CHAPTER 10

POLITICAL RISKS ARISING FROM THE INTERVENTION
OF HOST STATES

10.1 Introduction

All investments come with some risks.\(^1\) Therefore, international investors can expect to face a variety of risks in the course of their investments. In addition to the risks associated with all types of investments, international energy investors face a number of additional political risks because of the specific nature of their investments. International energy projects (IEPs), including oil and gas exploration, production, transportation and pipelines, predominantly operate in some of the world’s more unpredictable and unstable environments.\(^2\) These projects are very volatile by reason of the fact that they face economic, financial and political risks. Such risks may not only arise at the initial stage of an investment, but also last for the lifespan of an investment project.\(^3\) ‘At worst, an entire project’s viability is at stake’.\(^4\)

IEPs, generally, are set up between international companies and host states. Investors are investing large sums of money - billions of dollars - internationally. Without an understanding of the political risk involved in dealing with other states, those investments may be in danger.

This chapter is designed to look at the political risk to energy investment projects from several different viewpoints. Firstly the nature of the risks will be investigated, which will encompass both their definition and categorization. Then the way in which the nature of an energy investment project can make it particularly vulnerable to political risk will be looked at. We then move on to look at geopolitical influences, seeking to determine whether there is any difference

\(^2\) Available at: www.aon.com/us/busi/riskmanagement/risk_transfer/trade_credit/polincal_risk (Visited on 15 June 2014).
between the nature of the risk in developing and so-called ‘developed’ countries, and conclude with a historical analysis of political risk in this sector.

10.2 The Definition and Types of Political Risks

The concept of political risk, will be analysed by using various definitions given by scholars, the Organization for Economic Cooperation and Development (OECD), and an oil company.

Comeaux and Kinsella have defined political risk as ‘the risk that the laws of a country will unexpectedly change to the investor’s detriment after the investor has invested capital in the country, thereby reducing the value of the individual’s investment’. According to another scholar, political risk is ‘the risk or probability of occurrence of some political event that will change the prospects for the profitability of a given investment’. In the same vein, another author defined it as ‘the probability that the goals of a project will be affected by changes in the political environment’.

The OECD has defined political risk as ‘[t]he risk of non-payment on an export contract or project due to action taken by the importer’s host government. Such action may include intervention to prevent transfer of payments, cancellation of a license, or events such as war, civil strife, revolution, and other disturbances that prevent the exporter from performing under the supply contract or the. Buyer from making payment. Sometimes physical disasters such as cyclones, floods, and earthquakes come under this heading’. This definition covers a broad range of risks. It is difficult to describe environmental catastrophes as a political risk, but the OECD might think that the host state may fail to build the necessary infrastructure for the investment

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because of discrimination or other negative reasons. If a flood happens due to lack of infrastructure, that catastrophe may be ascribed indirectly to political risk.

The above definitions can cover all types of investments. Shell, one of the major oil companies, has defined political risk as ‘the probability of not maintaining the described contract during a ten year time span-in, the face of changing economic and political circumstances’.\(^9\)

Boulos has specifically described political risk from the perspective of the petroleum industry. He states that ‘political risk in any oil and gas investment in a foreign country is the possibility that the oil company investment will be expropriated, nationalized or otherwise unilaterally changed by the foreign government to the detriment of the oil company’\(^10\). According to his definition, political risks arise from host government actions. This concept forms the basis of Boulos’s definition.

As a whole, a key point in the above definitions is the question of probability. Changes are inevitable in the context of international energy projects since they are long-lasting projects. Lax has referred to these potential changes as political risk events.\(^11\) Political risk events cover: nationalization or expropriation, confiscation, war, uprising, depreciation of national currency, and restrictive measures by the host government, which can include ‘... new and adverse legislation, adverse contract changes and other modern day factors such as environmental activism, [and] ethno-linguistic factionalism’.\(^12\) One can also add a new list of modern political risk events:

- corruption and cronyism;
- bureaucratic delay and absence of decision;
- manipulation of competitive bidding;
- lack of confidentiality;

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11. Supra note 7.
- perpetual audits by government;
- deviant interpretation of laws;
- hostile relations of government with neighbors;
- weak institutions, and weak legal and regulatory framework;
- non-participation in major international conventions;
- public-interest litigation;
- non-independent local dispute-resolution systems.\(^\text{13}\)

In the energy industry, like other industries, political risk arises mainly in reference to relationships between the investor and the host state, but relationships with other players in the industry may also create political risk. Host states have ‘a wide variety of mechanisms available to interfere with rights in private property,’\(^\text{14}\) some of which are mentioned above.

Another important point in the definitions given above is that international investors may lose their capital and/or the profit they expected when the investments were made as a result of political decisions or events in a country.\(^\text{15}\) What is the objective of making an investment? That is a really key issue and is simple. From the point of view of international investors, they invest capital to make a profit. It is obviously not a good thing if, while you expect to make a profit, you lose your own capital.

10.3 Categorization of Political Risks

Political risks can be categorized and several authors have already worked on this area.\(^\text{16}\) Wagner firstly divides political risks into ‘firm-specific’ risks and ‘country-specific’ risks.\(^\text{17}\): He

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states that firm-specific political risks ‘are risks directed at a particular company and are, by nature, discriminatory,’\(^{18}\) such as breach of contract and sabotage.\(^{19}\) On the other hand, country-specific political risks are not directly aimed at: a particular firm and are countrywide, although a particular firm may ‘be affected. For instance, in mass nationalizations, all international investment in the host country will be nationalized, whether for political reasons or otherwise.\(^{20}\) Wagner makes a second distinction between two types of political risks, ‘government risks’ and ‘instability risks’.\(^{21}\) Government risks ‘are those that arise from the actions of a governmental authority, whether that authority is used legally or not,’\(^{22}\) such as discriminatory regulations and creeping expropriations. However, political power struggles may also cause political risks, called instability risks, such as mass labour strikes, civil war or urban rioting.\(^{23}\)

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<th>Table 10.1. Categorization of Political Risks</th>
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<td><strong>Government Risks</strong></td>
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<td>Firm-Specific Risks</td>
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<td>Country-Level Risks</td>
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*Source: Robert Egg\(^{24}\)*

Wagner argues that the risks that can be characterized as both government and firm-specific risks ‘contain an ambiguous mixture of legal and illegal elements’.\(^{25}\) Wagner further adds that ‘firms may be able to reduce both the likelihood and impact of firm-specific risks by incorporating

\(^{18}\) *Ibid*, see also A. Berlin, *Id.*, at 3.

\(^{19}\) *Ibid*.

\(^{20}\) *Ibid*.

\(^{21}\) *Ibid*.

\(^{22}\) *Ibid*.

\(^{23}\) *Ibid*.

\(^{24}\) *Supra* note 17.

\(^{25}\) *Supra* note 17.
strong arbitration language into a contract.... By contrast, firms usually have little control over the impact of country-level political risks on their operations. The only sure way to avoid country-level political risks is to stop operating in the country in question’. The last sentence of this quotation seems a bit of a last resort solution. As many, if not most, investors put large amounts of money to work in their investments and many investments are also quasi-irreversible, it is, therefore, very difficult to pack up and leave.

Lovells Law Firm has made a slightly different categorization. According to Lovells, political risk can be categorized in terms of the relationship between the investor and the host state, between the investor and other companies, and between the investor and individuals and other societal stakeholders.

Overall, political risks have been divided into three sub-categories by the HIS Energy Group. The first one is political risk, which includes war, political unrest, violence, find instability. The second category is socio-economic risk, which includes economic, energy, environmental and ethnic factors. The last category is commercial risk, which is composed of investment, repatriation, and fiscal terms.

Another categorization has been made based on September Eleventh. Quinley divides political risks into two parts: political risks before September Eleventh and after September Eleventh. This categorization is based on global terrorism and geopolitical instability.

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26 Ibid.
30 Supra note 1 at 1.
31 Ibid.
10.4 The Nature of Energy Investments: The Aspect of Political Risk

Why are energy projects so open to political risk? Some risks are very common in international investments in all industries. However, the energy industry is particularly vulnerable. There are several reasons why international energy projects particularly are under political risks. But before we come to the reasons in detail, it might be helpful to have a brief review of the nature of the energy industry.

The energy industry has certain types of risks which are unique, because energy investments are themselves unique transactions between investors and host states. The duration of an energy investment and ‘risk exposure is particularly long,’ capital investment is intensive, and ‘the project risk (geological, commercial, and political) is particularly acute’. Therefore, the energy industry ‘commonly adopt[s] certain customs and practices on an industry-wide basis to allocate those risks in a generally accepted manner’. Specific characteristics of the energy industry, such as ‘the capital-intensive nature of the industry, market price volatility, geographic scope of assets and operations, the. High-risk nature of exploration and exploitation of natural resources, technology requirements, environmental concerns, downstream brand promotion and protection issues, political sensitivities, scale and diversity of employee base, etc.’ cause high level political risks for international energy investors. The nature of energy projects has led to conflict between the parties. Thus, it is important for international energy investors ‘to be aware of the nature of these [political] risks that are specific to this industry’ and it is important for energy investors to manage those risks.

Let’s move on to the reasons why energy projects are so vulnerable.

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34 Ibid.
35 Supra note 28 at 4.
36 Id., at 2.
37 Id., at 4.
First, some countries’ main income comes from only one single industry, such as oil and/or gas. These countries are highly dependent on oil and gas revenue as a proportion of state revenues. Consequently, for many producing and exporting countries the expectations of politicians and the entire population of the country are high. If the state gets more rent or royalties, it means for the citizens of the country ‘more salaries, more schools, more employment and general wellbeing...’ Countries in this situation do not want to lose their control over such a vital industry.

Second, the importance of international energy projects is such that they have a great impact on public awareness. Energy products, such as oil and gas, are widely consumed by almost all of a given population. Every movement in the energy industry may affect the choices of voters. Because of this, ‘governments are likely to play a prominent role in regulation of entry, of prices, of quality of services, add of other aspects of investor behaviour.

Third, international energy projects are major long-term investments; many projects may last more than a couple of decades. The long duration of energy investments increases political risks. In Valera’s words, ‘the political risk facing international oil companies is directly related to the behaviour of political actors in the policymaking process within the host country’. That behaviour is created by:

- The roles the political actors play, which depend on the workings of basic institutional rules such as electoral and constitutional rules.
- The incentive? that motivate them. Multiple political actors with diverse powers, the horizons, and incentives interact in various arenas. There are diverse rules of engagement which can have an impact on the way the game is played.

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39 Supra note 32 at 6.
40 Id., at 5.
41 Supra note 27.
42 Supra note 32 at 3.
- The constraints political actors face, which depend on the workings of political institutions (such as congress, the party system, and the judiciary) as well as the rules of engagement among them.\textsuperscript{43}

Actually, not only the internal policy or policymaking process but also international politics affect the energy industry, that is, it has always been synonymous with both internal and international politics. During the life span of a contract, especially in developing countries,\textsuperscript{44} many things are likely to change and their new shape will affect the contract’s situation, such as the change of governments, political system, etc. The new government and/or system may not behave well towards international investors.\textsuperscript{45} Even if the old political system or government still stays in power, energy investment agreements may be subject to unilateral interventions by host states. The host states may take into account new public concerns and changes in energy prices, international politics, and the economy and so on.

Fourth, investment in energy projects is typically large (it is a big capital investment and has high visibility),\textsuperscript{46} is a permanent fixed investment,\textsuperscript{47} and requires long payback periods,\textsuperscript{48} ‘Once the investment is undertaken, in the light of adverse conditions the operator may be willing to continue operating as long as operating revenues exceed operating cost’.\textsuperscript{49} In other words, energy investments are …quasi-irreversible: their owners cannot (in the short term) pack up and leave…\textsuperscript{50} Because of this, according to some authors, after the investment starts, the host government’s behaviour towards the investment company may begin to change; into an opportunistic approach.\textsuperscript{51} Bargaining power shifts in favour of the host state and the investors ‘...are not well positioned to defend their own interest...’\textsuperscript{52}

\textsuperscript{43} Please see for further details J.L. Valera, supra note 590 at 3.
\textsuperscript{44} Many of the oil and gas producing companies operate in volatile political environments in developing countries. M. Somarajah, \textit{The International Law on Foreign Investment} 2nd edn.,75-87 (Cambridge: CUP, 2004), hereinafter referred to as ‘M. Somarajah, Foreign Investment’.
\textsuperscript{45} \textit{Supra} note 13 at 68.
\textsuperscript{46} \textit{Supra} note 32 at 4.
\textsuperscript{47} \textit{Supra} note 27.
\textsuperscript{48} \textit{Supra} note 27 at 4.
\textsuperscript{49} \textit{Supra} note 27 at 4.
\textsuperscript{50} \textit{Supra} note 27.
\textsuperscript{51} \textit{Ibid.’, See also J.L. Valera, supra note 593 at 5.; The obsolescing bargain: “the vulnerability of firms with large fixed’investments to find the terms of their operating agreements changed, or renegotiated, once their operations are in place and have proved successful’ cited in, S. Wallace, supra note 16 at 68.
\textsuperscript{52} \textit{Supra} note 27.
Finally, it can be said that, generally, many of the oil and gas dominant regions of the world are politically and economically unstable. States in these regions are heavily dependent upon the oil and gas industry.

As a result, ‘[the international energy industry is imbued with a bundle of government-derived problems referred to as political risk’.

Therefore, international energy projects are particularly prone to receive host country intervention.

10.4.1 Is there any Difference between Developed and Developing Countries in terms of Political Risk?

Petroleum production is directly related to the geopolitical location of reserves. The world’s energy demand is mainly fulfilled by developing countries. In other words, ‘[a]s shown in the table below major oil reserves are located in the regions of the world characterized by an unstable political environment’.

<table>
<thead>
<tr>
<th>Table 10.2. Distribution of Oil Reserves</th>
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<tbody>
<tr>
<td>Middle East</td>
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<tr>
<td>Commonwealth of Independent States and Eastern Europe</td>
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<tr>
<td>Western Europe</td>
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<tr>
<td>Latin America</td>
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<td>North America</td>
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<td>Asia and Pacific</td>
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<tr>
<td>Africa</td>
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Source: Berlin, A., ‘Managing Political Risk in the Oil and Gas Industries’.

According to the table, 4.5% of petroleum is produced by developed/stable countries, namely Western Europe and North America. The rest of the production, 95.5%, is produced by developing countries/unstable countries. Furthermore, state-owned companies control a significant amount of energy resources and play a very important role in energy projects. As a result, risks

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53 Supra note 16 at 68.
54 Id., at 72.
55 Supra note 17 at 1-2.
56 Ibid., 2.
57 Ibid.
can be doubled for international investors. A state can interfere with a contract as a sovereign power and at the same time as a contractor. Lovells clearly explains that ‘[d]ealing with state-owned oil companies in various jurisdictions introduces additional risk, complexity and political sensitivity to these transactions’. 58

Furthermore, some developing countries may not establish satisfactory judicial and administrative systems. Unsatisfactory systems may create additional risks to international investors. The following excerpts from Drucker can clarify the matter:

Legislation on company law, industrial relations and patents and trademarks may be dated and inadequate. An extreme example was given to me by one of the counsel to the International Finance Corporation (who) asked where he could find the laws of a particular country and was told, after some searching, that they were kept in a room in the Ministry of Justice. When he entered the room, he indeed found the laws, scattered in total disorganization around the walls.

Such difficulties in the legislation may be compounded by the methods by which such legislation is administered. The administration may be inept, it may be arbitrary, it may be dilatory and it may be corrupt. 59

Although the above example seems a bit extreme, it is quite a striking example. Actually, this example was given more than two decades ago; in the contemporary era, hopefully, there is some improvement. 60 Energy investments in developing/unstable countries may be risky ventures. Unstable legal and political administrations and state-owned companies or agencies may lead to economic disaster for international energy investors.

However, political risk is not only created by developing countries. 61 Quinley states that ‘[i]t is an axiom of political risk management that all countries pose certain types of political risk.

58 Supra note 28 at 4.
60 Alsaidi argues that in this century, national laws in developing countries have enough sophistication required to deal with petroleum investment contracts and any disputes that arise from them; for considerable detail please see A.M. Alsaidi, Petroleum Arbitration: Applicable Law and Appropriate Arbitral Forum (A Study of Petroleum Disputes in Arab Countries), unpublished PhD thesis, (London: Queen Mary University of London, 2004).
The difference is one of degree,62 in the same vein, Shaw adds that ‘[n]ationalisation for one reason or another is now a common feature not only in communist countries and Afro-Asian states, but also in Western Europe’.63 Several developed/stable states interfered with the property rights of international investors, such as the UK,64 France,65 Canada66 and other countries in Europe. This has raised concerns about expropriation. And even in the twenty-first century, states ‘may also confiscate property through the use of "trading with the enemy" legislation, though this more serious interference is normally limited to actual wartime conditions’.67

In the modern era, one of the main types of political risk is ‘creeping expropriation which stems from changes in legislation that affect the industry, such as taxes, labour, environmental regulations and other economic measures’.68 In this regard, it could be fairly said that this has even been seen in the United States.69 One example is the discussion on leases given by President Clinton in his second term in 1998 and 1999 to oil companies in the Gulf of Mexico. At that time, oil prices were around USD 15 per barrel. To encourage companies to invest in offshore drilling, the United States waived the royalty payment. The leases ‘... did not provide certain royalty rate increases in the event of increased crude oil market prices’.70 Since then, oil prices have dramatically increased. However, oil companies did not pay royalties. For these deep-water lease

62 Supra note 1 at 2.
64 The UK mainly started the process of nationalization in 1945 after the Labour party’s victory. Transport, coal, bank, civil aviation, etc. were nationalized. See K. Katzarov, The Theory of Nationalization, 46-53 (The Hague: Martinus Nijhoff, 1964). The United Kingdom forced the renegotiation of the North Sea Oil. The United Kingdom introduced the Petroleum and Submarine Pipelines Act in 1975, which made substantial changes in the terms of all existing production licenses, introducing a new form of petroleum taxation, and a mandatory carried interest for its newly established state oil company for North Sea field development. P.D. Cameron, ‘Stabilization in Investment Contracts and Changes of Rules in Host Countries: Tools for Oil & Gas Investors’, AIPN Research Paper Final Report, 2006, 20, hereinafter referred to as ‘P.D. Cameron, “Stabilization”’. Please see for detail, P.D Cameron, Property Rights and Sovereign Rights: The Case of North Sea Oil (London: Academic Press, 1983).
65 France nationalized almost half of industrial production from 1944 to 1948, see K. Katzarov, Supra note 68 at 42-43.
67 Supra note 14 at 154.
68 Supra note 17 at 2.
69 Ibid.
agreements\textsuperscript{71} and it was estimated that this would ‘cost the government nearly USD 10 billion in lost royalty revenues... ’.\textsuperscript{72} There was a huge debate in the American Congress about whether go back and change the original contracts. Some Republican politicians argued that ‘...those leases are binding contracts that cannot be changed except through an agreement by the companies’.\textsuperscript{73} On the other hand. Democrats ‘acknowledge[d] that the contracts are binding, but support[ed] a measure that would punish companies that refuse[d] to renegotiate their contracts by prohibiting them from acquiring additional oil and gas leases’\textsuperscript{74} Despite this debate, the U.S. House of Representatives agreed to renegotiate the original petroleum leases in 2006.\textsuperscript{75} Regarding this issue, the US Department of the Interior Mineral Management Service [MMS] proposed the Form MMS-2005 legislation. Regarding the Form, the six industry trade associations\textsuperscript{76} argued that ‘[t]he possibility that prospective legislation and regulations could result in unilateral amendment of an existing contract by the lessor would greatly diminish the certainty between the parties and would undoubtedly impact the monetary value of such OCS leases... This risk of unilateral lease amendment by the government is a new and inappropriate contract risk...’ They rightly argued that it might cause a unilateral change of contracts, which would mean that it was an indirect expropriation. As this event happened in the U.S., it could fairly be said that ‘the United States itself may be considered to present somewhat of u political risk’.\textsuperscript{77}

Following this, IHS Energy Group has compared overall political risks in two countries. According to MS, overall political risks in Norway and Nigeria have an equivalence of around 1.7 in Hallmark’s model.\textsuperscript{78} But, when we focus on sub-categories of political risks, which are war, political unrest, violence and stability, in Nigeria the political risk index goes up to around 3.6. By

\textsuperscript{72} Ibid.
\textsuperscript{74} Ibid.
\textsuperscript{75} P.D. Cameron, ‘Stabilization’, supra note 10 at 21.
\textsuperscript{76} The American Petroleum Institute (API), the National Ocean Industries Association (NOIA), the Independent Petroleum Association of America OPAA), the United States Oil and Gas Association (USOGA), (he Domestic Petroleum Council (DPC), and the Offshore Operators Committee (OOC).
\textsuperscript{77} Supra note 17 at 2.
\textsuperscript{78} In this model, political risk can be ‘rated from zero to five. Zero represents a risk-free zone, whereas a rating of five represents an extremely high risk zone. For further details about Hallmark’s model see L. Bossley, (MS Energy Group), supra note 29 at 33.
contrast, Norway’s goes down to just over 1.0. If we consider only overall political risks to exploration and production in petroleum, Norway and Nigeria have a similar overall rating. In addition to this, IHS further argues that Norway has very harsh legal and fiscal terms compared to Nigeria.\textsuperscript{79} ‘What that means is that if a company can work and manage the high level of political risk in Nigeria, it will do much better financially than in Norway, where political risk is minimal’.\textsuperscript{80}

Another issue is the political system. Many developing counties do not uphold the principles of democracy. For instance, in the early 1990s, many former Russian countries chose democracy but so far it is not a proper democracy.\textsuperscript{81} Middle Eastern countries are mostly governed by kings or sultans. Is it possible to argue that, political systems may create political risks?

It is a bit difficult to argue that political risk results from the political system or political ideology itself, though the political system may affect the property rights of international investors. However, international investors invest their capital and operate ‘successfully under all types of political systems, be they Marxist, capitalist, nationalist, socialist, monarchy or democracy’.\textsuperscript{82} Political risk usually comes into existence following ‘changes to the political and socio-economic conditions of the host country from those that existed at the time the agreement in question were originally entered into’.\textsuperscript{83} Changes in the political system or ideology may increase conflict between parties. For example, the new ideology or system may argue that the former system’s originally negotiated agreement did not protect the host state’s interests well enough. Further, the new system may insist that the original agreement should be terminated or renegotiated to get a ‘fair’ agreement.\textsuperscript{84} For example, it may be said that the communist system is a worse system with respect to the protection of private property rights.\textsuperscript{85} However, if the system has entered into an

\begin{thebibliography}{99}
\item\textsuperscript{79} ‘Norway’s ranking is 84th out of ninety-three countries, while Nigeria ranks 37th’ in L. Bossley, (IHS Energy Group), \textit{supra} note 29 at 33.
\item\textsuperscript{80} \textit{Supra} note 29 at 33.
\item\textsuperscript{81} See, N. Ante-lava, ‘People Power Forces Changes in Bishkek’, BBC News, available at: http://news.bbc.co.uk/2/hi/asia-pacific/6133350.stm (Visited on 20 December 20014). ‘... the region where political change is so often violent, and where democracy is, at best, a distant concept. The last time an anti-government demonstration was held in Uzbekistan in May 2005, hundreds of people were shot by the government troops in the city of Andijan. Two opposition leaders have been killed in Kazakhstan in 2004 alone; in Tajikistan, President Rakhmonov has’ just been re-elected for his third term in an election widely condemned by the international observers. And in Turkmenistan there simply is no opposition.
\item\textsuperscript{82} \textit{Supra} note 17 at 2.
\item\textsuperscript{83} \textit{Ibid}.
\item\textsuperscript{85} According to capitalist ideology.
\end{thebibliography}
agreement with an international company, the system generally will protect the agreement itself because the system has signed the contract. Generally speaking, it is in the nature of politics that a new political party or system does not like the work of the former party or system, because the new one believes that it will do better than its predecessor.

The major oil-producing countries Venezuela is the second most democratic state and Saudi Arabia is the most undemocratic state. However, nowadays, political risk in Venezuela is much higher than in Saudi Arabia. The relations between the United States and Venezuela are very tense at the moment. This may cause very high level political risk for American investors in this country. Another country which has a high level of political risk for international energy investors is Russia. Russia is the fourth most democratic state. Yet due to political developments investment in this country is an extremely risky endeavour.86

In short, as the above examples show,’... developed countries can pose significant political risks for energy investment. A well-developed system of laws, a solid judiciary, and an established legislative process are valuable but do not guarantee contract stability’.87

10.5 Historical Analysis of Political Risks to International Energy Investments

Political risk in international investment is as old as international investment itself. Pre-World War II, state interventions in different sectors of the economy occurred.88 One of the greatest risks that international energy projects have faced in the past is that of nationalization by host states. In the twentieth century, international investors were exposed to considerable political risks and a large number of international investments were nationalized. In 1918, in the Soviet Union, the energy industry faced the first major expropriation of international petroleum’

87 Supra note 70 at 13.
88 S. Rabiee, ‘Protection of Foreign Investment: the Development of International Law and Contribution of the Iran-United States Claims Tribunal’, Unpublished PhD Thesis, Universityof Exeter, 1991, 9. ‘In the nineteenth century many governments took large-scale economic initiatives such as the taking over of the railways by Belgium in 1834, by Germany in 1871 and in Russia in 1881. State interventions also occurred in the areas of banking, maritime traffic and insurance.’ K. Katzarov, supra note 64 at 30 cited in S. Rabiee, supra note 88 at 9, n. 3.
After the first experience of expropriation in the energy sector, several expropriations followed, particularly in developing countries such as Brazil in 1930; Mexico in 1938, Bulgaria, Czechoslovakia, Hungary, and Poland between 1945 and 1948, Bolivia in 1952, China in the 1940s and ‘50s, Egypt in 1956, and Cuba in 1959. Other nationalization occurred in the Middle East and Africa during the 1950s, ‘60s, and ‘70s.

Particularly after World War II, the main concern of investors was the risk of nationalization. The concern was real because most of the oil concessions were nationalized by their host states, such as Iran, Syria, Algeria, Iraq, Libya, Venezuela, Kuwait, Qatar, Saudi Arabia, etc.

Seven major international oil companies, known as the ‘Seven Sisters’- Exxon, Shell, British Petroleum (BP), Gulf, Mobil, Texaco, and Social – controlled almost all of the world’s petroleum industry at the beginning of World War II. Mikesell described this oligopolistic situation in 1971, noting, ‘...no important petroleum export industries exist in developing countries that are not operated by foreign firms’.

The picture shows us clearly that international companies

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92 S. Wallace, supra note 13 at 68, ‘Nationalization took on several forms In Iraq and Iran, the entire concession was nationalized. In Libya and Nigeria, only selective foreign concessions were nationalized whether for international political reasons or otherwise.’ see A.J. Boulos, ‘Assessing Political Risk’ supra note 10 at 5.

93 King & Spalding Law Finn, supra note 88 at 3.


95 R.F. Mikesell, Supra note 94 at 11.
controlled almost all exports of petroleum before 1970. But, around 1970, the picture of the international petroleum industry radically shifted in favour of producer states, thanks to the landslide nationalization in the energy industry. 96 Put differently, during the 1970s, at least eighteen states nationalized petroleum production and these nationalizations were equal to 74% of international petroleum production in 1970.97 Multinational oil companies have now lost their dominant position in the oil production industry.98 As shown in the table below, today, most petroleum companies in developing countries belong to states. State-ownership is generally 100%.

97 S.J. Kobrin, supra note 89. See also V.S. Mehta, supra note 654.
98 V.S. Mehta, supra note 94.
Table 10.3. The world’s 50 Largest Oil Companies

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<thead>
<tr>
<th>Rank 2005</th>
<th>Rank 2004</th>
<th>PIW Index</th>
<th>Company</th>
<th>Country</th>
<th>State ownership (%)</th>
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</thead>
<tbody>
<tr>
<td>1</td>
<td>1</td>
<td>30</td>
<td>Saudi Aramco</td>
<td>Saud Arabia</td>
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99. ‘PIW’s ranking of the world’s 50 largest oil companies is based on operational data from over 130 firms. The focus on operations allows meaningful comparisons of all types of companies—including state-owned firms—and thus differs from more financially oriented corporate rankings. PIW’s unique system uses as criteria oil reserves and production, natural gas reserves and output, refinery capacity, and product sales volumes.’ See Energy Intelligence,’ PIW Ranks the World’s Top Oil Companies’, available at: Kwww.energyintel.com/Document Detail.asp?document_id=137158 (Visited on 15 December 2014).
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[NOC, Iraq National Oil Co. now part of Ministry of Petroleum. † Marathon data include all of Marathon Ashland LLC, in which marathon has a 62% stake. PDV=Petroleos de Venezuela, NOS=National Iranian Oil Co., KPC=Kuwait Petroleum Co., Adnoc=Abu Dhabi National Oil Co., NNPC = Nigerian National Petroleum Co., EGPC=Egyptian General Petroleum Corp., ONGC=Oil and National Gas Corp., PDO=Petroleum Development Oman.

Source: Energy Intelligence Group, Inc.100

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Following the nationalization period, political risks for international energy investors became major issues in deciding about investments in developing countries. Energy investors, for political risk reasons, avoided countries with a history of, or types of government that might favour expropriation. Although international law holds that expropriation required the payment of adequate, prompt and effective compensation, this principle is not universally accepted.\(^\text{101}\) Furthermore, ‘as a practical matter, it can be very difficult to force a sovereign state to provide effective compensation for an unprotected investment’.\(^\text{102}\) Therefore energy investors wanted to invest only in those countries where the risk of expropriation was deemed to be relatively low. Having said that, IHS Energy Group argues that, ‘... the oil industry has not been scared away from any region by high political risk’.\(^\text{103}\) As we have seen above, most energy resources are geographically located in developing countries, that is, in unstable countries, and most states in those geographical regions have not got enough legal and political stability to protect investments from political risks. Postponement until political stability is in place may be an option\(^\text{104}\) but it is not a good option. For that reason, international energy investors ‘... are prepared to accept considerable political risk, if the potential reward is sufficiently attractive’.\(^\text{105}\)

What reasons have triggered the nationalization of international investments in the twentieth century? Several major factors - ‘the winds of change’ influenced host governments to interfere with the activities of international energy investors. Several radical changes in world politics affected the policies of most nations towards international energy investment. The reasons behind the nationalization of property are not only political, but also contain many non-political factors.\(^\text{106}\) These factors are social and economic.\(^\text{107}\) It is beyond the scope of this study to examine these social, economic and political factors in detail, but dealing with them broadly may be helpful to an understanding of the nature of political risk.

\(^\text{102}\) *Ibid.*
\(^\text{103}\) *Supra* note 29 at 33.
\(^\text{107}\) For further information see K. Katzaro, *supra* note 64 at 1-19.
First, the twentieth century witnessed the spread of capitalism and of ‘collectivist ideologies’ such as socialism and Marxism. After the revolution of the Soviet Union, many developing countries have followed the idea of collectivist ideologies. These ideologies also played a role in nationalizations in non-Communist countries. Comeaux and Kinsella point out that, ‘collectivist ideologies have controlled much of the developing world, combined with various political clashes and “misunderstandings” between the developing and developed world, [which] has lead to massive nationalizations and confiscations of the property of Western investors’. They use a quotation from Fidel Castro to illustrate the attitude of collectivist ideologies as follows: ‘We’ll take and take until not even the nails in their shoes are left. We will take American investments penny by penny until nothing is left’. The major event that alerted the industry to political risk was the Mexican nationalization of the international petroleum companies in 1938. The reason behind this nationalization was Marxist philosophy.

Second, host states were highly reliant on their energy industries for their economy. States did not want to lose control of this main industry because they were highly dependent on it ‘as a proportion of both government... revenues and Gross Domestic Product (GDP). Brownlie has clearly indicated why some countries pay great attention to the energy industry. In Brownlie’s words:

…. some countries with more than 90 percent of their income from one single industry, e.g., oil or copper cannot, if they are free of coercion, leave important decisions as to the pace of production, pricing, marketing, selling, etc. to a foreign corporation unfamiliar and maybe uninterested in national policies of the State concerned. This has to be viewed against the background that it is always admitted that the alien is considered as a visitor who as such has a

108 Main difference between collectivist ideologies and capitalism is the respect for the property rights of individuals. P.E. Comeaux & N.S. Kinsella, Protecting Foreign Investment. (Oceana publications inc dobbs ferry, new york.1977).
109 G.M. Ingram, Expropriation of U.S. Property in South America: Nationalization of Oil and Copper Companies in Peru, Bolivia, and Chile. 2 (New York: Praeger Publishers, 1974). See also. I. Brownlie, Principles of Public International Law, 6th edn, 508 (Oxford: OUP, 2003), 508, “[a]fter the Soviet revolution and the extension of the public sector in many economies, both socialist and non-socialist, the conflict of interest between foreign investors and their governments and the hosts to foreign capital, seeking to obtain control over their own economies, became more acute.”
111 Ibid.,
112 A.J. Boulos, ‘Assessing Political Risk’, supra note 568 at 4; See also G.M. higram, supra note 667 at VIII.
113 IMF, Opec, Global oil gas risks and rewards cited in O. Rewane, supra note 12 at 7-8.
duty to submit to the local law and jurisdiction and that the control and regulation of persons and assets is an aspect of domestic jurisdiction of a State and an incident of its sovereignty and independence in the territorial sphere.114

Host states relied upon petroleum to subsidise the economy, and for that reason, the industry was highly ‘“susceptible to being threatened by expropriation’.115

The third reason is that the colonial system has ended and newly independent nations wanted to take control of their natural resources,116 particularly energy resources. During the colonial period, it can be said that political risks to international investors were almost non-existent due to the exercise of military power.117 Since the end of the colonial period, ‘the consequent emergence of economic nationalism and the absence of protection through the exercise of military power and the diplomatic support have greatly increased the risks to foreign investment in the modern world’.118 In Wilkin’s words, ‘following a post-colonial declaration of independence, a civil war, or a takeover by a left wing government, a country would announce the confiscation or nationalization of foreign investors’ properties, usually accompanied by rhetoric about exploitation and national sovereignty’.119 National sovereignty gave the right to sovereign states ‘to change their laws, policies and regulatory systems for developing these resources, thereby increasing the risks to foreign investment’.120

As a result of the decolonization process, many independent states were created. They started a struggle to gain dominance economies and sought to achieve this, as far as energy is concerned, by expropriation or unilateral termination of the rights and assets of the international energy companies.

115 G.M. Ingram, supra note 109 at 4.
116 Somarajah. Foreign Investment, supra note 45 at 18-30 and 75-77.
117 Rewane, supra note 512 at 2.
118 Ibid.
119 S. Wilkin, ‘Managing today’s Political Risks’, The Risk Management Letter'It, no. 6 (2001): 1, 2. Wilkin gives us some statistical information related to the post-colonial period. ‘A number of academic studies have unearthed almost 2,000 cases of these types of events virtually all prior to 1980. Other academic studies estimate that between 15% and 20% of all US foreign direct investment was lost to expropriation during the 1970s.’
120 Rewane, supra note 12 at 16, 1.
The fourth k as on is connected with the third reason given above, the end of colonialism, which coincided with a United Nations Resolution in 1962 on Permanent Sovereignty Over Natural Resources (Resolution 1803). The resolution recognized the right of all states to dispose freely of their natural wealth and resources in accordance with their natural interest and in respect for the economic independence of states. Many producing countries had relied on the principle of the state’s sovereignty over its natural resources, that is, the inherent and overriding right of a state to control and dispose of natural wealth and resources in its territory for the benefit of its own people, to justify their interfering with concessions. Although the legal binding force of UN resolutions remains a controversial issue, many states acted along the lines of the resolution. In addition to establishing permanent sovereignty over natural resources, many petroleum producing states cooperated with each other and set up the Organization of Petroleum Exporting Countries (OPEC). Until OPEC’s establishment. It, petroleum producing countries had little, perhaps no, power over petroleum production. After the establishment of OPEC, Member States of OPEC started to put pressure on international investors to change or revise their original agreements through Resolutions such as OPEC Resolution XVI in 1968. This resolution formally called for renegotiation for existing concessions on the basis of changed circumstances. Several declarations have been made following this one. According to them, 'member states of OPEC were enjoined to have increased participation and complete control in the exploration, exploitation and development of petroleum resources in their domain by the year 1983.

The fifth reason relates to differences in objectives. International investors and host states have different aims when they are making investments. The common objectives of the

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122 However, at the same time the resolution, guaranteed that ‘nationalization, expropriation or’ requisitioning shall be based on grounds or reason of public utility, security or the national interest which are recognized as overriding purely individual or private interests, both domestic and foreign. In such cases, the owner shall be paid appropriate compensation in accordance with the rules in force in the State taking such measures in the exercise of its sovereignty and in accordance with international law’, see Art. 4 of the Permanent Sovereignty over Natural Resources, G.A. res. 1803 (XV), 17 U.N. GAOR Supp. (No.17) 15, U.N. Doc. A/5217 (1962). Also, customary international law allows nationalization of property under the same conditions. The principle has been confirmed in many bilateral treaties for the promotion and protection of foreign investments and in the 1994 European Energy Charter Treaty. See also the ‘Declaration on the Establishment of the New International Order’, Resolution of May 1, 1974 and the ‘Charter of Economic Rights and Duties of the States’, Resolution of 26 Jul. 1974. See Permanent Sovereignty over Natural Resources, G.A. res. 1803 (XVII), 17 U.N. GAOR Supp. (No.17) 15, U.N. Doc. A/5217 (1962).
predominantly profit motivated international energy investors, interesting in maximizing their investment at the least risk, can be listed as:125

- Investment security against political risks;
- a return on the investment;
- ‘freedom of operation for the management to earn a return on the investment’;
- ‘freedom to remit the original investment, together with any return of that investment...’;
- ‘freedom to remit payments in hard currency for any know-how, patents, trademarks, and other industrial and intellectual property and services which have been provided to the new venture’.

Host states, on the contrary, of course focus carefully on the use of investment to develop their energy resources in order to strengthen their economies and improve their population’s well-being.126 While international energy investors seek legal and political security, and stability for their investment, host states may change their minds regarding the terms of an investment agreement. There are many reasons why states may change their mind.127 For example, the economic return and quality or quantity of the resource reserve may turn out to be very different from earlier predictions on which the original agreement was based. Also, energy market prices are unpredictable so prices may exceed the levels originally contemplated. Besides, the techniques of production may be improved and the profitability may increase more than expected.128 In light of such changes, host states may want to receive more rent/royalty or share than the agreement allows and then they may begin to interfere with the original agreement, using several methods.

As a result, the different objectives between the parties and ‘[t]he complex nature of energy contracts offers an infinite variety of ways for host governments to disrupt financial returns and destabilize a project’.129 This difference in objectives can be considered as one of the main reasons for expropriations. The last reason is the type of investment. In the past, most energy investment

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125 See for further details, T.C. Drucker, supra note 59 at 108; and also A.J. Boulos, ‘Mutuality of Interests’ supra note 112 at 13.
127 See, T.W. Waelde & G. Ndi, supra note 33 at 225.
128 Ibid.
129 M. Flores, supra note 104 at 147.
agreements were concession contracts. In order to understand concession agreements, it is worth quasiung from O’Connell and the Petroleum Economist: a concession always involves a more or less complicated system of rights and duties between the concessionaire on the one hand and the state on the other. This relationship is one of mixed public and private law.

Their principal features were long durations, usually 60 to 70 years. Large areas of territory covered, sometimes amounting to the whole of a country, and payment of a fixed royalty... But most significant of all, once oil had been found, they gave the companies the power to determine how much should be produced and at what price it should be sold. It was against these two factors that the governments of producing countries expressed growing dissatisfaction and it is here that the new types of agreements differ most from concessions.

The main characteristic of oil concession agreements is that states are involved in the agreements. In many concession agreements, concessionaries were granted extensive rights for long periods. In many cases, the agreements ran for fifty or sixty years or more. Almost 100% of investment ownership was by international companies. While concession agreements provided international investors with extensive rights, privileges and exclusive appropriation of petroleum profits with small royalty payments and few other obligations in return, the host states rights were at a minimal level.

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133 Some authors, like Comeaux and Kinsella, believe that concessions contracts are subject to International law. They argue that if one of the parties is a state in a contract, the state makes the relationship subject to international law. See for further details P.E. Comeaux- & N.S. Kinsella, ‘Reducing the Political Risk of Investing in Russia and other C.I.S Republics: International Arbitration and Stabilization Clauses’, Russian Oil & Gas Guide (1993) 2, N6 2, 21, 21, hereinafter referred to as P.E. Comeaux & N.S. Kinsella, ‘Reducing the Political Risk’.
136 A. Sampson, the Seven Sister (New York: Bantam Books, 1976), 162, cited In S.J. Kobrin, supra note 89 at 141.
137 S.A. Zom, ‘Unilateral Action by Oil-Producing Countries: Possible Contractual Remedies of Foreign Petroleum-Companies’, Pordham mt’l L. J. 9, 63, 67(1986).

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Why did states sign such heavy condition concession agreements and why did host states create political risks after signing a contract? We can make several assumptions about why they signed this type of contract. The first reality is that most of the concession agreements were signed by states under the rule of colonial administrations.\(^{138}\) In order to understand why colonial states signed these burden some agreements we must start with the meaning of colonialism: ‘... meaning the annexation and direct government of one country...’\(^{139}\) by another. The author believes that there is no need for further comment. Naturally, the imperial power focuses on its own advantage rather than that of the colonial state.\(^{140}\) Colonial states have been dominated by colonial powers from Western countries,\(^{141}\) and therefore, it has been difficult for them to refuse to sign a contract or change the clauses of a contract. It will be interesting to discuss whether states under colonial power can legally sign a binding contract or not. Put differently, they may or may not have the legal capacity. If they can, another question arises over ‘whether concessions contracts are in the nature of property rights’.\(^{142}\)

Similar things are happening in the twenty-first century. In Iraq, several energy contracts have been signed by ‘the first elected (or selected) government’ or by ‘the unenlightened government’ between Iraq and international companies following the invasion by the United States and the United Kingdom. Two important things come to mind: first, whether the contracts signed under the shadow of weapons are legally binding or not. Second, the contract may be signed to thank the United States for rescuing Iraq from the Saddam regime. It is worthwhile thinking about how long this period of gratitude will last. If the next elected government is not happy with these contracts, what will happen then? There is a very short answer; it is quite possible that the agreement will be renegotiated, terminated and/or expropriated;


\(^{140}\) M. Sornarajah, Foreign Investment, supra note 603 at 75-76; B. Sen, supra note 138 at 5.

\(^{141}\) B. Sen, supra note 138 at 5.

Another important reason that states have signed heavy concessions agreements is that developing states, particularly newly independent states, did not properly realize the effect and/or the consequences of these agreements. It can be said that they did not have enough knowledge of international law and international contract law. On the other hand, Kolo and Waelde point out that such a view can hardly be defended now with increased globalization, maturity and sophistication of most host governments. They further add that states which have not got enough knowledge to sign sophisticated contracts may employ independent experts to get advice on negotiations with international investors. A similar view was expressed by a distinguished energy lawyer in the USA; he said if countries that have not enough knowledge of international law and contract law hire me, I can fight for them. This is a clear point; however, the author has some reservations about the above view. This is not always the case, whether because of the matter of cost or other reasons. The following may be an extreme example, but it is worth noting here. A senior officer in a state-owned energy company, of course in a developing country, recently said that when they enter into a contract they do not get any help from a lawyer. The contract is signed by a senior officer of the state company with an engineering background. But, once a dispute arises, they look to a lawyer who is an expert in energy contracts. However, international companies employ armies of lawyers to assist with all this legal work. As a result, this author cannot see a significant difference between a contract signed by an adult and a child, and a contract signed by an international company and a newly independent state.

The third reason is that almost nothing inhibits the contract maker, a king, a sultan or a competent authority, in developing countries from entering into a contract when the contract maker is content with signing the contract. Behind the reason for this support may be corruption,

144 Ibid.
145 Partner in one of the leading law firms. Interview in Houston in April 2008.
146 Senior Director of a gas firm in a developing country. Interview in May 2006.
147 The late twentieth century, former Russian (Soviet) courtiers entered into several energy Agreements, mostly concession agreements, just after they gained their independence from the Soviet Union.
149 Flores clearly notes that ‘corruption is still a problem in many countries around the world. Corrupt government officials often siphon investment revenue away from legitimate government programs and instead use the revenue for self-enrichment or to fund military activities. Corruption is a complex problem that is
bribery or the buying of army equipment illegally, etc. While the top official of the state may siphon off money from investors for his own use, the investor may only think of it as an investment. For example, one author argues that bribery may be used for the avoidance of political risk. In his words:

Another form of loss control falls in a moral, ethical, and legal gray area - bribery. Some observers might consider bribery of top officials in the most powerful political parties in some countries as a form of ‘loss control’ or ‘avoidance.’ This observation is not entirely impertinent. For obvious reasons, the practice is not easily documented but doubtlessly exists. There likely are companies that set aside funds for such purposes, though they may list these expenditures as ‘political’ or ‘campaign contributions’. It is not unusual for companies to set aside funds for ‘costs of doing business’ in certain countries. ‘Baksheesh’ is an accepted mode of exchange in many countries for greasing the wheels of an otherwise sluggish bureaucracy and for getting things done.\textsuperscript{150}

Quinley mentions in his work that this unethical method may be used for preventing political risk. If international investors use this method to sign a burdensome investment agreement, is it acceptable to anybody who has a strong business ethic? Due to the fact that energy investment contracts are generally billion dollar contracts, it is therefore easy to pay a couple of hundred thousand or a million to the contract maker or a top officer or a leader of a political party to make a contract.\textsuperscript{151} In contrast, a contracting party in a developed state usually has much greater inhibitions in this matter, and this can prevent them from making a contract on the sort of terms that might be more possible in developing countries. Now if the host state enters into an agreement thanks to unethical ways, that is, bribery or ‘baksheesh’, should or must the state honour the

\textsuperscript{150} K.M. Quinley, supra note 1 at 5.

\textsuperscript{151} For example, recently, there was a serious allegation that Halliburton, ‘one of the world’s largest providers of products and services to oil and gas industries’, was paying more than 170 million dollars of bribes to win 7 billion dollars of building contracts. Please see for further detail B. Sergeant, ‘Nigerian Bribery Scandal Takes on New Twists’, Alexander’s Gas and Oil Connections Online Journal 11. no. 16 (2006), available at, <www.gasandoil.com/g6c/company/cna63421.htm>, (visited on 15 December 2014). After serious investigation, “[a] former colleague of the US Vice-President, Dick Cheney, has pleaded guilty to funneling millions of dollars in bribes to win lucrative contracts in Nigeria for Halliburton, during the period in the Nineties when Mr Cheney ran the giant oil and gas services company.” See S. Poley, ‘Cheney Colleague Admits Bribery in Haliburton Oil Deals’, The Independent, 4 Sep. 2008, available at: www.independent.co.uk/news/world/americas/cheney-colleague-admits-bribery-in-halliburton-oil-deals-918133.html,( Visited on 20 December, 2014).
agreement? Therefore, lawyers who design international energy investment contracts to protect investment take these realities into account and devise contracts with flexibility in order to reduce conflict.  

Valera has strongly argued that any new political system or government 'must honour the legislative and contractual commitments and obligations of previous regimes'. This seems to the author to put the point too strongly, because, as has been mentioned above, concession contracts, particularly of the old type, were concluded usually on 'inequitable' terms:

The question of treatment of these concessions has become an important issue after decolonization. The international law commission, while dealing with the law relating to succession in respect of treaties, did not endorse the thesis put forward by some jurist that there was a presumption that a newly independent State consented to be bound by any treaties in force with respect to its territory. The commission held that, in accordance with the principle of self-determination, which was an important Charter principle, (tabula rasa) the clean slate rule was applicable in the matter of succession to treaties. It might "be asked whether the same rule should not be applicable to concession contracts concluded with the foreign concessionaries before new states attained independence. 

Therefore, we may say that states ‘should’ honour the commitments of the previous system but not ‘must’.

The last, but not least, reason is weak bargaining power. It is generally assumed that, before investments start international investors have more bargaining power than host states, whereas after investment takes place, bargaining power shifts in favour of the other side. This assumption seems to the author to be right, as before, investment takes place, states have not got

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153 J.L. Valera, supra note 32 at 22.
154 S.C. Jain, supra note 142 at 18.
155 Ibid.
156 World Economic Forum has published the Global Competitiveness Report. According to the report, ‘the governments of Ukraine, Russia, Ecuador and Hungary are among the worst offenders in failing to honour the commitments of their predecessors’; cited In S. Wilkin, supra note 119 at 4.
157 This general assumption is not always true.
definite ideas about the presence of petroleum deposits, and they have not got enough knowledge and capital to operate energy investments themselves. Host states therefore most strongly need international investors at this time. This need gives more power to the investors. Because of weak bargaining power, the host state avoids asking for more rights during the negotiation of the contract. The stronger party may lead the weaker party to make a contract only on terms dictated by the stronger party.159 Indeed, as a result of weak bargaining power host states may not get a ‘fair’ share in the contract during the original negotiations. So, it could be described as a ‘win-lose’ agreement rather than a ‘win-win’ style agreement.

However, after the investment takes place and if the investment is successful in discovering and developing resources, the bargaining power shifts to the host state. Since the international investor has by now sunk a large amount of capital into the investment and has to protect its property rights, it is not easy to leave everything behind and go back home. When the balance of power shifts in favour of the host states, these states find themselves able to change or revise the "unfair" contract to meet their own needs.160

Cameron has summarized the concession agreement, as follows:

Initially, the host government transfers rights through the license to oil companies on terms based on poor knowledge of the territory. At this stage, the presence of petroleum deposits in commercial quantities may be suspected but cannot be known for certain. From the moment petroleum is discovered in substantial quantities, the host government will appear disadvantaged through the agreed terms. From that time its role may appear too passive to its own citizens. It will, for instance, probably lack the power to initiate development of the field. As a result of discovery the government will come under increasing domestic pressure to initiate renegotiation or revision of the license terms.161

In order to get a fair share of profit, states may be pushed by citizens of, the country towards a revision of the contract. After that, states seek ‘direct participation in oil production through

160 There might be a debate that the question of what is or is not ‘fair’ is an extremely subjective determination.
formal expropriation and contract renegotiation...\textsuperscript{162} by doing this, host states attempt to obtain strategic control over their national assets or resources.

The relationship between states and oil companies has thus evolved from concession to participation, the role of states from passive rent collector to active partner, and the financial benefits to governments from simple royalty to equal profit sharing, income tax and other revenue-sharing arrangements.

\textbf{10.5.1. Today’s Political Risks}

“The ending of the twentieth [c]entury and the beginning of a new era... have brought the issues of political risk into focus in a different setting than [in the] earlier days of the international oil and gas industry”.\textsuperscript{163} The twenty-first century’s political risk is as critical as the risk of the last century.\textsuperscript{164} Political risk still plays a major role in today’s investment decisions in international energy projects.\textsuperscript{165} In this century, some types of political risk, such as expropriation or confiscation, are no longer a major problem\textsuperscript{166} in the energy investment business because conditions for international energy investment are totally different now than they were in the past.\textsuperscript{167} During the twenty-first century, as compared with the twentieth century, a relative decrease in political risk (particularly expropriation) can be seen.\textsuperscript{168} In last a couple of decades a small number of expropriations took place. For example, ‘in 1975 there were eighty-three cases of expropriation. From 1981 to 1992... There were no more than 11 such cases’.\textsuperscript{169} So, is it possible to argue that political risk was a major problem in the past and not any- more?\textsuperscript{170} In order find out the answer to this question the following question was posed to the survey respondents:
More than half of the respondents felt that expropriation risk is more likely today than in the past. By contrast, around 25% of the respondents thought that it is less likely than in the past. Less than 20% thought that the same level of risk exists today. Interestingly, just around 2% of the respondents said that expropriation is not a risk any more in this century. According to these results, the answer to the above question is ‘greater’: today political risk is still one of the major problems for international energy investors but probably in slightly different forms. A survey conducted by AON Corporation revealed that:

Only 21 percent of Fortune 1000 risk managers think their companies are well protected from political risk losses....AON’s survey also revealed that 86 percent of respondents thought political risks pose a moderate-to-great risk to their company. Almost one-quarter had sustained losses from trade risks, like embargoes. Almost one-fifth suffered losses from political violence, and 18 percent sustained losses from expropriation risks. Eighty percent of the survey’s respondents said it was important or very important to use disciplined tools to assess political risks, but only about one-fourth thought that their own companies had achieved this goal. Only 30 percent said they were comfortable with their company’s handling of political risks.\footnote{\textit{Supra} note 1 at 1.}

Globalization, the effects of international financial organizations, privatization, the types of investments being made, and a new political culture have affected the forms of political risk in the contemporary era.

The types of political risks that are most often faced today are government instability, changes in monetary and fiscal policy, and unpredictability in local tax and regulation regimes, including environmental and human rights - in short, indirect or creeping expropriations. Having said that, we should keep in mind that expropriation may take place again. The host state still has several mechanisms available for interfering with international investments. It might be useful to review the reasons for the changes in the nature of political risk today. There are a number of reasons for such changes.

For a start, globalization is one of the main factors. The world is becoming smaller and smaller, through globalization. Because of this trend, it is a bit unlikely that host states, especially
in developing countries, would expropriate an international energy investment.\textsuperscript{172} In today’s world, the World Bank, the European Investment Bank, the International Monetary Fund (IMF), and other multinational organizations are playing very important roles in the world’s economies.\textsuperscript{173} They tend to ‘lessen considerably a foreign nation’s exercise of the right to nationalize an oil concession of a foreign owner’.\textsuperscript{174} On the other hand, globalization comes along with some types of political risks such as terrorism, which are outside the.

Some argue that ‘[t]he physical lubricant of globalization is also a principal trigger of nationalism. This is the paradox of oil. It trades in a truly global market but strikes an essentially local chord. Its supply lines attract global attention but its acquisition is driven by national interest’.\textsuperscript{175} The paradox of oil may cause a domino effect leading to government interference. Globalization may cause nationalism or resource nationalism\textsuperscript{176} and then nationalism may cause nationalization.

The second important reason is that the objectives of expropriation have been mainly achieved. After the vast nationalizations in 1970s, host states took control of most petroleum resources. In today’s world, most petroleum companies in developing countries belong to the state. (As shown in table 2.3). ‘Even with State control, the emergence of privatization and market-oriented economies further neutralized the political risk of nationalization’.\textsuperscript{177}

The third reason is privatization. Boulos observes that ‘[p]rivatization changes the basis for nationalization; the State transforms National Oil Companies into private enterprises to compete in the market for international oil and gas ventures and obviates the need to nationalize foreign companies’.\textsuperscript{178} However, recently, Bolivia’s president, Evo Morales, announced that the country’s oil fields would be nationalized and taken out of the hands of private operators.\textsuperscript{179} This

\begin{footnotesize}
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\item \textsuperscript{172} Supra note 119 at 2.
\item \textsuperscript{173} A.J. Boulos, ‘Assessing Political Risk’, supra note 10 at 5.
\item \textsuperscript{174} Ibid.
\item \textsuperscript{175} V.S. Mehta, supra note 96.
\item \textsuperscript{176} For a full discussion on the history of resource nationalism, see P. Stevens, ‘National Oil Companies and International Oil Companies in the Middle East: the Shadow of Government and the Resource Nationalism Cycle’, Journal of World Energy Law & Business 1, no. 1 (2008); 5, 5-22.
\item \textsuperscript{177} Supra note 10 at 6.
\item \textsuperscript{178} Ibid., 5.
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forceful move from private to public management seems to go against the grain of the modern-day rhetoric of privatization. As one expert comments, privatization ‘... calls for the very stable and orderly framework for investment’.¹⁸⁰

Privatization may have some side effects. Generally, especially in developing countries, the main aim of privatization is that states dismantle uneconomic investments. In other words, states sell off economically inefficient state-owned companies to private investors. By doing this, they generate some amount of money for the state. Beside this reason, after a wave of nationalizations many states have some problems running nationalized investments because they are ‘burdened by excessive staff, appointed on the basis of political or family connections’.¹⁸¹ Two important things may occur after privatization, from the perspective of expropriation. First, for example, what if uneconomic investment(s) begins to make a big profit; what will a government’s reaction be to this? Some argue that it is this kind of profitable investment which ‘has been the most tempting target for nationalization’.¹⁸² Second, after privatization, what if ‘... the acquiring company would seek to recoup their investment by increasing the prices ...’¹⁸³ and the state does not allow this increase? On this point, we need a quotation from Smoots: ‘... no contract and no host country promises can save a privatization... deal that ignores fundamental economic realities. If the privatizing country is extremely poor, no matter what promises were made, increased price will either not be permitted or will not be paid to the acquiring company’.¹⁸⁴

Fourth, with regards to developing countries, many of these governments do not have large enough budgets to cover all major projects such as energy investments. So there is a very big race among developing countries to attract international investment to their countries.¹⁸⁵ In order to achieve this aim they are ‘... preparing specific laws and legislation and also... taking into consideration two main concerns about foreign investment, which are the legal and solid

¹⁸¹ T.C. Drucker, ‘supra note 617 at 111-112.
¹⁸² Ibid.
¹⁸⁴ Ibid.
guarantees of and incentives for these investments’. The violation of contracts with international investors heightens the political risk rating of the host state, thereby diminishing the rate of international investment flow into the country. It is not the threat of legal sanctions, but the risk of loss of reputation and credibility, which will prompt states to comply with energy arrangements if they are to encourage investment in their country.’ Given these circumstances, again from the perspective of developing countries, international investments are unlikely to be expropriated.

The last reason is the form of energy investments. The distinction can be made between so-called ‘traditional’ and ‘new’ types of energy investments. Concession agreements can be categorized as traditional agreements. Generally, the ownership of an investment is in majority or wholly foreign-owned subsidiaries. By contrast, production-sharing agreements represent new types of energy investments. As is frequently the case with production-sharing contracts, host states participate in projects and they secure control over the projects. This new type of agreement has a good ‘political image among developing’ countries’. Political risks and legal obstacles in the host country might be positively influenced by the percentage of equity capital sought by an investor.

In summary, because of the aforementioned reasons, host states may not interfere with international energy investments directly, that is, direct expropriation may not occur in today’s world. However, we should keep in mind the possibility of direct expropriation, because ‘resource nationalism’ and/or nationalistic, ideas may still pose a danger to international energy investors. For example, Bolivia’s president Morales recently claimed that nationalization will help him use his country’s resources for the benefit of his people. Another case of expropriation is the Chad-Cameroon oil pipeline, where the local government attempted to exercise strong-arm tactics.

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186 Ibid.
187 S. ‘Wilkin, supra note 119 at 2.
188 For general information on types of petroleum contracts, please see P.D. Camren, Petroleum Licensing, supra note 719 at 5-14. See King &Spalding Law Finn, supra note 649 at14-22. See also Y. Omorogbe, The Oil and Gas Industry Exploration & Production Contracts,58-70 (Lagos; Malthouse Press Ltd, 1997).
189 An investor who seeks all or the majority of the equity capital in a new venture is consequently referred to as a ‘traditional investor’. See T.C. Drucker, supra note 59 at 106.
190 Ibid. 106-107.
192 G. Monbiot, supra note 179; However, the developed world is sceptical and has already labeled this move as going against Bolivia’s development goals.
193 ‘The oil fields will be developed and operated under a 30-year concession by a consortium of
and go against certain pre-written agreements. However, aside from a few cases we do not expect vast expropriation in this century. Rewane has noted that:

> [e]ven though it is unlikely that a wave of nationalism will sweep across a vast area of the globe as it did during the post-war era, foreign investors should be aware that there is still an entrenched fear in some nations that a new period of economic dominance will be ushered in by an unfettered flow of foreign direct investment (FDI) and that the entry will see multinational corporations, backed up not only by their own economic strength, but also by the power of their home states, ushering in another period of subservience, at least in the economic sphere.

As noted above, straightforward seizure or expropriation by the host state may still occur in this century but states also may prefer the less dramatic strategy of ‘indirect’ or ‘creeping’ expropriation. Indirect expropriation yields results similar to direct expropriation but is less visible, if more insidious, than direct expropriation.

**10.6 Conclusion**

In this chapter we have examined political risks in energy projects in the past and today. The chapter examined the reasons behind the vast expropriations of energy projects in the past. It also looked at why expropriation has metamorphosed into creeping expropriation in today’s world.

Political risks act as a key obstacle or problem to international energy investment projects. As mentioned above, the characteristics of energy investments may escalate the creation of political risks. Lots of factors may create conflict between the international energy investor and the host state, as mentioned in the above sections. Conflict thus manifests itself in a variety of ways; such as,

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ExxonMobil, Petronas and Chevron. Two special purpose companies, TOTCO and COTCO, joint ventures between the oil consortium and the Governments of Chad and Cameroon, have been established to build and operate the transport component of the project, that includes a 1070 tan oil pipeline from the Doha oil fields to the Cameroon coast near Kribi, three pump stations, one pressure reduction station and an off-shore storage and loading facility. For further details about the Chad pipeline investment, available at: www.eib.org/news/press/press.aspx?press=116&style=printable>, (Visited on 18 November, 2014).

194 G. Monbiot, supra note 179.
195 Rewane, supra note 12 at 5

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- ownership and control of investments;
- sharing profits;
- the type of investment contract;
- new regulations;
- tax provisions;
- environmental protection;
- human rights.’

What will be likely to happen in this conflict situation? Insistence on a better contract or a ‘fair’ contract by the host state may result in unilateral termination of the contract, unilateral change, expropriation-including creeping expropriation-or adaptation.

Developed countries have a stable liberal democracy, an independent judicial system and a reliable protection of property rights.198 Because of these positive factors, political risks may be a minor concern for international investors.199 By contrast, due to lack of political and legal stability, international investors may not get an adequate protection of their investment in developing countries.200 It can be said that developing countries are more risky countries than developed countries. But it does not mean that political risks can only been seen in developing countries. There is no place in the world that is, tree from political risks.201 ‘The difference is one of degree’.202

Briefly, in Wilkin’s words: ‘... today’s political risks are not the classic risks associated with communist takeovers or post-colonial outbursts of anti-foreign sentiment. They are more subtle, arising from legal and regulatory changes, government transitions, environmental and human rights issues ...’203 and affect the value of international energy projects.

199 Ibid.
200 Supra note 32 at 18.
201 M. Foss, Interview in Houston on May 2008.
202 Supra note 1 at 2.
203 Supra note 119 at 7.
Finally, in reality, conflict-free agreement does not exist. Political risk is not wanted, no doubt about it. We have to admit that for a lot of reasons it cannot be escaped, but political risk can be minimized or managed.204

204 A. Kolo, supra note 3 at 3.