Expropriation, Nationalisation and Risk Management

After a period of relative calm, the oil and gas industry has been hit by a new wave of action by host countries, imperilling resource development. These actions fall under the broad category of ‘political risk’, which includes expropriation, currency instability and political violence.

The most direct and egregious form of political risk (expropriation) occurs when a host country seizes a company’s development rights or facilities and its products for the host country’s own use, usually under the guise of the national interest. Nationalisation is the evil twin of expropriation, and occurs when the host country makes an expropriation and hands the property or development rights over to a national company. Because the international business community frowns on expropriation by host countries, some countries move towards their goal of expropriation in small steps. This ‘creeping expropriation’ can come in the form of increased regulations, confiscatory taxes, limits on the repatriation of currency, changes in exchange rates and forced re-negotiation.

The new millennium has brought a new era of expropriation and nationalisation. Venezuela has garnered headlines for its nationalisation and expropriation of oil operations. In February 2007, Hugo Chavez issued Decree No. 5.200, requiring operators in Venezuela’s Orinoco Belt to agree to new contracts with the state oil company, Petroleos de Venezuela SA (PDVSA). If they did not comply, the companies faced expropriation. Venezuela also seized foreign-operated facilities, and ultimately expropriated the Orinoco Belt properties of ExxonMobil and ConocoPhillips. Exxon has responded with a series of legal actions designed to freeze the assets of PDVSA outside Venezuela.

Ecuador has imposed a deadline for oil companies to accept new subcontracting agreements, which would cancel existing joint venture agreements. The new agreements would also prevent oil companies from making appeals to the International Center for the Settlement of Disputes (ICSID). Ecuador also created a 50% tax on ‘extraordinary profits’ based on crude oil prices. In 2006, Ecuador expropriated Occidental Petroleum’s interest in the Block 15 Field.

Bolivia issued Supreme Decree No. 28701 on 1 May 2006, which required producers to relinquish control of the production of hydrocarbons to the state oil and gas company, Yacimientos Petrolíferos Fiscales Bolivianos (YPFB). Russia used its environmental permitting process to threaten contract cancellation for projects operated by Total and Exxon Mobil. Russia also forced Shell and BP to relinquish the Skhalin-2 and Kovykta gas projects to Gazprom and the state-controlled company Rosneft.

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The robust return of the risk of expropriation and nationalisation to international oil and gas development requires international oil and gas companies to focus on risk management. Insurance is a common method of managing certain types of risks. Natural disasters, injuries to third parties and even business risks can be covered to some extent by insurance. As insurance is market-driven, companies can make informed and quantifiable decisions about what risks they wish to shift to insurance companies. Governmental and private insurers offer policies designed to manage political risks, including the risk of expropriation and nationalisation. Many countries have governmental or quasi-governmental entities that provide political risk insurance for companies from that country when investing internationally, including:

- US – Overseas Private Investment Corporation (OPIC);
- Japan – Nippon Export and Investment Insurance (NEXI);
- UK – Export Credits Guarantee Department (ECGD);
- France – Compagnie Française d’Assurance pour le Commerce Extérieur (COFACE);
- Canada – Export Development Canada (EDC);
- Austria – Export Finance and Insurance Corporation (EFIC); and
- Germany – German State Export Guarantee Scheme, managed by Hermes.

The Multilateral Investment Guarantee Agency (MIGA) is sponsored by the World Bank. MIGA offers guarantees of investments where the applicant is investing outside its home country. Guarantees are available for investments in countries that are members of MIGA. MIGA guarantees can be used to protect against expropriation, nationalisation and confiscation. In cases of creeping expropriation or partial confiscation, coverage may be limited.
Mohammed Bin Rashid Al Maktoum, Vice President & Prime Minister of the United Arab Emirates & Ruler of Dubai

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MIGA provides guarantees to manage risks from expropriation and nationalisation as well as currency inconvertibility and transfer restrictions, war and civil disturbance and breach of contract. If an investment is completely expropriated, MIGA will cover the net book value of the investment. If the host country expropriates funds, MIGA will cover the value of those funds. If MIGA has guaranteed a loan, the lender can recoup the principal and accrued interest. A MIGA guarantee usually has a 15-year term, although the term can be as long as 20 years. MIGA will guarantee up to 90% of an equity investment, and up to 95% if the principal is a loan. In each case, there is additional coverage for earnings or interest, as the case may be. A guarantee from MIGA can be as much as US$180 million. If the project requires greater coverage, MIGA can assist with re-insurance to increase the coverage. MIGA also requires a demonstration that the project will be commercially sound.

One of the earliest government-sponsored programmes to offer political risk insurance was OPIC. OPIC is a US agency established in 1971 to foster foreign investment in foreign countries. OPIC coverage can be used to insure against expropriation, political violence and the inconvertibility of foreign currency. Like MIGA, OPIC provides political risk insurance for new projects, but limits its coverage to US companies investing internationally. As OPIC is a government agency, its coverage is limited by some policy considerations. As a general rule, the US company must own at least 25% of the equity in a project, and as it is a US agency, OPIC will not provide coverage for investments that would injure the US economy or US employment.

OPIC will usually insure up to US$250 million per project, but will increase that cap to US$300 million for offshore oil and gas projects with payments in hard currency. That cap can go to US$400 million where the project receives an investment grade credit rating. OPIC will insure against expropriation, including creeping expropriation. In the oil and gas sector, OPIC will provide coverage for abrogation or breach of concessions, production-sharing contracts and similar oil and gas agreements.

The Export Credits Guarantee Department (ECGD) is another example of a government-sponsored insurance and guarantee programme. ECGD provides overseas investment insurance (OII) for UK investors, and covers a wide range of political risks, including expropriation. The OII programme can be used for equity investments or loans. The OII programme covers direct expropriation as well as creeping expropriation. Usually, the expropriation must last for one year to give rise to a claim under the OII policy. As with MIGA and OPIC, ECGD favours coverage for new investments or significant expansions of existing investments through new capital infusions, but will not cover existing projects. ECGD will allow recovery for partial expropriation.

In addition to MIGA and the governmental insurers, some private insurers now offer political risk policies that include insurance for expropriation. Chubb, for example, offers confiscation, expropriation and nationalisation (CEN) Insurance. The Chubb CEN policy provides up to US$550 million per country, with a policy period of up to 10 years. A single Chubb policy can cover multiple countries. Zurich North America also offers political risk insurance that covers expropriation and creeping expropriation. The Zurich policy can cover up to US$125 million per transaction, with a policy term of up to 15 years.

In complex transactions, an oil and gas company may combine private insurance with a policy from a governmental agency or with MIGA. MIGA itself now often syndicates large political risk insurance matters with private insurers. The private market has some advantages over OPIC, as coverage terms are not governed by foreign policy considerations, and a private insurer may be able to be more responsive. Coverage can be more flexible, and some companies offer packages combining political and commercial risk coverage. The US Import–Export Bank now also offers such comprehensive coverage. In more complicated projects, it is common to put together a package of insurance and re-insurance policies to address political and commercial risks. Political risk insurance is not a panacea. It does not cover every political risk, but it can be used to manage risks such as expropriation, nationalisation and creeping expropriation.

In addition to using insurance to blunt the impact of expropriation or nationalisation, companies can bargain for some dispute resolution measure that may give them a chance to recover losses arising from such actions by the host country.

Companies operating internationally may be able to take advantage of multilateral investment treaties (MITs) and bilateral investment treaties (BITs), which are designed to provide protection to foreign investors between and among countries. These treaties are typically designed to attract investment in the host country by providing protection against expropriation or nationalisation, among various other risks. The company making the investment will need to review the applicable treaties for each host country.

A company operating internationally also takes on some risk that its contract will not be properly enforced by the local court system, especially if the other party to the contract is the host country’s oil and gas company. One way to mitigate this risk is to require all disputes to be resolved through international arbitration. The American Arbitration Association, the International Chamber of Commerce, the London Court of International Arbitration and other arbitration organisations have rules designed to provide for the arbitration of disputes between companies from different countries.

International arbitration can be especially helpful if a company needs to return to the host country to enforce its judgement. About 110 countries are signatories to the 1958 New York Convention on the Recognition of Foreign Arbitral Awards, administered by the UN Commission on International Trade Law (UNCITRAL), in which host countries agree to enforce arbitration awards. Thus, a judgement rendered through international arbitration may be more collectable than one awarded by a US court or any other court outside the host country. There remains some risk that a host country may apply the UN Convention or an arbitration award in an unexpected manner. A US-based oil and gas company might, for example, be inclined to negotiate a dispute resolution provision requiring that all matters be heard by the Texas courts. The host country may resist enforcing a judgement from the Texas courts, and may indeed have laws on its books allowing it to ignore that decision. However, if the host country has signed the New York Convention, it is obliged to honour and enforce the outcome of an international arbitration. While the company may believe that securing a judgment will be easier in Texas, enforcing that judgement could be much more difficult.
Another useful approach to dispute resolution is to insist on resolution under the rules of the International Center of the Settlement of Disputes (ICSID). About 130 countries have signed the ICSID Convention on the Settlement of Investment Disputes between States and Nationals of Other States. However, a host country can require the disputant to exhaust local remedies before moving to ICSID dispute resolution, which has the potential to prejudice the outcome and may well delay recovery of damages. Also, as noted above, Ecuador has attempted to put new contracts in place that will preclude ICSID dispute resolution.

While there is no perfect shield from host country expropriation or nationalisation, the measures described above can help manage that risk and bring some additional certainty to investment decisions.

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