in exchange for a price. The project company in this type of contract searches for the oil in its own expense; the payment is made only if it produces.[50]

Investor State Contracts

i) Implementation Agreements

An implementation agreement addresses the political, economic aspects of a project that is concluded between the host government and the project company. Implementation agreements carry significance for they -include the necessary assurances and guarantees given by the host government for the operation, construction and financial viability of the

[48] *Financial Times*, May 17, 1996, p. 3
[49] Comeaux, *Protecting Foreign Investment Under International Law: Legal Aspects of Political Risk,* p. 127
[50] E. Smith, J. Dzienkowski, ‘A Fifty-Year Perspective on World Petroleum Arrangements’, *Texas Journal of International Law*,vol. 24, 1989, p. 13

project. These agreements are acknowledged for their efforts to mitigate the political risks and provide support in an unstable political environment.[51]

The contracts between the state and the project company might not always bear desirable results for each side. For that reason during the negotiation period the host government might be unwilling to include certain clauses. The reason behind this is that the host government may find it more advantageous to leave some issues open to discussions rather than being obligated under clear cut clauses in the contract. However negotiations between the host government and the project company might bear fruit. The negotiation period can reflect the potential problems that both of the parties can face in the future. The project company may even carry the issue in international arbitration which might impose the host government to do certain action or pay compensation.

Numerous clauses might be included in the contract to reduce the exposure to political risk; however three provisions are considered to carry significance in every contract between the host government and the project company. Each will be discussed below.

1) Sovereign Guarantees

The risks concerning an investment in a country, often within the control of the host government, need to be reduced by relevant support from the government such as a sovereign guarantee. A sovereign guarantee is an assurance to the investor by the host government to compensate it upon the occurrence of events specified in the contract.[52] Sovereign guarantees often assure the obligations of the product purchaser, alongside with political risks, promises on the stability of the legislation regarding the industry of the project, a manifestation by the government reflecting its support on the project. However an investor should not rely on the enforcement of the guarantees too much. Without the involvement of major international development banks the enforcement of sovereign guarantees might be intricate. Moreover apart from the political reasons, a government might be unable to pay under a sovereign guarantee instantly due to the scarcity of available funds. The inability to disburse the funds under the sovereign guarantee might also be because of legal restrictions. For instance the government might be required to introduce a code in order to make such payment, which would take considerable time thus incurring additional costs for the project company; at this point the sovereign guarantee would be against its very purpose to avoid such costs.

An important feature of the government guarantees can be inferred from a reasoning such as the host government providing a sovereign guarantees to assure the investor that the investment is going to be protected from certain risks. This kind of a promise may prevent the government from taking financial measures such as devaluation to cure specific economical problems.[53] Taking this point of view, a prevention of a possible devaluation is a benefit to the project company that no political risk insurance covers since it is not considered as a political risk.

2) Arbitration Clause

The project company should seek to include the arbitration clause in the contract in order to settle the disputes with the host government through an impartial and independent council of

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[51] Hoffman, op. cit., p. 147

[52] J. Inman, 'Government Guarantees for Infrastructure Projects',*Project Finance. Int'L*, vol.36, 1995, p. 68

[53] Hoffman, op. cit, .p. 153, C. M. Lewis, A., Mody, 'Contingent Liabilities for Infrastructure Projects- Implementing a Risk Management Framework for Governments', Public Policy for the Private Sector World Bank Note, August 1998

experts.[54] Even though the sponsor fails to arrange the inclusion of arbitration clause, a bilateral treaty between the state of sponsor and the host state might allow the parties to take the issue to international arbitration. However in this case the sponsor would not have the option to choose the governing law and other details regarding the procedure to be followed.

3) Choice of Law

Failure to include the choice of law clause might cause the issue to be resolved by the law of host government. The sponsor should be persistent upon the choice of another law which would be more convenient. The project sponsor should aim to exclude the application of the host state's law in the contract. In general the presumption is that the laws of the host state would favour the state against the investor. Moreover the government can always change the law governing the project which might worsen the conditions for the sponsor. Thus the project company should demand assurances from the host government to protect itself from the change of law. The project company, to protect itself fully, can propose the application of the- law of another state which is well developed and impartial. However it is difficult for a government to comply with another country's legal rules which would raise queries about the host government's sovereignty. A government is disinclined to be bound by the laws of another government. The solution to this problem lies in the provisions of the contract regarding the governing rules between the parties. The issues that are not arranged with the contract would be governed by either the law of the host government or relevant rules of international law. [55] Choosing international law as the governing law of the contract might seem a reasonable solution; however the boundaries of international law and the applicability of it are not feasible. Some authors have emphasised the difficulty of determining the rules regarding contract law in international law and that there is not a precise set of rules.[56] Some project[57] contracts include international law to be applied harmoniously with the chosen law. The question then arises: if there is no distinct international law on contract law, how should this provision be applied? It could be inferred that such a phrase could give the contract an international aspect which would refrain the host government from infringing it.

4) Stabilisation Clauses

"...Effective political risk analysis is not just a question of evaluating country risk. Instead, risk assessments must identify the implications of economic, political, and social conditions for each project.... The key to analyzing political risks facing a project is to identify the winners and losers, and assess their relative abilities to help or hinder a project, whether directly or by influencing a host government."[58]

Stabilisation clauses mainly concern political risks. These kinds of guarantees are particular tools that subject the investor-government relationship to certain rules by excluding applicable law.

[54] Comeaux, *Protecting Foreign Investment Under International Law: Legal Aspects of Political Risk,* p. 134
[55] Ibid., p. 136
[56] D. W.,Bowett, 'State Contracts with Aliens*:* Contemporary Developments on Compensation for Termination or. Breach', *British Year Book of International Law*, 1988, p.49
[57] *Kaiser Bauxite v. The Government of Jamaica* 1 ICSID Repts. 296, 303 1999, TOPCO*,* Preliminary Award, 53 I.L.R. 389,1979, p. 404
[58] S., Markwick, 'Trends in Political Risk for Corporate Investors' in *Managing International Political Risk,*T, Moran (ed), John Wiley & Sons Incorporated, p. 55

Investors investing in developed countries are less likely to negotiate stabilisation clauses because the likelihood of exposure to political risks is considered to be slight. Yet a reasonable investor would always consider the need to identify and allocate the political risks. Developing countries are mainly believed to be in an unfavourable position regarding the bargaining power during the negotiation of the stabilisation clauses with the investors. Developing countries might make commitments under particular stabilisation clauses which many developed countries would not accept under normal circumstances. The need for foreign investment can lead a developing country to compromise on its sovereign elements. The investor desires to replace the applicable law of the country with dispute resolution and stabilisation provisions for it lacks confidence to the legal system of the host state.[59] This issue can be addressed in Nigeria's case where Shell's successful investment in Nigeria is mainly result of favourable terms for Shell in the concession contract. Nigeria government was in a relatively weak bargaining position due to its desire to attract foreign investment to the country.[60] Host countries' dependence varies on the project company's size. A host country would be more responsive to the needs of a large project company rather than it would that of a smaller company. Still, managers of the project company may increase the dependence of the host government on the project company in several ways. The use of sophisticated technological methods in operation of a project lessens the risk of actions of a government that would be to the detriment of the project. For instance, an oil company operating in Russia had used complex structure in drilling oil which needed qualified engineers for the use of that particular technology. The Russian Government was less inclined to use any of its sovereign powers to obtain the control of the project as it would be incapable of operating the facility in the absence of the skilled personnel.[61]

i) The Purpose of the Stabilisation Clause

The function of the stabilisation clauses is interpreted differently by many scholars. Some say that under international law any action by the host government to the detriment of the foreign investor is illegal giving the investor the right to pursue remedies. They argue that the inclusion of the stabilisation clauses is unnecessary for that reason.[62] However other scholars conclude- that even if the existence of stabilisation clause would not stop the government from impeding the contract, it would ensure the payment of compensation to the investor.

The stabilisation clause precludes the host government from modifying the laws which might cause obstructions to project's progress. This provision aims for the project company to be subject to same set of legal rules in at the date the contract is validated. The stabilisation clause asserts that sponsor's approval is needed in case of a change in the law which affects the assets and the rights of the sponsor. The host government is constrained from eliminating the project company in such an arbitrary way.[63]

The issue here is whether the state can obligate itself in such a way. Several authors[64] argue that a state undertaking the obligation to not to change its laws disregards its sovereign

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[59] Waelde, op. cit., p. 223

[60] J., G., Frynas, 'Political Instability and Business Focus on Shell in Nigeria', *Third World Quarterly*, vol. 19, Sep., 1998, p. 460

[61] W., J. Henisz, B. A., Zelner, 'Political Risk Management: A Strategic Perspective' in *International Political Risk Management: The Brave New World*, T. H. Moran (ed), The World Bank Multilateral Investment Guarantee Agency, p. 157

[62] R. Higgins, 'Legal Preconditions of Foreign Investment', *Energy Law,* vol. 1, 1986, p. 243

[63] Comeaux, *Protecting Foreign Investment Under International Law: Legal Aspects of Political Risk, p.* 139

[64] I., Brownlie, *Principles of Public International Law*, Oxford University Press, USA, 1990, p. 551

power. Generally it is thought that a state can commit to not to act in certain ways or to act in a certain way. The presumption is that a state can undertake such obligations and responsibilities thorough using its sovereignty. In the *Topco*[65] case the tribunal, contrary to the views of some authors, expressed that a state entering into concession contracts in fact acted as a sovereign state by undertaking such obligations under the concession contract. It used its sovereign power to decide to be committed under such an agreement. However this is not the case when it comes to the compensation methods in case of a breach of a stabilisation clause. Arbitrators, on deciding the compensation issues, act more sensitive to not to cause any disrespect to the host state by obliging it to do specific performance in the award. A stabilisation clause should be regarded as a compensation method, in case of an infringement of it, rather than a provision that would enforce the state to perform specific action.[66] Breach of such a clause would give the project company a claim for compensation thus an award in international arbitration would add an international aspect to the issue. As a result the state would be unwilling to take expropriatory actions on the project property or investor's assets.

ii) Illustration of a Stabilisation Clause

Two cases demonstrate the significance of including a stabilisation clause. In *Topco*[67] case the tribunal concluded that nationalisation conducted by Libya government constitutes a breach of the stabilisation clause which bans the state from amending laws that would infringe the rights of the investors. The award rendered was an unusual one in the manner that the tribunal decided the Government of Libya was violating an agreement that would have effects on international scale. Libya was enforced to restore the rights that it had removed illegally. It is remarkable that a tribunal had ordered a government to restore the situation to its previous state. This case shows the importance of an inclusion of a stabilisation clause in a concession agreement. The presence of the stabilisation provision has led the tribunal to consider the action of the government illegitimate.

Another case; *Liamco*[68] the concession agreement between the project company and the government, conditioned the government to get the consent of the project company to a change to any provisions of the concession. Libya breached the stabilisation provision and conducted a nationalisation of rights regarding the project. The tribunal concluded that this action of the government imposed a liability on itself to pay the damages which the project company suffered. Even though the company was not awarded the amount of the investment as compensation, the inclusion of the stabilisation provision influenced the tribunal to award the project company an equitable amount of compensation.

Contrary to the cases explained above, in *Aminoil*[69] the stabilisation clause in the concession agreement was not regarded as sufficiently clear and explicit to prohibit a possible nationalisation by government.[70] The tribunal reasoned in its decision on the facts that such a solemn commitment would be expressly stated. Despite a clause denoting that the validity of the actions regarding the rights in the concession agreement would depend on the consent of the project company, the arbitral tribunal considered this clause too uncertain to be applied. However the project company was paid equitable compensation. Unlike the cases explained

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[65] TOPCO, Preliminary Award, 53 I.L.R. 389, 404 (1979)
[66] Comeaux, *Protecting Foreign Investment Under International Law: Legal Aspects of Political Risk, p.* 140
[67] *Texas Overseas Petroleum Company and California Asiatic Oil Company (TOPCO) v. The Government of the Libyan Arab Republic,* 53. I.L.R. 289 (1979)
[68] *Libyan American Oil Company (LIAMCO) V. Government of the Libyan Arab Republic,* 1977, 62 I.L.R. 140
[69] *Government of Kuwait v. American Independent Oil Company,* 66 I.L.R. 518 (1982), 21 I.L.M. 976 (1986)
[70] Comeaux, *Protecting Foreign Investment Under International Law: Legal Aspects of Political Risk, p. 142*

above, this case shows that even an inclusion of such a clause does not ensure full protection against the risk of expropriation of the project.[71] Still, the existence of such a provision has influenced the decision of the tribunal on payment of compensation.

The *Aminoil* case suggests the important aspects of an effective stabilisation provision. The project company should ensure that the wording of the agreement makes it clear that the host government is not permitted to nationalise. Likewise, the provision should set out that the parties are bound by their statements unless the stabilisation provision is later modified explicitly by the parties, thus creating a non-binding statement. This provision provides the sufficient certainty for an arbitral tribunal on deciding whether the stabilisation clause is removed, weakened or invalidated by later negotiations between the host government and the project company. To prevent such problems the stabilization clause should stipulate that a later agreement between the parties is required to address the modification of the stabilization clause specifically. The stabilisation provision should be designed, if the parties decide to modify, in such a way that specific reference should be made by a separate agreement besides parties' written explicit consents.

Still the project company is not protected fully as the state might still breach the contract despite the clear wording of the stabilisation clause or the tribunal may be unwilling to accept that the host government infringed the concession contract as the arbitral tribunal in Aminoil which concluded that the wording of the stabilisation clause was not explicit enough to prohibit such actions of the host government even though the purpose and the intentions were clear.

5) Damages

There is no doubt that the existence of a stabilisation clause raises the possibility of getting compensation in cases of breaches of the concession agreement. Yet it might be beneficial for the project company to include a damages clause to guarantee the compensation of its loss. Such a clause would state that even though the host government is prohibited from nationalising or expropriating the project property, if it takes such actions it would be obliged to pay the damages.[72] Proper wording should be chosen when constituting such a clause. Concepts such as "equitable" or "full compensation" might lead to different understandings since the meanings of the words differ in each context and thus their meanings are open to discussion. The inclusion of this clause might cause a state to reconsider its decision on expropriating the project; it is not tempting for the host government to nationalise the project property if it is going to pay compensation in return. "Misconduct" in international law is also not a distinct and a clear concept. Thus the project- company should ensure that such actions taken by the host government (i.e. nationalisation) would be reckoned as misconduct under international law. This would strengthen the application of the damages clause as it would be recognised by the arbitral tribunal in an international perspective. The parties should draft the damages clause carefully not to breach the compulsory rules on the damages of the relevant arbitration rules. Payment of liquidated damages might infringe the mandatory rules. To avoid such problems the damages clause should form for the calculation of the damages on the different valuation ways of the nationalised project.

The arbitration rules sometimes might require a party to bring its claims in local judiciary before taking the dispute to arbitration. Evidently the investor would prefer not to seek its rights in another country's courts rather than a neutral tribunal. To protect itself against this

[71] Ibid, p. 143
[72] Ibid., 144

risk the project company should involve a waiver clause on which it waives its right to object the jurisdiction of the arbitral tribunal upon the skipping the exhaustion of local remedies.[73]

6) Force Majeure Clause

The occurrence of force majeure events justifies the party's non performance of its obligation under the contract. Excluding political actions from force majeure events assure the coverage of political risk insurance. Since force majeure events are uncontrollable, political actions might be deemed as force majeure events especially if the agreement is between the host government authority and the project company as the government authority claiming that the political action is beyond its control, thus excusing its non performance of its obligation under the agreement.[74]

In situations where there is no explicit clause eliminating the political action as a force majeure event, the political risk insurer might claim that the host government did not breach the contract since the action was justified by force majeure clause. The project company should involve a clause indicating that non performance of the state authority would not be justified by any political action thus denying that the political actions are interpreted as force majeure events.[75]

Mitigating of political risks can be undertaken but the risk would still exist even if at its lowest level. That reveals the importance of political risk insurance for the project company because political risk insurance assures that it is going to compensate the project company. However interpretation of a political action as a force majeure event increases the possibility of the insurer considering the situation as an uncontrollable event which didn't violate the contract. At this point the worst would happen to project company as it would not get the compensation it expected in these kinds of situation. Therefore an explicit statement that the political actions are not deemed as force majeure events carries utmost significance in this situation.

The Problems Associated with the Binding Nature of the Arrangements between the Host Government and the Project Company

The change of government creates risk to a certain degree, the risk is that the new government with political incentives might seek to reverse the actions that the previous government has done. This might include the revocation of the concessions granted to a project company. The investor should consider this risk and act strategically. For instance it should maintain its distant relations with the old government and avoid a close relationship. A close relationship with the old government might endanger the project for this would be considered as one of the shortcomings of the project by the new government. Diversified support from the many parts of the society and the governmental structure would reduce this risk.[76] The absurdity exists in this situation in the manner that if a project company avoids close relationship and favourable treatment by the old government that would cause impediments in obtaining relevant licenses and concessions. However if it maintains a close relationship it faces the risks of removal of its investment by the next government. Considering these, a project company should balance these factors in addition with the measurement of the risk of change of government through unlawful means.

[73] Comeaux, *Protecting Foreign Investment Under International Law: Legal Aspects of Political Risk, p.146*
[74] G., Delaume, 'Law And Practice of Transnational Contracts', *Foreign Investment Law Journal*, vol. 3, no. 2 *1988*,p. 50-57
[75] Comeaux, *Protecting Foreign Investment Under International Law: Legal Aspects of Political Risk, p.148*
[76] Hoffman, op. cit., p. 156

The presence of a contract between the host government and the project company also implies that to a certain degree political instability exists since the contract is arranged to reduce the relevant risks.

Chapter 5

Political Risk Insurance: A Way to Remedies

Perhaps the most common protection method of the investment in a project against political risks is political risk insurance. Political risk insurance is provided by several organisations; the major ones including OPIC and MIGA are supported by states. The political risk insurance commonly covers the political risks such as, expropriation, currency risks, political aggression.[77]

OPIC

OPIC (Overseas Private Investment Corporation) was created by the US government under the Foreign Assistance Act. OPIC is a government entity which offers insurance against political risks in addition to loans for the financing of the projects. The U.S. Government supported this organisation heavily which made it well known and a trusted insurance entity. OPIC offers insurance against political risks in many developing nations for U.S. investments.[78] To determine whether the investment is eligible to be covered by OPIC, compliance with the basic requirements of OPIC should be examined. The presence of one of the following conditions is sufficient for OPIC coverage: a mutual treaty between U.S. government and the host country; project company being a U.S. based company; or at least a majority of the shares being owned by U.S. citizens. It should be mentioned that OPIC does not differentiate between small or big scale projects. The size of a project budget does not make a difference on the application of OPIC insurance.[79] Besides the positive requirements that the project ought to have, there are negative requirements that the project should not have. The project should not lead to any detrimental effects to the financial system of U.S. nor should it deteriorate the environmental conditions of the host country. In determining the possible occurrence of political risks OPIC is more advanced compared to the other insurers. This is due to its access to some sources (i.e. CIA) that provide classified information. This aspect increases the accuracy of OPIC's identification of the political risks.[80]

Coverage of Currency Risks by OPIC

OPIC insures the currency risks which include the risk of transfer of the currency out of the host country and the risk of limitations of the exchanging from local currency to hard currency. A different exchange rate that is applied solely to the project in a discriminatory

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[77] Comeaux, *Protecting Foreign Investment Under International Law: Legal Aspects of Political Risk, p.151*
[78] Comeaux, *Reducing Political Risk In Developing Countries: Bilateral Investment Treaties, Stabilization Clauses*, p. 33
[79] P. M. Torrado, 'Political Risk Insurance and Breach of Contract Coverage: How the Intervention of Domestic Courts May Prevent Investors from Claiming Insurance', *Pace International Law Review*, vol. 17, 2005, p. 315
[80] Ibid., p. 315

manner is also considered as a risk which is included in the insurance provisions of OPIC. A distinction should be drawn between discriminatory exchange rates applied to project and the depreciation in the value of the local currency. It should be indicated that OPIC does not cover the risk of devaluation of the local currency. Additionally, insurance against risk of inconvertibility of currency would not pay out in the situations where the inconvertibility of the currency was present from the date of the submission to OPIC.

1) Expropriation

Under the title of "expropriation" OPIC include the political actions like nationalisation, confiscation and creeping expropriation. The common characteristic of these political actions is that they deprive the sponsor of its essential rights associated with the project. Due to the recent demands in the market for risk insurance, OPIC has included two more risks in the coverage: seizure of the profits by the government and violation of the specific undertakings in the contract by the government which results in impediment of the operation of the project. The first is a currency related risk having expropriatory effects and the latter is a breach of contract that leads to expropriatory actions. [81] Both of them are covered under expropriatiory actions. OPIC Insurance on Expropriation Risk

Mitigation of expropriation risk can prove expensive. The cover offered by the insurance differs with each entity. OPIC insures the project also in cases of nationalisation by other political bodies allowing that de facto control is sufficient. On the other hand MIGA's cover is limited to the actions of the host country.[82] The action should last for a specific period of time such as three to six months or in creeping expropriation it might be a year.[83]

OPIC insures the project against expropriation risk, expropriation is defined as series of actions carried by the government that effects the business of the investor or the property that is associated with the project. However it must be kept in mind that appropriate measures taken by the government or events triggered by the sponsor are not deemed as expropriating acts. OPIC describes these acts as a divestiture of main rights and facilities regarding the project. The so called series of action should be expropriatory as a whole. Additionally, it should be kept in mind that the actions conducted by government as a commercial party are not regarded as state actions. The actions that government conducts as a supplier or purchaser are deemed as commercial actions and cannot be compensated by political risk insurance.[84] Contracts between the state entities and the project company involve dispute resolution clauses. OPIC deems that the requirements for payment of compensation are not fulfilled unless these dispute resolution clauses are be followed by the parties. In this manner it covers the government's disobedience with the dispute resolution clauses and the award that is granted in dispute resolution. These agreements require a period of time for the action to last such as six months. The amount of compensation paid by OPIC is the whole amount of the investment excluding the profits. As one might expect, the project company can not keep the title to interests and receive compensation at the same time. In oil and gas projects, OPIC follows different methods of insurance of political risks. In these projects, adverse changes caused by government are regarded as sufficient for payment of compensation by OPIC. Repudiation of fundamental contracts between the project company and the government or violation of these contracts can be considered as examples to this situation. Moreover, the completion of the dispute resolution process is not a prerequisite for the payment of

[81] Ibid., p. 316
[82] Tinsley, op. cit., p. 212
[83] Ibid. 213
[84] Hoffman, op. cit., p. 262

compensation. OPIC provides sufficient coverage for the political actions that obstruct the operation of the project for at least six months as it is surely more reasonable for OPIC, to cover the prevention of the activity, rather than to compensate all the investment at the end. OPIC requires the transfer of all rights on the investment to itself to reclaim them later from the government. It is possible that these rights might be granted to other lenders in which case inter-creditor contracts are arranged for clarification of the situation. Lenders who are insured by OPIC are covered for the amount of debt including the accrued interest to the current day.

MIGA before compensating demands the transfer of rights in the expropriated assets of the project. MIGA excludes some actions in its definition of expropriation that are unbiased and legitimate.

2) Currency Inconvertibility

The project company being incapable of exchanging the local currency into foreign currency or the restrictions imposed on the transfer of the currency to another country are the most common currency risks that are covered by OPIC. Introduction of discriminatory exchange rates and local authorities' non compliance with their duty to convert the local currency into hard currency are the examples that OPIC identifies as currency risks. It should be mentioned that OPIC compensates the inconvertibility of the currency only where the project company is unable to exchange the currency through lawful means. The risk of acquisition of the assets of the project by the host government is compensable by OPIC only where the act of the host government is deemed to be illegal.[85] However the risk of devaluation of the local currency is not covered by OPIC.

3) Political Violence

Political violence consists of politically motivated activities which cause substantial damages to the project's property or project earnings.[86] The source of the political action might arise out of national or international contexts; it might be war, civil uprising or revolution. Civil strife is also included. However it might be excluded at the request of the project company. Civil strife relates to the employment industry or student rights is not included in political violence insurance of OPIC.[87] It must be borne in mind that the availability of political insurance by OPIC depends on many factors. The host country's political and financial conditions will be examined, especially the likelihood of occurrence of political violence, the historical aspects and possible tensions that might break out, the link between the investment and the possible political outbreaks. After this long investigation stage- OPIC determines whether it is going to provide insurance for the project. It is important to consider the conditions OPIC requires for the compensation; the contract might include provisions that oblige the project company to take necessary precautions and if the damage is done, repair of some parts is required to reduce the costs in such a case.

The amount of insurance is usually the earning losses or the assets of the project. However both options can be chosen together. The expected earnings, usual expenses and operational costs throughout the repair period can be compensated. The additional expenses besides the damage such as rental charges on extra machinery can also be covered. The period of time of the coverage cannot exceed one year even though the facility is restored. The coverage of

[85] Torrado, op. cit., p. 317
[86] Comeaux, *Reducing Political Risk In Developing Countries: Bilateral Investment Treaties, Stabilization Clauses, and MIGA & OPIC Investment Insurance*, p. 35
[87] Comeaux, *Protecting Foreign Investment Under International Law*, p. 156

assets option offers the replacement of the property or the price of the object on the date that it is damaged. Compensation will be paid for three years by OPIC and the compensation is limited to 9 items.[88] The compensation amount is limited to twice the price of the item's value.[89]

Special Insurance Programmes

OPIC provides particular insurance programmes for oil, natural sources and other energy projects. Usually it offers insurance for risk of termination or violation of the contract by the government.

MIGA

MIGA was established via World Bank by 42 states as "Multilateral Investment Guarantee Agency", it is an independent insurance organisation. The ultimate aim of MIGA is to sustain the development of the projects by providing political risk insurance for those signing states of the Convention.[90] MIGA's insurance programme is beneficial especially for developing countries which lack sophisticated insurance programmes on a national dimension. The insurance programme, of MIGA follows similar patterns as OPIC's programme only with slight distinctions.

1) Currency Inconvertibility

Under this title, similar to OPIC, MIGA covers most of the currency related risks, such as the limits on the transfer of the currency to another state and introduction of new regulations on exchange rates that causes impediment to the operation of the project. MIGA guarantees to pay the investor the amount in the hard currency. MIGA covers most of the currency risks yet again currency devaluation is excluded from the coverage of currency related risks. The rationale behind this is devaluation of currency is considered as a commercial risk rather than a political risk. [91]

2) Expropriation

The coverage by MIGA's programme extends to any type of expropriation that restricts investor's access to project's assets. The significant dissimilarity between OPIC and MIGA's coverage of expropriation is that MIGA eliminates the coverage of expropriation in situations where the host government introduces non-discriminatory rules that create expropriatory effects in practice. For that reason any host government that amends its regulatory rules in an effort to improve to economic conditions is excused under MIGA's insurance programme. That is an important point for the project company to consider.

The compensation amount extends to the net value of the investment on the paper. In comparison with the other national insurance programmes MIGA covers partial expropriation

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[88] Ibid. p. 157
[89] Hoffman, op. cit., p. 263
[90] Comeaux, *Protecting Foreign Investment Under International Law*, p. 168
[91] Ibid, p. 170

where many other insurance programmes offers coverage only for total expropriation. For partial expropriation the compensation is only paid for the covered portion of the assets.[92]

3) Political Violence

Losses in equity investments are compensated based on the paper value of the shares of the investor. Also the damaged property may either be replaced or the cost of it will be compensated. In addition disturbance of the operation of the project will be a lengthy one such as one year which would have a significant impact on the budgetary costs.

4) Breach of Contract

The violation of the contract by the host government is also covered by MIGA. The payment of compensation for this risk is conditioned upon the commencement of alternative dispute resolution methods. The investor is required by MIGA to take the dispute to the resolution committee and the committee shall render an award against the host government. However if the host government does not comply with the award or the resolution procedure is impeded as a result of government's actions MIGA pays the insurance to the investor.[93]

Eligibility for MIGA

For investors seeking coverage from MIGA, they have to carry certain requirements to be entitled to MIGA insurance programme. The investor should be a citizen of one of the member countries other than the place of the investment. Companies have to be established according to the laws of a member state to qualify for insurance programme of MIGA. The fact that the majority of the shares of the project company is in possession of the citizens of the member states is a sufficient qualification.[94]

It is often said that the qualifications MIGA require to cover an investment are not as stringent as the conditions of OPIC. This can be explained by the fact that MIGA is an international organization that does not prioritise its own political policies because it is formed by many states whereas OPIC is an entity of U.S. government.

The project company is less exposed to political risk as a result of MIGA's direct involvement in the project. This factor diminishes the possibility of the host government taking political actions that would have material impacts on the project.[95]

The approval of the host government is needed before the MIGA applies the political risk insurance programme. The approval is usually requested by the insurance agency itself. The grant of such an approval will also ensure the project company to the extent that the host government supports the project officially.[96]

Case Study : A well structured Mitigation of Political Risk by Shell

Africa is deemed to be one of the most unattractive places, by many industrial experts, to invest because of the amount of the political tension that exists in the continent. Despite the presence of the political volatility, more sophisticated and big scaled projects are introduced

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[92] Ibid.
[93] Torrado, op. cit., p. 323
[94] Comeaux, *Protecting Foreign Investment Under International Law,* p. 172
[95] Torrado, op. cit., p. 321
[96] Hoffman, op. cit., p. 157

as the time passes by. One of the well known cases is the Shell investments in Nigeria.[97] The uniqueness about Shell's case is that although Nigeria is not a desirable place to invest Shell continues on investing in Nigeria. The concepts of political instability and political risks should not be confused. Political instability causes damages to the assets and the property of the project. Instability can occur in forms of insurrection or adverse changes in laws of the host government. Political risk is the likelihood of political stability affecting the investment. For investors, Nigeria, in the short term, despite the presence of the political tension, is defined as safe place to invest. However for the long term the stability of the country cannot be assured. Some authors[98] state that a political risk in a country does not have the same impact on all the areas of the business in that country. They argue that effects of a certain political risk might vary on different investments. To explain Shell's expansion in Nigeria, first the difference between the policy risks and the political instability should be pointed out.[99] Policy risks are budgetary measures, exchange controls, price restrictions and other reforms that have impacts on certain industrial areas, whereas political instability refers to potential occurrence of political threats such as revolution, civil strife etc. Clarifying these two concepts helps to analyse the reasons behind Shell's investment in Nigeria. It is important to mention that in Nigeria, despite the governmental instability (changes in the government), the oil industry is not affected.[100] These changes however have not altered the government policy about oil industry.

One of the reasons why Shell maintained its investment in Nigeria was the success of the terms it negotiated with Nigerian government. In the past Nigeria has mismanaged oil production which left the government in a lack of capital that obstructed its potential investments in its own companies in oil industry. This caused the Nigerian Government to be in a weaker position in agreements with Shell due to its limited options among the oil companies. The Nigerian Government needed Shell's investment in oil exploration, drilling and storage. The "Nigerian Liquefied natural gas project" is the case where Shell successfully negotiated terms in its favour. Exclusions from various administrative rules, special permits granted by the Nigerian Government in concession agreement support this fact. Nigeria's extensive oil reserves also influenced Shell's decision maintain its investment in Nigeria. Shell ended its investment in Vietnam which had a well structured monetary policy, due to substantially limited oil reserves compared to those in Nigeria.[101] It can be concluded that rather than causing harm political stability had in fact beneficial effects on Shell. The Nigerian government, to preserve the level of investment, had to raise the profit shares of the oil companies throughout the unstable political periods. This is one of the unique cases where an investor not only accomplished the mitigation of political risks but it benefited from the political risks. However additional factors should not be overlooked in this specific situation. The host government was unable to negotiate the terms in its favour due to its financial situation. In addition the political instability in Nigeria didn't have any impact on the oil policies since the wealthy part of the nation was earning from the oil industry.[102] Still, little is known on Shell's strategic approach to political risks in Nigeria since the information is confidential. However it is supported by the evidence that the political risks weren't obstructing Shell's business. The political instability in the administrative system prevented

[97] Frynas, op. cit., p. 457
[98] S. H. ,Robock, K. Simmonds, *International Business and Multinational Enterprises,* R. D. Irwin, 1977, p. 379-382
[99] K. D. Miller '*A Framework for Integrated Risk Management in International Business'*, Journal of International Business Studies Second Quarter, vol. 23, 1992, p. 317
[100] Frynas, op. cit., p. 460
[101] S. A., Khan, *Nigeria the Political Economy of Oil,* African Affairs, London, 1995, p. 94
[102] Frynas, op. cit. , p. 468

the Nigerian Government from introducing new rules that would take the oil companies under control. This led Shell having a major position in the oil market. Although the instability in the administrative system had benefited Shell, complete disorder can also lead to losses.

The reasons why a company would be vulnerable to political risks are still unclear, however it might be asserted that export related businesses are less exposed to political uncertainty. Export oriented businesses are less affected by the financial troubles that the host government experiences. The business would manage to function despite the existence of financial problems in the country. Shell demonstrates how the link between political turmoil and financial situation should be analysed on a case to case basis. In addition, the consistency in Shell's investment shows it would not be right to say that the mere presence of political instability makes an investment unprofitable. In fact many factors (incentives of the company, potential return on the investment etc.) contribute to the success of an investment.[103]

Private Insurance Programmes

Apart from National Insurance programmes, private companies also offer insurance for political risks. These large companies are mostly located in the U.S. and UK. The insurance programmes of these companies generally provide asset coverage along with contract coverage. Asset coverage applies to situations where government possesses illegally the investment's assets (expropriation, confiscation, nationalisation). Contract coverage, similar to the other government backed insurance programmes, includes breach or termination of the contract or currency inconvertibility as a result of political turmoil. Political turmoil however does not involve the conflicts between dominant countries of the world or the tension between the host government and the project company's home country.

Private insurance companies offer relatively short term programmes ranging from one to three years periods. The short term coverage is inefficient and deemed as one of the shortcomings of the private insurance programmes.[104] Private insurance is a convenient option for the investors who are not eligible for MIGA and OPIC's programmes although they are deemed to be much more expensive.

The choice between private insurance companies, OPIC, MIGA or national insurance programmes depends on the circumstances on each case. However private insurance is considered to be a suitable programme for many investors as it could be negotiated through the needs of the investor additionally the arrangement of it would be faster than the other programmes. Moreover, the autonomous aspect of private insurance provides further options since it is not dependent on any political entity. On the other hand it should not be overlooked that the U.S. government is behind OPIC and, MIGA is a World Bank's entity. These factors lead the host government to refrain from taking actions that would have adverse impacts on the investment since the host government wouldn't prefer to have political tensions with these powers. [105]

Overall the coverage by insurance programmes does not always match the demand in the insurance market. As the investors mostly demand expansion of the scope of the political risk insurance regarding the coverage of breach of contract, the insurers offer coverage mostly

[103] Frynas, op. cit., p. 475
[104] Comeaux, *Protecting Foreign Investment Under International Law*, p. 182
[105] Ibid., p. 184

associated with expropriatory losses occurring upon breach of contract. The coverage for risk of devaluation of currency is also highly demanded by many investors but since this risk is deemed as a business risk it is covered neither by public nor by private political risk insurers. At the end the investor is not satisfied by the insurance service for it spends a vast amount of money in an insurance which even does not cover the actual risks (devaluation, breach of contract).[106]

Another matter that should be mentioned about the insurance programmes is that, the payment of compensation by the insurer can be made after some requirements of the insurer have been met. The insurance programme might require that the incident that harmed the investor shall be "directly" or "exclusively" related to the political action. These kinds of adverbial restrictions might impede the payment of compensation by the insurer for the loss caused by the political action might be an interaction of events that is based on that political action.[107] In these situations it might be difficult for the investor to pursue remedies from the insurer. For instance the host government might order its own entity not to take any action although the state entity is obliged to perform under the contract. In this situation the investor would have difficulty in proving the action of the host government having direct effects however the action of the government is evidently a wrongful one. Investor should seek ways to improve the causation standards that are usually set by the insurer.[108]

Chapter 6

Options of an Investor Under International Law against the Host Government

Sanctity of Contracts (Pacta Sunt Servanda)

International law is not a particular compilation of laws which are not enforceable through specific authorities. However treaties between states impose liabilities to a certain degree that leads the host government to consider the consequences of the actions that it is taking. The presence of such treaties enables the investor to persuade its own government to react to the infringement of certain obligations undertaken by the host government in the relevant international treaty.

The principle of sovereignty should be explained in order to understand the link between international law and political risks. Every state is sovereign and is not subject to other states' laws within its national borders. The concept of sovereignty comes into existence in the very cases of expropriation. A government finds the right to expropriate the property of the project in concept of sovereignty. However the concept became less strict with the emergence of international law that consists of international treaties, norms and common principles of law identified by many states. International law balances the act of state by obliging the state to pay compensation to the investor. To the extent the principles of international law allow, every state is entitled to take action within its borders. Political risk depends on the scale between sovereignty of a state and international rules that it is bound with. The debate is whether a state can enjoy its right to change its laws and can take political actions claiming that a state has right to use its sovereign powers. Under international law it is assumed that a state is restricted in its use of sovereign powers in cases where it is violating the promises that

[106] Moran, op. cit., p. 14

[107] Ibid., p. 15
[108] Ibid., p. 16

it has given to other state nationals. It was stated by a judge[109] that *pacta sunt servanda* was the fundamental element of a contractual relationship. It means contracts should be respected therefore to be obeyed by the parties in it. However not all the contracts between a state and a national of another state are binding. Internationalisation of contract is required for a contract to be recognised under international law. Parties should state that international law should govern the contract and it is cannot be repudiated unilaterally by the host government.[110] Internalisation of the contracts can be made through stabilization clauses.

Bowett stated that the inclusion of stabilisation clauses reflects the *pacta sunt servanda* principle ensuring that the host government would not terminate the agreement unilaterally.[111]

Other scholars have explained that determining international law as a governing law in the contract would "internationalise" the contract and therefore a breach of a stabilisation clause in that contract would impose liability over breach of international law. The inclusion of stabilisation clause combined with the choice of international law as applicable law impose a liability to the host state in an international scale.

In *Khemco*[112] the arbitrators concluded that an internationalised contract between investor and the host government bound the host government however the host government could breach it but it would be obliged to pay compensation in return.

The issue of internationalisation of the contracts had influenced the outcome in TermoRio[113] case. The Council of State had overlooked that the agreement between the investor and the government had an international character. The Council of State concluded that there was a lack of internationality in the agreement on the grounds that the parties did not explicitly state in the provision that the agreement had an international aspect. However it was disregarded by the Council of State that the transaction mainly concerned the foreign investment in the region which gave the transaction an international character. Council of State by deciding that the transaction didn't have an international character hindered the application of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards to the transaction since the Convention only applies to international disputes.[114] The decision of the Council can be regarded as a political risk since it disregarded the interests of the foreign investor. Despite the presence of the intentions of the parties on submitting their disputes to international arbitration, the judicial authority by ignoring the parties' intentions to exclude the jurisdiction of the national courts which infringes the fundamental principle of arbitration that mainly concerns the intentions of the parties.

An investor has to take certain steps before it is entitled to claim for breach of contract coverage under MIGA or OPIC. These steps include submitting the issue to arbitration if there is an arbitration clause otherwise taking the issue to the courts, after obtaining a decision through one of these processes seeking the enforcement of the decision. If the investor is unable to obtain an award or either it is impossible to enforce the award the investor is entitled to claim for coverage of breach of contract from MIGA or OPIC. The political risk insurer in case of contract breach expect for the investor to obtain a decision in

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[109] *Sapphire International Petroleum Limited v. National Iranian Oil Co.* 35 I.LR. 181 (1953) Judge Calvin
[110] Bowett,op. cit., p. 49
[111] Bowett, op. cit., p. 54
[112] *Amco Asia Corp. V. Republic of Indonesia*, 27 I.L.M., 1314 178 (1988)
[113] *TermoRio S.A. E.S.P. v. Electrificadora del Atlantico S.A. E.S.P.* (Arb. 2000)
[114] Torrado, op. cit., p. 340

regarding the matter of breach of contract conducted by the host government in favour of the investor. The insurer leaves the judgement on whether a breach in the contractual obligations exists by the host government to courts and arbitral tribunals. However obtaining a decision can be impeded by the host government, due to procedural difficulties or simply because of the decision is against the host government. This brings the principle of denial of justice which is explained by the combination of cases where the investor is unable to obtain a decision due to undeveloped judiciary system, unfair judgement, misapplication of laws or difficulty in access to the courts.[115] *TermoRio* could claim that the principle of denial of justice existed where the entity of the government disregarded the choice of international arbitration as a dispute resolution by the parties in the contract and ask for remedies for on breach of contract coverage. However the contract coverage under political risk insurance programmes does not extend to this wide interpretation of the principle of denial of justice. The *TermoRio* case demonstrates the unforeseeable risk of falling outside the scope of the political risk insurance. An investor applies to political risk insurance programmes to avoid situations where it can become a victim of an undeveloped legal system of a country. However certain conditions of political risk insurance coverage can ironically put the investor in those undesirable situations like in *TermoRio* case where the investor tries to obtain in order to receive compensation under political risk insurance, a decision that holds the host government responsible upon the breach of the contract. The insurers have to consider this paradox and should enhance the scope of the political risk insurance programme.[116]

Torrado[117] claims that without proper allocation of political and commercial risks the conditions for foreign investment in a developing cannot be improved. The author probably refers to the situation where *TermoRio* did not consider the law of Colombia concerning international arbitration rules which was unclear on the fact that whether the parties could decide to their own arbitration rules. *TermoRio* without reviewing the law regarding this manner engaged the transaction. However it is not clear what Torrado meant by the phrase "if investors cannot manage and allocate ... political risks properly"[118], for, the definition of "proper allocation of political risk" does not exist. There are no objective criteria for "proper allocation of political risks" in the doctrine. "The efforts of governmental entities and legislators to improve foreign investment conditions in developing countries are not sufficient if investors cannot manage and allocate commercial and political risks properly..."[119] this conclusion of Torrado is rather unclear due to her analysis about the *TermoRio* case in previous sections of her article. The evidence shows that *TermoRio* was a victim of the poorly planned judiciary system, it should not be expected from the project company to foresee the arbitrary decision of discarding the consents of the parties to international arbitration which annuls the award that is in favour of the host government.

It would not be fair for the investor to bear the consequences of an action that is justified under the title of sovereign action. Instead, when the host government exercises such actions it should compensate the investor.

Some[120] argue that mere breach of contract by the state does not necessarily mean that it is a breach of international law. A mere breach of contract by the host government does not impose liability on the state for it would not constitute an action that is equivalent to

[115] Ibid., p. 325
[116] Ibid, p. 345
[117] Ibid.
[118] Ibid.
[119] Ibid.
[120] Brownlie, op. cit., p. 549

expropriation. Determination of which situations would be considered as breach of international law carries importance for the investor, for it would determine whether the investor would be entitled to pursue its rights under international law and get compensation from the host state. In addition the author claims that the contract between a host government and an investor would not be a correspondent to an international treaty between states. The reasoning of the author is such that a state cannot alter its obligations under a treaty by amending its national laws whereas in a contract under a chosen law with an individual that is not the case.

State Responsibility

State responsibility concerns whether a state could be held liable as a result of a breach of international law. A state can be responsible from its actions towards the investor where its actions cause damages. However it is required that the action has to be an illegal action under international law. Generally individuals are not entitled to claim for damages from a state. Only the home state of the individual can pursue for compensation the other state for its actions.[121] However recent developments changed this fact, nowadays investors can also claim for its damages from a state separately. Apart from the claims under international law some state laws enable the investor to pursue its remedies under its local law, however this option does not exist in countries with emerging economies since the judicial system is influenced by the government. Generally the injured investor would claim for its damages in a neutral state or in its own state. The problematic issue for the investor is that it would face the concept of sovereign immunity which reflects that a state cannot discard another state's sovereignty by assuming its jurisdiction over an issue that the latter is involved.

For all the reasons stated above, an investor should include an arbitration clause in the contract with the host government. The arbitration option would ensure a neutral and independent council that would resolve the dispute under the chosen law by the parties.[122] However, in international law it is often required that the individual first should seek remedies for its damages in the state that has caused the injury before initiating a claim under international law. Yet this requirement can be waived by the contract between the host government and the investor. The risk that the investor would bear as a result of this principle that it might have to engage in a lengthy process in a foreign country which might not grant a fair compensation to the investor due to lack of a developed legal system.[123]

It can be said that an investor does not have many options against a state under international law or local law. Each method that an investor can pursue its remedies through involves uncertainties. Long term sophisticated project require certainty and compensation of its losses in situations where the project is incapable of operation. Due to the size of these projects every detail should be considered and every risk should be analysed, an investor cannot tolerate a situation where it is left without a remedy due to the complications arising out of international law for a vast number of participants including banks, constructors etc. would bear the consequences of it.

Waiver of sovereign immunity in a contract between the host government and the investor enables the investor to pursue its remedies against the host government under the jurisdiction

[121] Comeaux, *Protecting Foreign Investment Under International Law,* p. 34
[122] Ibid., p. 37
[123] M.N. Shaw, *International Law*, Grotius Publications, Cambridge, 1991, p. 509

of another state. In the past the concept of sovereign immunity was stricter as it is today. The absolute concept reflected that no state would be submitted under the laws of another. The European Convention regarding the sovereign immunity issue concludes that a state would not be immune to the jurisdictions of other states if the action in question is a commercial one. However the immunity is granted regarding the political actions of a state.[124] This again indicates how significant to identify if an action is of commercial or a political nature. The investor would face the barriers to pursue its remedies under international law according to the principle of sovereign immunity if the action is politically motivated.[125]

This was reflected in *Topco* case where a clause asserting that the general principles of international law should be applied was included in the agreement. If Libya were to change the contract unilaterally that would be an infringement of the principle *pacta sunt servanda*.

Bilateral Treaties Between the States

Bilateral treaties between states are arranged in the need to maintain a stable legal framework for foreign investments. Investors have lack of confidence over the legal systems of states due to their arbitrary interventions over the investment. States might change their laws concerning the investments causing impediments on the operation of the projects. Bilateral treaties have emerged between developing countries and developed countries as a need to protect the investments where instability regarding the legal system and political turmoil existed. Investors of nationals of developed countries would be protected under these bilateral treaties. Many third world countries engaged in these agreements to attract foreign investment within their borders. However a number of countries have avoided these contracts on the justification that no national of a state should be treated in a particular way in comparison with their own nationals, including Nigeria and India. Bilateral treaties are deemed to reduce the risks that the investors are facing in Third World countries. The fundamental mission of these bilateral treaties besides the encouragement of investment is to protect against the risks of expropriation and nationalisation.[126] Most of the bilateral treaties determine the amount of compensation to be equitable and efficient.[127]

Payment of compensation for the losses caused by political violence is not guaranteed under bilateral agreements. However the host state promises to treat the foreign investors on an equal basis with its own nationals. The definitions in the bilateral treaties also carry importance for they determine the situations where investors would be entitled to seek compensation from the host government. These definitions would differ in every bilateral treaty. Some bilateral treaties use a general description of events such as “damages... owing to the outbreak of hostilities or a state of national emergency...”[128] whereas other bilateral treaties might state in a more detailed way such as “losses... owing to war or other armed conflict, revolution, a state of national emergency or revolt...”[129]

Another mission of bilateral treaties is to provide efficient resolution systems for the disputes arising out of the contracts concluded between the foreign investor and the host government.

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124 Comeaux, *Protecting Foreign Investment Under International Law*, p. 46

125 See the discussion of the distinction between commercial and political risks

126 J., Salacuse, *Bit by Bit the Growth of Bilateral Investment Treaties and Their Impact on Foreign Investment in Developing Countries*, International Law, vol. 24, 1990. 663

127 “Hull Formula” a standard determination of compensation under international law created by US government

128 Agreement Concerning the Encouragement and Reciprocal Protection of Investment, Aug 27, 1988, Japan China 28 I.L.M. Article VI

129 Agreement Concerning the Encouragement and Reciprocal Protection of Investment, Jan 30, 1968 Denmark Indonesia Art V, 720 U.N.T.S. 159

Bilateral treaties ensure the application of ICSID arbitration to those disputes between the investor and the host government. ICSID is an institutional arbitration that requires the states to waive their sovereignty partially by subjecting states to its own jurisdiction. ICSID arbitration ensures the enforcement of the awards effectively. This is one of the reasons why many third world countries chose to be excluded from bilateral treaties. ICSID sets specific rules for investor and host government disputes which are against the principle of equal treatment of national investors of a host country with foreign investors.[130]

The protection granted by the terms of a bilateral treaty seems to show little effect to the investment. However the existence of a bilateral treaty positions the investor in a much stronger place during the negotiations with the host government. Moreover, the presence of mandatory provisions that oblige the parties to submit the dispute to arbitration, leads the host government to reconsider its political actions.[131] On the other hand, no dispute under bilateral treaties had ever been resolved by arbitration either because the efficiency of it is unproven therefore the benefits of it are doubtful or the presence of such provisions effectively prevented the host government from taking any actions. Apparently, bilateral treaties provide further protection compared to international law. Due to the vagueness of the provisions in bilateral treaties, different interpretations of the provisions can be made and this might lead to a completely different contract than it was originally intended.

Bilateral treaties carry importance for the investor due to their obligatory measures of dispute resolution. This feature can ensure that the investor would be allowed to pursue its rights under the contract with the host government. The existence of these treaties assures the investor by causing the host government to be reluctant in taking political actions that would be to the detriment of the project.

The presence of arbitration clause might give the investor of a feeling of security however a government being unwilling to comply with an arbitral award would lead any court to reconsider enforcing that award.[132] This is best explained by Esty & Ferman: “Arbitration ... works best when the parties continue to support is as a solution. Absent an ultimate authority ... to exercise force in support of the rules, it is uncertain whether there can be a dispute resolution regime that provides the certainty investors would like.”[133]

The Importance of the Cooperation of the Host government and the Project Company in the Management of Political Risks

Governments are in general are uncooperative in the process of management of risks. The risk ratings analysed by political risk services are usually perceived as offensive by the host governments. Therefore the process of management of risks often lacks the sufficient cooperation of the host government. The only incentive for the host government to engage in this process is the attraction of the investment. The current situation regarding the cooperation between the host government and the project company in the management of the risks mainly diminishes the effective mitigation of risks that are uncontrollable by neither party.[134] Waelde[135] suggests that a cooperative approach by both parties would render more preventative measures in the elimination of those risks additionally by lowering the costs of

[130] Salacuse, op. cit., p. 672
[131] Ibid, p. 674
[132] Moran, *International Political Risk Management*, p. 18
[133] E. A. Witten, *Arbitration of Venezuelan Oil Contracts: A Losing Strategy?,* Texas Journal of Oil Gas & Energy Law, vol. 4, 2008-2009, 56
[134] Waelde, op. cit., p. 237
[135] Ibid.

such procedures. The host governments approach the issue by arguing that this process is only but to the advantage of the investors. However Waelde proves this wrong, by asserting that the high rate of political risks would eliminate many investors which are considering investing in the host country. In addition the risk management would be more costly for the project company the higher the political risk gets. In that sense, additional costs for managing a high rated risk would affect the earnings and the profits of the company by reducing it. In return the reduced earnings would result in lesser amount of tax payments. Therefore the costlier the management of a political risk gets the lesser the tax revenues become. Accordingly, collaboration in the management of the risk is essential for both parties.

The perceptions of the both parties on the management of the risks might differentiate for various reasons. The possibility of losing against an investor in arbitration, waivers of sovereign immunity and other applications that might seem disadvantageous for the host government often result in political discussions in which the host government pays a high political cost. A case where the host government undertakes a situation where it bears the consequences later would not be beneficial for the investor in the end. Sensible and realistic management methods can create benefits for the both parties in the long run.[136] The favourable treatment of the foreign investors compared to the treatment of other local investors might lead to criticisms of the host government for conducting discriminatory actions towards its national investors. Furthermore it might create detrimental conditions for the project. The actual example to this situation is the *Dabhol* case where the new government regarded the previous government’s treatment of the project as harmful to the country. After this determination by the new government the investor was threatened with the renegotiations of the contractual terms.

Chapter 7

Conclusion

As seen throughout the chapters, the methods of mitigation of political risks usually serve to the benefit of the investor however these methods do not always protect the investor fully. Investor can choose might apply these methods to reduce the political risks or to protect the investment from those risks by insuring the project. One must bear in mind that there are disadvantages to all these methods.

An investor might negotiate strategically important clauses with the host government to allocate and reduce the risks. An investor has to be in a strong bargaining position in order to negotiate a better deal for itself. This bargaining power depends on the political and financial situation of the country alongside with the size of the investment. Some say that Shell’s success in its investment in Nigeria is partly due to its negotiation power. On the other hand Enron’s investment for instance was an attractive investment for the Indian Government and although Enron got a favourable deal, the deal was broken at the end by the new government.

Agreements between the host government and the investor, help to reduce the political risks by mostly preventing the political actions of the host government. However as discussed by some major cases, the presence of these agreements does not always prevent the host government from taking actions. Moreover the sovereign character of states makes the application of the penalties much more difficult and the available remedies under international law are limited. Even if states by their own will restrict their actions under a

[136] Ibid. p. 38

contract and agree to comply with the award of an international forum, the judicial authorities will be reluctant to render decisions that are in favour of states.

Political risk insurance is an attractive option for an investor however the costly side diminishes the advantages. Moreover the political risk coverage does not extend to other possible threatening situations that a project company might face and the complex procedural requirements of political risk insurance programmes endanger the payment of compensation.

Henisz and Zelner[137] argue that the contractual undertakings never secure a project 100%. Even under perfect circumstances political risks in a project are not fully eliminated, however they can be reduced to a certain level. The effective allocation of political risks depends on variety factors including cooperation with local risk analysts and a collaborative management of the political risks with the help of the host government. However one can see that allocation of political risks is a complicated subject that is developing every day by the contribution of bilateral agreements concerning the protection of the foreign investments mostly in developing countries with developments in the enforcement of international law.

[137] Henisz, op. cit., p.167

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