An Integrated Approach To International Energy Investment Protection

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Synopsis

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§ 1.01. Introduction.

[1] Stability and Sovereignty.

One of the fundamental challenges for international energy projects is to reconcile the desire of investors for *stability* with the desire of host governments for *sovereignty*. Recent headlines illustrate that the management of these competing interests is as difficult now as it has ever been. With respect to stability, today's international energy projects require unprecedented commitments of capital that can only be recovered over long periods and in accordance with precise contractual risk allocations. With respect to sovereignty, today's high energy prices, intense global politics and strong national energy companies are all encouraging host governments to seek improved benefits, adaptable contracts and increased control over their natural resources. These dynamics warrant an integrated approach that considers not only legal remedies but also pre-remedy protections designed to strengthen the contractual bargain.

[2] Traditional Focus on Legal Remedies.

Legal authors frequently approach the subject of overseas investment protection with a passion for discussing the exotic legal remedies available in the event of expropriation or material adverse change in host country law. After all, these are the "ultimate" disputes, calling for the maximum legal response to the worst-case damage. The legal weapons wielded in these circumstances are formidable and generally include the stabilization, governing law, dispute resolution and enforcement mechanisms available pursuant to the investment contracts, domestic laws and international conventions, on the one hand; and the rights and remedies of the investor under political risk or other insurance policies and auxiliary contracts, on the other hand.

[3] Recommended Focus on Pre-Remedy Protections.

However, protections that are practically capable of being invoked only after the lights have been turned off should not be the transactional lawyer's exclusive or predominant focus. Our experience on this subject has been concentrated on the risk analysis, structuring, drafting, negotiation and administrative phases of major energy projects, rather than on the aftermath associated with formal dispute resolution proceedings. In reviewing the legal literature on the subject, we are struck by how little attention is paid to the subject of pre-remedy legal protections, particularly the business incentives and practical considerations with which we and our clients regularly deal. Lawyers can play an important role in integrating all the means by which investors can protect themselves, prior to invocation of legal remedies, and against a much broader variety of threats to the integrity of their clients' bargains.

[4] Enhancing Value to Host Government of Respecting Bargain.

Transactional lawyers can best advance their clients' goals by helping them integrate a variety of economic, legal and above all *practical investor protections that also enhance the value to the host government of respecting the bargain implicit in the private foreign investment*. This phrasing may appear to be the polar opposite of the usual way the objective is expressed—as the enhancement of the value of the investment to the foreign investor. But we suggest that structuring the overall relationship in a manner that preserves the incentive of the host government to honor its commitments actually enhances the value of the investment to the international energy company.

[5] Due Diligence and Sustained Relationships.

To be sure, some of these practical investor protections involve crafting foundations for the possibility of ultimate exercise and enforcement of legal remedies. But the most effective shields against investment contests begin with thorough risk identification; prudent project selection and self-examination; deep and broad cultivation of key relationships with governments, communities, partners, contractual counterparties and insurers; and economic incentives for voluntary cooperation by those counterparties. Only after due diligence review, analysis and action are undertaken in each of these areas can the legal remedies be properly structured to compel such cooperative behavior, or at least to compensate for its absence.

[6] Scope and Approach.

This paper is not intended to cover in detail the myriad of legal principles and mitigation tools, but rather is designed as a general overview of an integrated approach to international energy investment protection. Section 1.02 begins with a discussion of the risks inherent in international energy projects and the need to examine and confront the so-called political risks. Sections 1.03, 1.04 and 1.05 discuss the respective roles that prudent project selection, long-term relationships, and incentives for stakeholder cooperation can play in mitigating political risks. Contract structures and clauses mandating investment support are discussed in Section 1.06, and legal remedies for deprivation of investment or breach of contract are discussed in Section 1.07. Section 1.08 concludes with a summary of the approach.

§ 1.02. Identifying and Evaluating Risks.

[1] Risks Generally.

Any significant investment decision, whether domestic or international, should be made only after a thorough identification and evaluation of project risks. Those risks are not limited to political risks. First, even in the absence of adverse political factors, all investments face *market risks*, such as changes in the demand, supply or price of inputs and outputs; changes in the interest rate, exchange rate or cost of equity capital; and the risks of credit erosion, illiquidity or default of the investor or the project counterparties. Second, investments face a number of *operational risks,* such as the prospect of casualties, liabilities, business interruption, delays or cost overruns, in each case relating to project engineering, procurement, construction, operation and maintenance.[2]

Third, *physical and logistical risks* associated with a host country or region can change ordinary expectations for an international energy company's role in a project. Substantial lack of or limited access to expected resources or markets may require additional investments and additional counterparties. For example, a resource extraction investment in a landlocked country may require the resource investor to also invest in transportation or other infrastructure projects. Thus, an investor in an oil and gas production project in Azerbaijan must consider whether also to become the proprietor or

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[2] *See* Ayaz R. Shaikh, Jane Wallison Stein, Todd Culwell & Philip J. Tendler, "International Project Finance," in Carole Basri, Ed., *International Corporate Practice* (forthcoming 2007) (manuscript at 25, on file with authors).

long-term operator of a railroad system, electric utility or export pipeline that may be essential means of transporting or supplying inputs and outputs.[3]

[2] Political Risks.

[a] Generally.

Finally, international energy companies must examine and confront the so-called *political risks*. Some authors narrowly define political risk as "the risk of governmental intervention."[4] But others note that non-governmental instability (e.g., insurrection or criminal activity) is an important exposure separate and apart from any actions a sovereign entity might take. And governments can act either across the board as to all industry participants, or with discriminatory impact on all foreign investors or on a particular foreign investment project.[5] Furthermore, an action regarded by one investor as discriminatory "intervention" may be perceived by other observers as intelligent "government," appropriately imposing differential treatment on differently situated parties.

For these reasons, this paper adopts a broad understanding of political risk to embrace a variety of *governmental and social impairments of the integrity of the commercial bargain represented by an investment contract*. This paper follows our law firm colleagues' useful breakdown of governmental political risks into four categories—expropriation, regulatory, contract and currency.[6]

[b] Expropriation Risk.

Expropriation risks of course include the formal appropriation of private property rights by returning them to the state or diverting them to another entity, in the absence of just compensation. Classic examples include the nationalizations of the oil industry decades ago across the current OPEC states; the Bolivian and Venezuelan actions of last year share many features in common.[7] Most contemporary concerns deal with "creeping" or "regulatory" expropriation, in which a combination of taxation, regulation and similar governmental acts substantially eliminate the value of the investor's stake. Regulations are emerging as the single most pervasive form of erosion of investment economics. Formal expropriation has become anathema for developing states; instead, indirect expropriation has become the "single most important development in state practice" for foreign investment integrity.[8] Governments may feel pressure to protect

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[3] As an extreme case one can consider Uzbekistan, one of the two countries on earth that are *double-landlocked*—entirely surrounded by countries that are *themselves* landlocked. (The other is Liechtenstein, which tends not to be mentioned in investment protection discussions!)

[4] Paul E. Comeaux & N. Stephen Kinsella, "Reducing Political Risk in Developing Countries: Bilateral Investment Treaties, Stabilization Clauses, and MIGA and OPIC Investment Insurance," 15 N.Y.L. Sch. J. Int'l & Comp. L. 1, 4 (1995).

[5] *See* Alan Berlin, "Managing Political Risk in the Oil and Gas Industries," 1 Oil, Gas & Energy L. Intelligence 2 (2003), at http://www.gasandoil.com. All online sources cited in this paper were visited and available on January 5, 2007.

[6] *See* Ayaz R. Shaikh et al., *supra* note 2, at 13, 63.

[7] *See, e.g.*, Daniel Yergin, *The Prize: The Epic Quest for Oil, Money & Power* 389 et seq. (1993) (OPEC nationalizations); Juan Ferero, "Bolivia Epitomizes Fight for Natural Resources," N.Y. Times, May 23, 2005; note 17 *infra* (Venezuelan actions).

[8] Rudolf Dolzer, "Indirect Expropriation: New Developments?" 11 N.Y.U. Envt'l L.J. 64, 65 (2002).

domestic industries or consumers, the environment, or public health, and may regulate to the point that an overseas investor claims an expropriation.[9]

Additionally, actions justified on environmental or similar police power grounds may be easy means of combating a deal that is economically disfavored without attracting claims of expropriation. "Governments 'have learned that more value can be extracted from foreign enterprises through the subtle instrument of regulatory control.'"[10] While Russian officials have denied an intent to use environmental concerns regarding the Sakhalin liquefied natural gas ("LNG") complexes as a means to revise the fiscal terms or obtain greater stakes for Russian companies, in fact Western investors responded by agreeing to such modifications.[11]

[c] Regulatory Risk.

The regulations typically issued by a host government may not eliminate the investment, but may nonetheless erode the expected returns in ways not anticipated in the parties' bargain. *Regulatory risk* in the investment protection context refers to state legislative or administrative agency actions having a discriminatory effect on foreign or private investment, notwithstanding the ostensibly public purposes of the lawmaking or adjudication.

[d] Contract Risk.

Contract risk in this context refers to the ordinary project risk of default or repudiation by a counterparty, as amplified by the circumstance of the contract counterparty's being a government instrumentality or local entity. In such a governmental setting, repudiations and declarations of unenforceability are more likely and raise a risk separate from non-performance of an acknowledged legal obligation. The Dabhol power project in India is a classic example of contract risk in international energy projects. Despite tightly structured project agreements, multilateral lenders and political risk insurance supported by a government guaranty, Indian authorities alleged that the agreements were unenforceable by virtue of fraud, corruption, misrepresentation and illegality.[12]

[e] Currency Risk.

Currency risk includes both the risk that the host country's currency is severely devalued or declared not to be convertible, as well as the risk that profits, loan repayments, return of capital or other distributions are prohibited from being transferred outside the host country. The risk of currency inconvertibility is the risk that due to acute foreign exchange shortages, either (i) the host country central bank lacks the foreign exchange to convert the local currency or (ii) the host country central bank actively

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[9] *See* Rudolf Dolzer, *supra* note 8, at 66.

[10] Witold Henisz & Bennet Zelner, "Managing Policy Risk," at http://www.ifc.org, manuscript at 1, quoting George Chifor, "Caveat Emptor: Developing International Disciplines for Deterring Third Party Investment in Unlawfully Expropriated Property," 33 L. & Pol'y in Int'l Bus. 179 (2002).

[11] *See* "After Sakhalin," The Economist, Dec. 16, 2006; "Yukos revisited?" The Economist, Sept. 23, 2006.

[12] *See* Shekhar Hattangadi, "Slowdown on India's 'Fast Track,'" Business Week, June 19, 1995, at 26; Gary McWilliams, Sharon Moshavi & Michael Shari, "Enron: Maybe Megadeals Mean Megarisk," Business Week, Sept. 4, 1995, at 52.

imposes exchange controls as a matter of monetary policy. The risk of nontransferability is the risk that the host country central bank will convert the local currency into foreign exchange on its books, but will not permit the transfer of such foreign exchange out of the host country.

International energy projects whose ultimate revenues are paid in local currency in the host country, such as power projects, are more vulnerable to currency risk than are projects whose revenues are paid in hard currency outside the host country, such as oil projects. Brazilian power projects notably faced currency risks due to the Brazilian government's currency controls and its prohibition on Brazilian companies denominating or indexing payments in currency other than the Real.[13]

[3] Political Risk Planning.

An international energy company's exposure to political risk is to a surprising degree within its control, at least at the point of the initial investment decision. Being sensitive to local norms, developing the right relationships, and demonstrating long-term commitment to a country all can reduce exposure to adverse governmental interventions. Even a foreign investor in a sector as strategic as the energy industry can anticipate political consequences of an action, help frame the public perception and discussion of the firm and the project, and find partners with aligned interests.[14]

International energy companies frequently engage in *scenario planning* to anticipate the political consequences of particular sets of actions, occurrences or economic events. When a company lays off workers, for example, politicians may feel forced to take unfavorable action in order to shore up popular support. If a nation is in an economic downturn, citizens and politicians are more likely to interfere with a foreign business that, because of contractual entitlements (and prior risk assumptions and investments), is then making a large profit—or if energy prices have skyrocketed but the country's upside return is limited. Even concession agreement clauses that expressly entitle the investor to that high rate of return can "serve as a lightning rod for public criticism and political action, especially in the wake of a crisis."[15] By visualizing these events and the likely responses, the lawyer and client can structure the incentives and legal protections that are part of the investment bargain.

§ 1.03. Selecting Projects.

[1] Investor's Competitive Advantage.

With the general and political risks of a proposed investment identified and evaluated, the international energy company should then identify the types of roles and projects for which it is best suited, and the countries in which it has the best prospects for success. In essence, the company should take a long, good look in the mirror. By objectively assessing its own qualities and the characteristics of the project and the market, the investor can determine what strategic values (and limitations) and competitive advantages (and challenges) it enjoys (and suffers). This determination of

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[13] *See* Jorge M. Guira, "Preventing and Containing International Financial Crisis: The Case of Brazil," 7 Law & Bus. Rev. Am. 481 (2001); Marilda Rosada de Sa Ribeiro, "The New Oil and Gas Industry in Brazil: An Overview of Main Legal Aspects," 36 Tex. Int'l L.J. 141, 164 (2001).

[14] *See* Witold Henisz & Bennet Zelner, *supra* note 10, manuscript at 4.

[15] Witold Henisz & Bennet Zelner, *supra* note 10, manuscript at 3-4.

value and advantage must be made both as against international competitors and as against the host country's own resources. The determination also needs to be made in terms of the balance sheet not only as of today, but also over the expected life of the investment.

[2] Party Roles.

An important result of such a candid assessment may be that roles that make sense in a home country or in the developed world may not be appropriate in an emerging economy. It may be prudent either to scale down (e.g., be a project adviser rather than a turnkey contractor) or to scale up (e.g., be a turnkey contractor rather than an adviser).

For example, a large U.S. public utility was quite experienced in acting as general contractor for research and development facilities in its home territory, subcontracting with local specialty firms that were driven to meet and exceed the utility's requirements by the well-developed legal system (and by the prospect of repeat business). When an affiliate of that utility attempted to act as a contractor for a similar R&D facility for an overseas government entity, it carried that same general contractor mindset into the new project. But local subcontractors had no incentives for repeat business with the affiliate—no further facilities were in the offing—and the legal system was not well developed. As a result, the affiliate became embroiled in disputes both with the host government company as well as with the subcontractors. In this circumstance, taking on more operational risk—for example, by assuming full performance by its own forces, or using higher-priced international firms as subcontractors—might have entailed less overall exposure than only taking on the general contractor role. "Responding to adverse economic conditions by 'doubling down' may seem economically or financially foolhardy, but it can bring substantial benefits in terms of political capital."[16]

[3] Country Risks.

[a] Country Risks Generally.

In addition to sizing up appropriate roles, the client should evaluate the *country risks* as applied to the particulars of the project in question. Does the client's home country provide it with advantages or disadvantages in the target country compared with competitors? Does it make sense to associate with a joint venturer from the host country or from another outside country? Does the client's investment in another country create either problems or opportunities with respect to the subject project?

There are numerous recent examples of the importance of thoroughly evaluating the country risks of an international energy project. With respect to oil and gas projects, the relationship between the host country government and the investor's home country government has had a major impact on the stability of the investment.[17] With respect to

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[16] Witold Henisz & Bennet Zelner, *supra* note 10, manuscript at 3.

[17] While the United States remains Venezuela's biggest customer, Venezuela's recent efforts to reduce its reliance on the United States, instead focusing on Latin America and the thriving Asian market, particularly China, illustrate the impact of home country–host country relations on the stability of international oil and gas investments. *See* Jonah Gindin, "To Sow the Oil, or Give It Away?" Alberta Views, Dec. 4, 2006; Michael Piskur, "Venezuela Moves to Nationalize Its Oil Industry," Power and Interest News Report, May 19, 2006, at http://www.pinr.com.

power projects, the general performance of the host country's domestic economy and its monetary and fiscal policy have been major factors.[18]

[b] Specific Measures of Political Risk.

A variety of measures of political risk are available in specific countries for particular types of projects. Generally, an investor should look for "a well-developed legal and regulatory framework, including favorable tax and labor codes, investment laws, property laws, the protection of intellectual property rights and competition policy, as well as relative industrial deregulation."[19] Global private consulting firms offer various measures and country reports on the political, investment and social climate of various nations and often provide ratings and recommendations. International energy companies also seek advice from local consultants and legal counsel.

However, generic descriptions of the investment "climate" or the "attitude" towards foreign direct investment in a given country may be less helpful than specific assessments of the energy sector and of the counterparties who will be involved in a given project. The particular insights derived from direct experience of project personnel or consultants in the energy industry in that country may be of greater value. "In the words of one insurer, 'There is no such thing as abstract political risk, in my opinion; political risk very much depends on who you are and what you are doing in a country.'"[20]

[c] Unauthorized Payments.

A looming problem in many jurisdictions is the possibility that government officials will expect payments or other items of value not authorized by the sovereign in the publicly disclosed investment contract. Since 1977, United States investors have been subject to especially stringent rules from their home country concerning such payments, under the Foreign Corrupt Practices Act ("FCPA"). The Organisation for Economic Co-operation and Development ("OECD") Anti-Bribery Convention ("OECD Anti-Bribery Convention") adopted in 1997 has mandated similar regimes throughout OECD member states, however, and many countries have established local laws to the same effect.[21]

Some time ago, concern was expressed that these home country laws combating demands for unauthorized payments placed an investor in a disfavored situation. But many negotiators for multinational energy firms conclude that those prohibitions are their best friends. Such laws permit the negotiators to "just say no," foreclose any discussion of such benefits, and protect the integrity and reputation of the investor—rather than face the prospect of trying to resist and deal with them over the course of the project.

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[18] International power projects in Pakistan and India have revealed their "Achilles heel," namely that the projects are ultimately captive to the host country's domestic market for electricity. The fundamental value of such projects is therefore dependent on the long-term economic performance of the host country. *See, e.g.,* David Parish, "Evaluation of the Power Sector Operations in Pakistan," Asian Development Bank Working Paper 2001-1, at http://asiandevbank.org.

[19] Malcolm D. Rowat, "Multilateral Approaches to Improving the Investment Climate in Developing Countries: The Cases of ICSID and MIGA," 33 Harv. Int'l L.J. 103, 104 (1992).

[20] Witold Henisz & Bennet Zelner, *supra* note 10, manuscript at 2.

[21] Such laws have been enacted in countries including Brazil (Law 10.467 amending the Brazilian Penal Code), Chile (Law 19.829 amending the Chilean Criminal Code), and South Korea (Act on Preventing Bribery of Foreign Public Officials in International Transactions). For a complete list of signatories to the OECD Anti-Bribery Convention, visit www.oecd.org.

[d] Investor Country Considerations.

A related point is that political risks can arise as a result of the *investor's* home country, either generally or relative to the particular country or investment. Political risk from the investor's country can come in the form of sanctions against the country where the investment is to be made, or where key inputs or equipment for the investment are produced. Investor countries can also regulate or prohibit transfers of sensitive technology into countries they find problematic (e.g., prohibitions on transfer of certain United States technology to a variety of countries). Host countries as well as home governments may enact and enforce boycotts of trade with certain nations, and in response other states may enact anti-boycott legislation.[22]

Clients must assess their own countries' current laws, as well as the developing relationship between host and investor countries, in order to gauge the viability of a long-term energy investment. Economic sanctions originating with multilateral organizations such as the United Nations, or with the investor's home country (particularly the United States), are difficult to manage and have been of growing significance as a form of political risk. Since the international energy company has no choice but to comply, the techniques for managing the political risk of sanctions tend to consist of indirect forms of mitigation such as forecasting and anticipatory measures; reacting to specific sanctions before and after they arise; prohibiting assignments of interests to nationals of sanctioned countries; and political lobbying and structuring in an attempt to accomplish business objectives without triggering or violating sanctions.[23]

[4] Energy Investments in Particular.

[a] Vulnerability of Energy Projects.

Of all international investment subjects, energy projects are perhaps especially vulnerable to government intervention. The valuable natural resource or energy facility is in, or on, the host country's ground. The sovereignty of a nation extends to its natural resources, and in most countries such resources are owned by the public and administered by the government.[24] The principle of permanent sovereignty over natural resources has been reflected in various documents, including the 1963 United Nations Resolution on Permanent Sovereignty Over Natural Resources and the 1974 United Nations Declaration on the Establishment of a New International Economic Order.[25]

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[22] *See* Michael P. Darden, *Legal Research Checklist for International Petroleum Operations* 3-7, 62-63 (ABA Section of Natural Resources, Energy & Envt'l L. Monograph No. 20, 1994).

[23] *See* Thomas W. Wälde, "Managing the Risk of Sanctions in the Global Oil & Gas Industry: Corporate Response Under Political, Legal and Commercial Pressures," 36 Tex. Int'l L.J. 183 (2001).

[24] *See* Michael P. Darden, *supra* note 22, at 21-27; John S. Dzienkowski, "Concessions, Production Sharing, and Participation Agreements for Developing a Country's Natural Resources," in Ernest E. Smith, John S. Dzienkowski, Owen L. Anderson, Gary B. Conine, John S. Low & Bruce M. Kramer, Eds., *International Petroleum Transactions* 392-478 (2d ed. 2000).

[25] United Nations Resolution on Permanent Sovereignty Over Natural Resources, U.N.G.A. Res. 1803 (XVII), *reprinted in* 2 I.L.M. 223 (1963); United Nations Declaration on the Establishment of a New International Economic Order, U.N.G.A. Res. 3201 (1974), *reprinted in* 13 I.L.M. 715 (1974).

Once the resource is discovered and the infrastructure for extracting and exploiting it is built and paid for, there will be little appreciation in the host country for the exploration, development and construction efforts of the companies that took risks and incurred investments to reach those results. This dilemma of the "obsolescing bargain" has been put forward as one of the more significant political risks associated with the long-term, capital-intensive nature of international energy projects.[26] Governments looking for respect and self-determination on the national as well as international stage can be more protective of domestic energy sources than of other economic sectors. High current prices for low-cost marginal production further obscure the risks undertaken in the original investment.

[b] Emerging Economy Political Risk.

Concerns over obsolescing bargains are particularly prevalent in the developing world and the formerly centrally planned economies, where countries are rapidly developing infrastructure that in turn demands new energy and new cash sources. Energy-rich countries are reluctant permanently to cede control of their valuable resources, or to acknowledge that prior transfers of control necessarily bind future governments. For example, in the pending U.S.-Russia Bilateral Investment Treaty, Russia specifically exempts ownership and use of subsoil resources from the general range of assurances to foreign investors of "national treatment." A letter of understanding between Russia and the United States provides that Russia "intends" to give national treatment to U.S. investors with respect to use (but not ownership) of subsoil resources.[27] The withholding of full protection to foreign participants illustrates a general reluctance of countries to relinquish control over natural resources.

[c] Developed Country Political Risk.

Difficulties from government intervention are not confined to the developing world. The United Kingdom and the United States, for instance, can be regarded as agents of creeping expropriation or regulatory political risk every time they enact new regulations that eat away at a project's viability. In the mid-1970s, the United Kingdom introduced a wholesale renegotiation of license terms, a new form of petroleum taxation, and a mandatory carried interest for its newly established state oil company for North Sea field development.[28]

Oil and gas companies' experience with leases in the Gulf of Mexico is also instructive. Controversy arose last year in the United States when it was publicized that offshore oil leases awarded in 1998 and 1999 did not provide certain royalty rate increases in the event of increased crude oil market prices. Some American officials argued "that those leases are binding contracts that cannot be changed except through an agreement by the companies." Significantly, however, other politicians "acknowledge that the contracts are binding, but support a measure that would *punish companies that*

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26 *See* Louis Wells & Eric Gleason, "Is Foreign Infrastructure Investment Still Risky?" Harv. Bus. Rev., Sept-Oct. 1995, at 44; Klaus Peter Berger, "Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators," 36 Vand. J. Transnat'l L. 1347, 1349 (2003).

27 *See* Paul E. Comeaux & Stephen N. Kinsella, *supra* note 4, at 8-9, 16.

28 *See* Peter D. Cameron, "Stabilization in Investment Contracts and Changes of Rules in Host Countries: Tools for Oil & Gas Investors," (Association of International Petroleum Negotiators, July 5, 2006) at http://www.aipn.com.

refuse to renegotiate their contracts by prohibiting them from acquiring additional oil and gas leases."[29]

As the North Sea fiscal revisions and the Gulf of Mexico royalty outcry illustrate, even 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.

Nor is a democratic form of government a guaranty of insulation from assaults on the integrity of the client's bargain. Change in government, rather than the form of government per se, is the predominant factor influencing investment political risk.[30]

[5] Internal Client Characteristics.

A final and client-specific consideration is the risk appetite of the multinational enterprise and its own investors. In this regard, it is important to recognize that the perspective of shareholders, the headquarters executives, or the finance department may be very different from the preferences of the local business unit. Even different divisions within a business unit may have competing projects and interests.

Little appears to be written on how the internal characteristics of the investor impact the harm suffered as a result of the occurrence of a political risk event. Examples include the ability of international energy companies to mitigate currency risk by using local currency from one project in the host country for operations relating to another project in that country, and the ability of resilient and patient firms to weather temporary political risk events to their advantage over competitors with less staying power. A careful, candid self-examination should be made early in the development process, as the client's appetite for political risk, delays and associated early transaction costs is often one of the more important factors in its ability to persevere.

§ 1.04. Cultivating Relationships.

[1] Key Stakeholders.

Overseas investors must evaluate, select and cultivate relationships with key stakeholders at all levels and over all relevant times. In addition to the national and local government, private parties have significant impacts on the success of the investment. These other stakeholders include local communities and nongovernmental organizations, local and international partners, and a wide variety of contract counterparties.

[2] Government Relationships.

[a] Right Relationships.

It is clichéd but nonetheless critical to cultivate the right relationships at the right levels of the host government. In some countries, a strong relationship with the legislature can garner public support, because it shows the agreement was held to the fire of full political debate and fully vetted under strict scrutiny. In other countries, a relationship with a credible, established executive or ministry may be the most practical

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[29] Edmund L. Andrews, "Chevron Could Avoid Huge Royalties From Oil Find in the Gulf," N.Y. Times, Sept. 12, 2006 (emphasis added).

[30] *See* Alan Berlin, *supra* note 5.

way of obtaining the investment and achieving as many protections as are practically available. Such relationships are driven by, but not exclusively dependent on, legal rules that require executive decrees or legislative acts to authorize and implement the investment in question.

[b] Diversified Relationships.

Relationships need to be diversified wherever reasonably possible. Today's government function may be privatized tomorrow, and functions currently performed by private firms may be nationalized in the future.[31]

Concentrated contacts at a high level in the current government may confer large current influence and protection, but may be all the more vulnerable to a change in administration. An international company might enjoy advantages over domestic players because a minister is a vigorous proponent of foreign roles, but any such advantage can dissipate quickly if that minister returns to the private sector.

Changes in political parties and changes in the very form of government of course increase the chances of intervention.[32] A government contract, particularly in the energy sector, will likely feature a term longer than the current term of the head of state or prime minister. A new government may take a hard look at the previous government's dealings. Shifts in the social and economic environment may have led to the change in government and therefore increase the risk of adverse intervention.[33]

[c] Local Relationships.

Relationships should not be maintained solely at the level of the national government. The client must consider the relationships of the client and the sovereign to the provincial or municipal governments, which may oppose the project in question (or any project at all). The investor and its stakeholders may be able to offer special incentives to local authorities. However, the investor must be ever mindful of the competition and other dynamics between national and local governments. The international energy company will have to make a subtle and complex judgment as to whether to engage directly in domestic political debates, or instead attempt to stay out of the fray.

There can be no general guidance on this topic whether deep relations at both levels make sense. Marathon's proposed LNG regasification complex in Mexico is an example of the difficult interplay between federal and state governments. After years of development and following significant progress with federal approvals, the site of the proposed complex was seized—by the Baja California Norte local government.[34]

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[31] *See* Daniel Yergin & Joseph Stanislaw, *The Commanding Heights: The Battle Between Government and Marketplace That Is Remaking the Modern World* (1998).

[32] *See* Alan Berlin, *supra* note 5.

[33] *See* Louis Wells & Eric Gleason, "Is Foreign Infrastructure Investment Still Risky?," Harv. Bus. Rev., Sept-Oct. 1995, at 48-49 ("Infrastructure projects remain very vulnerable to attack by opposition politicians who are looking for ways to discredit a government. … It is easy for an opposition party to appeal to nationalism by claiming the government sold out to foreigners in allowing them to control critical infrastructure").

[34] *See* Simon Romero, "Fears Drain Support for Natural Gas Terminals," N.Y. Times, May 14, 2004.

[3] Nongovernmental Stakeholders.

Likewise, government support even at both the national and local levels does not necessarily confer local harmony on the energy project. Support—or at least the lack of objection—from local communities and influential nongovernmental organizations can also protect sustainable investment and the conditions for expanded opportunities. Energy and natural resource investors in Papua New Guinea, for example, have had decidedly different results based on their relations with tribes, community organizations and global environmental groups.[35]

[4] Local or International Partners.

Clients should identify and cultivate advantageous partnerships with private sector economic entities outside the national government. Sometimes, a project can be more attractive if a client can partner with local or other international firms. Moreover, a number of countries have legislation mandating local participation or hiring.[36] Separate from the political benefits of partnering with a local sponsor, partnering with private sector entities has also been identified as an important technique for spreading the risks involved in energy projects.[37] Such partnering is inherently associated with sharing of decision-making and control, however, so the investor will need to evaluate carefully the costs and benefits of this form of diversification.

[5] Contract Counterparties.

An investor can undertake a variety of risk transfers to contract counterparties. Engineering, procurement and construction contractors regularly absorb the risk of delays, cost overruns, and mechanical or process failures (albeit for a fee and subject to force majeure and other conditions and limits). To protect against shortages in raw materials, an investor can obtain long-term and diversified supply commitments, and can demand security for the suppliers' obligations. Price escalations can be contractually passed on to offtake purchasers. Both assured cash flow and some insulation from alternative projects can be obtained through deliver-or-pay or take-or-pay obligations of project suppliers or offtakers.[38]

Counterparties that are state-owned entities are frequently sought to allocate political risks away from the international energy company. These contractual allocations include (i) shifting exchange rate and local inflation risk to state-owned offtakers through dollar-denominated or indexed pricing; (ii) shifting risks of adverse change in law to state-owned offtakers through "grossing up" of payments in the event of additional taxes; and (iii) shifting the risk of political violence or war to state-owned offtakers or suppliers through strong force majeure provisions. These risks are often ultimately shifted to the

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[35] *See* Jared Diamond, *Collapse: How Societies Choose to Fail or Succeed* 441-452 (2005) (comparing experiences of foreign investors).

[36] *See* Michael P. Darden, *supra* note 22, at 36-37; Noah Rubins & N. Stephan Kinsella, *International Investment, Political Risk and Dispute Resolution: A Practitioner's Guide* 40 (2005).

[37] *See* Margarita Coale, "Stabilization Clauses in International Petroleum Transactions," 30 Denv. J. Int'l L. & Pol'y 217, 219 (2002) ("When a company tries to 'spread the risk' it usually tries to form joint ventures to create a united and stronger front against an interventionist host country").

[38] *See* David Blumenthal, "Sources of Funds and Risk Management for International Energy Projects," 16 Berkeley J. Int'l L. 267, 288 (1998).

host government, through a guaranty by the host government of the obligations of the state-owned counterparty.[39]

[6] Political Risk Insurers.

[a] Sources of Political Risk Insurance.

International energy companies should consider purchasing political risk insurance, or international or governmental export credit funding or guaranties that afford similar protection. Entities such as the Overseas Private Investment Corporation ("OPIC") and the Multilateral Investment Guarantee Agency ("MIGA") offer to eligible investors a degree of insurance covering certain specific political risks.[40] OPIC was established as an agency of the U.S. government in 1971 and provides political risk insurance to U.S. investors, contractors, exporters and financial institutions involved in international transactions. MIGA is a member of the World Bank Group and provides political risk insurance to investors and lenders in order to promote foreign direct investment from one member country to another member country. OPIC's and MIGA's advantages derive in part from being agencies of the U.S. government and an international organization, respectively, thereby enabling them to provide a measure of deterrence against adverse government actions and allowing them to influence the resolution of potential disputes. However, it is important for investors to appreciate the limitations on coverage afforded by traditional political risk insurance, and the risks associated with the need to invoke formal dispute resolution to qualify for certain coverages.[41]

[b] Investor and Project Criteria.

To obtain political risk insurance, investors and their projects must meet criteria that vary from insurer to insurer. Specifically, OPIC insurance is available to U.S. citizens and business organizations beneficially owned by U.S. citizens, foreign corporations that are more than 95% owned by U.S. investors, and other foreign entities that are wholly U.S.-owned. Projects eligible for OPIC insurance are investments in new ventures, expansions of existing enterprises, privatizations and acquisitions with positive developmental benefits.

MIGA's requirements are of course not limited to U.S. investors. MIGA insurance is available to nationals of a World Bank member country other than the country in which the investment is made, and to nationals of the host country in certain cases provided the funds originate outside the host country and the host government approves the investment. Projects eligible for MIGA insurance are new, cross-border investments, as well as investments associated with the expansion, modernization or financial restructuring of existing projects and acquisitions involving privatization of

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[39] *See* John Mauel, "Common Contractual Risk Allocations in International Power Projects," 1996 Colum. Bus. L. Rev. 37-59 (1996).

[40] *See generally* Multilateral Investment Guarantee Agency, *Investment Guarantee Guide*, at http://www.miga.org (the "MIGA Investment Guide"); Overseas Private Investment Corporation, *Program Guide,* at http://www.opic.gov (the "OPIC Handbook"). Private insurance coverage of political risks varies depending on the insurer, but tends to be more expensive than the sponsored counterparts discussed in the text.

[41] *See* Paola Morales Torrado, "Political Risk Insurance and Breach of Contract Coverage: How the Intervention of Domestic Courts May Prevent Investors from Claiming Insurance," 17 Pace Int'l L. Rev. 301 (2005).

state enterprises, in each case if they contribute to host country development objectives and are made in a developing country that is a member of MIGA.

Political risk insurers regularly proceed beyond generic assessments of a country's hospitability to foreign direct investment to scrutinize the degree to which a particular infrastructure project impacts the wider geographical area and contributes to indigenous and cross-border conflict. Such insurance providers encourage corporate responsibility by offering better rates and coverage to projects they deem socially responsible.[42]

[c] Scope of Political Risk Coverage.

As a general matter, political risk insurers will not cover commercial risks deemed to be within the investor's control. Losses resulting from failed assessments of supply and demand or workforce availability would not likely be insured. A governmental increase in tariffs or interruption of fuel supplies, however, may not be in the insured's control and thus may be covered.[43] The management of political risks therefore needs to be integrated with the client's overall approach to investment risk.

The political risks covered by MIGA insurance are currency inconvertibility and transfer restriction, expropriation, war and civil disturbance, and breach of contract.[44] The political risks covered by OPIC insurance are similar but include certain special coverages for oil and gas exploration, development and production in developing countries. These supplemental protections address the abrogation, impairment and repudiation or breach of concession, production sharing and other agreements between the U.S. company and the host government.[45]

In addition to the types of political risks covered, it is important that international energy companies consider the limits on the extent of the coverage available. MIGA's maximum guarantees (subject to overall ceilings for particular projects) include 90% of equity investments, plus an additional 450% of the equity investment to cover future earnings; and 95% of the principal of loans or guaranties, plus an additional 135% of the principal to cover accrued interest. OPIC's maximums include 90% of equity investments plus 180% of the equity investment to cover future earnings, and 100% of principal and all accrued interest on loans from financial institutions to unrelated third parties.

[7] International Lenders.

The international energy investor should consider having one or more multilateral global institutions such as the International Finance Corporation ("IFC") or a regional multinational group such as the Inter-American Development Bank as a lender or co-investor. A host country may be less likely to nationalize or impair the economics

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[42] *See* Daniel Wagner, "Project Financiers' and Insurers' Roles in Promoting Social Responsibility in the Developing World" (2004), at http://www.irmi.com. This trend is not unique to political risk insurers. Lenders are also incorporating corporate responsibility into their lending criteria for large-scale international projects. *See* Oliver Balch, "Building a Better World (for Investors and Whales)," The Banker, July 1, 2006; Paula L. Green, "Lending Policies; Banking on Responsibility," Global Finance, Sept. 2005, at 22.

[43] *See* Daniel Wagner, "The Impact of Political Change and How to Protect Your Business Against It" (2000), at http://www.irmi.com.

[44] *See* MIGA Investment Guide, *supra* note 40.

[45] *See* OPIC Handbook, *supra* note 40, at 25-36.

of a project if a World Bank affiliate or other international financing institution has a stake. Working with financing providers from countries deemed friendly to the host country may also give the government pause before it interferes with a negotiated deal. Diversification can lead to more favorable financing options or reduce the amount of financial exposure.

On the other hand, incurring debt and diversifying investments more generally have the inherent effect of reducing an investor's control over its project, and make it difficult to take quick, concerted action. There may also be increased pressure to make cash-flow driven decisions. The international energy company will need relationships with creditors that allow it the independence to maneuver the complexities of a long-term overseas investment.

§ 1.05 Incentivizing Stakeholder Cooperation.

[1] Dynamics of Host Government Contracting.

Private parties used to striking bargains of small or moderate scale, in the shadow of a well-developed legal system, need to reset their instincts before embarking on a major investment with an instrumentality of a foreign government. In the private setting, an unfortunate bargain often must be chalked up to experience, and a party's need to preserve its reputation for future deals will constrain it from sharp dealing. In the government setting, a bargain that turns into a bad bet for the sovereign can and will be "cured" by a wide variety of means, not all of which are capable of prevention by legal means. A major energy transaction may be the parties' only relationship, and future deals may be driven by demand from other parties with short memories—or with the conviction that, somehow, their experience will be different.

[2] Sharing Upside and Downside Exposures.

[a] Aligning Economics.

The voice of long experience counsels that *if a deal appears too good for you, it probably is too good for you*. The international energy company should consider aligning the economics so that at least some benefit is shared by the government and some burden is shared by the investor in circumstances beyond the government's control.

A currently topical example from the energy industry is a Production Sharing Agreement provision whereby development costs are fully recovered by the operator before large distributions of additional sums are made to the government. Such a provision, without sophisticated modifications, defers and even eliminates the government's share of the take in the event of cost overruns. This can be particularly sensitive if, as would be typical, the government believes those overruns were within the private contractor's control. This dynamic appears to be one catalyst for the dispute that erupted over the Russian Sakhalin LNG projects.[46]

[b] Sustained Benefits to Host Country.

To maximize an agreement's durability, direct foreign investment should benefit both the host country and the investor—not just at the outset or during development, but

[46] *See* Andrew E. Kramer, "Shell Bows to Kremlin Pressure on Sakhalin Project," Int'l Herald Tribune, Dec. 11, 2006.

also over time, and across a broad variety of foreseeable scenarios. It is true that investment can bring a developing country badly needed infrastructure, new capital and industries, diversified economy, job growth, and an influx of knowledge and technology. But the timing of these benefits to the host government and country may be considerably different from the timing of the corresponding benefits to the investor.[47] Companies are more likely to receive continued favorable treatment initially by highlighting these benefits, and then by implementing agreements that distribute the benefits equitably in a number of possible economic situations.

[c] Progressive Fiscal Terms.

One approach to the sharing of costs and benefits of a project is a progressive royalty rate, distribution system or tax regime. First, the parties should establish a development budget and timetable with contingencies and allowances for overruns in the private contractor's favor. After those contingencies and allowances are exhausted, the cost recovery from revenues can decrease or ultimately terminate, and the contractor begins to share the pain of lower returns while the public entity starts to see some distributions. Alternatively, the royalty rate can be tied to crude oil or natural gas market prices. When market prices are very low, so is the royalty rate; when prices rise, the percentage royalty rate can increase. The cost element and the market price element can be combined in a measure of return on investment, which in turn can drive the royalty rate. Some variation of these themes is common in modern production sharing and entity joint venture production arrangements.[48]

[3] Fixing Total Government Take.

Another common method of aligning the private interest with the interest of at least the executive branch of a government entity is to devise economic arrangements around the concept of *total government take.* This term is usually defined as the sum of (i) all taxes, duties, fees and other exactions at all government levels *plus* (ii) the royalty rate, profit and other commercial distributions that would be due to the government under the investment contracts. It is commonly defined as a particular percentage of revenues received during a given time period.

Total government take can be used as the baseline for an offset clause. If legislation or regulation is enacted or applied in a manner that causes the total take to increase above an agreed baseline level, then the government's commercial distributions can be set off against those increases so that the take remains constant (or is not increased by more than a given amount or factor).[49]

[4] Staying in Arrears.

Foreign investment is an arena in which it is often better to be a debtor than a creditor. Since it is very difficult for a foreign investor to sue after the government's non-performance, wherever practical it is advisable to structure commitments so that the government is to perform first. Then, if that performance occurs, the foreign party is

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[47] *See* Michael A. Geist, "Toward a General Agreement on the Regulation of Foreign Direct Investment," 26 Law & Pol'y in Int'l Bus. 673, 679 (1995).

[48] *See* John S. Dzienkowski, *supra* note 24.

[49] An international survey of offset principles with particular focus on the rights of financial institutions is William Johnson & Thomas Weden, *Set-Off Law and Practice: An International Handbook* (2006).

obliged to render its part of the bargain. Needless to say, the international energy company may be required to post considerable security to assure the government that the return performance will be made. And it is not easy to negotiate such an order of performance. Where it is possible, however, staying in arrears incentivizes the government to perform in accordance with the bargain—without the foreign party's needing to resort to, or even to threaten, formal dispute resolution proceedings.

[5] Satisfying Host Country Markets.

The private investor can induce cooperation by agreeing to make energy products available to the home market. Such supply may take place at prices below the world market. Structured correctly, this can meet the host country's energy needs while still ensuring a profit. More importantly, it may lower the likelihood of government intervention as the host country directly derives significant benefits from the project. The investor may want to include protections such as maximum volumes, cash payment terms or their equivalent, and minimization of excise or other taxes or exactions for such favored sales.

[6] Furnishing Technology and Training.

Host countries are often interested in obtaining technology and training. This is especially true in developing countries that have a large technology deficit. Companies that offer training to local workers in high-skill positions benefit the host country and incentivize a stable investment. Appropriate secondments of home country personnel into the project entity or the investor's corporate group can facilitate relations down the road.

[7] Utilizing Host Country Labor, Contractors and Services.

Companies can offer (or be required) to bring domestic interests and resources into a project as a means of enhancing the agreement's stability. By committing to domestic inputs such as local employment, contractors, insurance and other services, a client can give a stake in the project to individuals and organizations who can influence opinion in the home country. Again, those benefits can be conditioned on the government's and the local parties' continuing to observe contract provisions.

[8] Investing in Local Communities.

Energy investors can enlist further support by identifying and addressing local interests. Prudent grants or loans to local governments or to nongovernmental organizations are not only an investment in the community, but also an investment in the long-term stability of a project itself.

§ 1.06. Obligations Mandating Investment Support.

[1] Establishing Specific Obligations.

Incentives for voluntary cooperation are important, but they can only go so far to protect an investment. The private and public parties will administer their relationship in the shadow of the investment contracts that impose specific obligations on them. While it is not always practical to enforce such obligations legally against foreign public entities, at a minimum their presence provides political cover for governments to justify acting consistently with those terms. We stress that not all host government agreements can and should contain all or any particular obligations, but the following roster of potential protections may be useful to consider in structuring a transaction.

[2] Investment Agreement Structure.

The form and structure of investment agreements vary greatly from industry to industry and country to country. Oil and gas investment agreements can include production sharing, royalty, and other concession documents executed by the host government or its agencies. Power project investment agreements can include implementation agreements, offtake agreements, guaranties, and indemnities. Regardless of the industry, investment agreements range from brief grants of specific rights to comprehensive documents addressing such matters as local permits, change in law, currency conversion and transfer, use of infrastructure, security, tax treatment, immigration, offshore bank accounts, and put options in the event of extended political force majeure. A properly structured investment agreement can provide not only a degree of contractual recourse against a host government in the event of breach, but also an underpinning for certain types of political risk insurance that require a host government contractual obligation.

[a] Parties and Legal Form.

The investor must determine whether the state itself will be a party to the principal investment contract. Even if a contract contains clauses that suggest a government is responsible, courts may find that a signatory agency is acting independent of the state and therefore has not bound the state or subjected it to international arbitration.[50] Requiring the state, through an appropriate representative, to sign an agreement will clarify whether a state should answer for the conduct of an independent state agency.

On the investor side, parent entities or affiliates of project companies should be beneficiaries of appropriate protections under the investment agreement. In this manner, parties outside of the host country's jurisdiction will have greater powers to enforce the bargain. Interests of customers, suppliers and contractors should also be protected in the investment contract, since they rather than the project company may be the direct target of political risks.

Because of the tax, host country law, liability and financing issues involved, the type of entity to act as the project company is typically determined before execution of the investment agreement, and it is generally advisable that such entity be a the party to the investment agreement from the outset. In many states, especially developing countries, the legal framework for foreign investment is codified in investment and company laws requiring that the project company be a specific type of entity and that the shareholders of the project company include local participants. As a result, investment agreements sometimes provide assurances by the host government that the project company has been duly organized, the necessary government approvals for the project company will be obtainable, and the host country limited liability and tax treatment characteristics of the project company will be maintained.

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[50] *See* Bridas S.A.P.I.C. v. Government of Turkmenistan [Turkmenneft], 345 F.3d 347 (5th Cir. 2003). In some cases, it is desirable or essential to have the contract issued by the legislature, or by the government in the form of an executive decree. In this case, the contract will to some extent have the force of law. *See* Michael P. Darden, *supra* note 22, at 40-41.

[b] Right to Pursue Project.

Unless domestic statutes are clear, the host government agreement can confer an express right on the investor to pursue the project. That right may be granted on an exclusive basis, subject to becoming non-exclusive or being terminated if certain milestones are not timely achieved.

[c] Technical Standards.

The host government agreement can also expressly state the standards to which the project will be developed and operated. Such standards may include design, capacity, throughput and similar technical characteristics, as well as environmental, health and safety standards. In particular, defining the scope of abandonment and reclamation obligations at the end of a natural resources extraction project can be important. These standards may be those of the host country or, more commonly in the energy industry, may codify current and anticipated worldwide practices.

[d] Duration of Project and Protections.

The term of the project, or of the investment protection commitments, may be set forth or left silent and presumed to be indefinite or for the actual or expected life of the project. The investor may seek rights of termination in the event of failure of cooperation covenants or force majeure events, if practical. If a definite term is set for the duration of either the project or the protections, then renewal terms at the option of the investor are of course desirable.

[e] Suspension Rights.

Carefully crafted force majeure, impracticability, frustration and similar suspension clauses can delineate each party's responsibilities under a variety of extreme circumstances threatening the integrity of the project's economics. These clauses can excuse a party from its obligations when events outside its control make performance impracticable, or frustrate the economic value of the project. Traditional force majeure clauses contemplate natural disasters, but nothing prevents parties from considering economic and legal changes, or from creating suspension rights for foreseeable occurrences that might not qualify as force majeure under the applicable law. The decision of an investor's own home country to embargo a host nation, or sanction a country that manufactures a key component, can be just as debilitating as any physical cataclysm.

[f] Location of Assets.

Some authors recommend minimizing assets and activities under the host country's jurisdiction and control.[51] The less a host country has to gain from expropriation, the less likely it is to undertake such an act. Companies benefit because if expropriation does occur, fewer of its assets are at risk. This recommendation is not easily followed by energy or infrastructure project investors.

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[51] *See* Philip R. Stansbury, "Planning Against Expropriation," 24 Int'l Lawyer 677, 678 (1990).

[g] Assignability and Preemptive Rights.

Investors will want to consider inserting a clause that gives them the right to transfer to another party, or a clause giving them a right to object to an assignment by another contract party (particularly if of a nationality with which a party cannot associate, due to U.S. or U.N. sanctions, for example). However, the government may insist on similar assignment and preemptive rights (such as rights of first refusal), and the risk of yielding such benefits to the government must be weighed against the private party's need for flexibility and liquidity.

[h] Project Sale and Purchase Options.

Another alternative is a put option in the hands of the investor to sell its investment to the government at an agreed or formula price. Such options are difficult to negotiate, and invite the corresponding request for a call option in the government's hands.

[3] Affirmative Cooperation Duties.

One important subset of the clauses in any host government agreement consists of provisions obliging the government to take certain actions that are neither mandated nor prohibited by domestic legislation or by treaties. These are activities where the executive branch of government has the discretionary power to assist the project and the investor, though it may need to induce ministries, agencies, local governments or other independent state subjects formally to take the action in question.

[a] Cooperation on Permits.

The host government agreement can require the cooperation of the national and local governments with respect to permits franchises, licenses, and other governmental approvals. This cooperation is required not only on the issuance of permits, but also on their administration, renewal, and enforcement on a non-discriminatory basis. Ideally, permit fees and conditions should not be allowed to increase the overall government take.

[b] Acquisition of Land Rights.

The host government agreement should empower the investor company to acquire land and facilitate its acquisition activities. In some cases, eminent domain power can be held by the project company, or the government can agree to exercise that power in its own name for the project's benefit. In addition to rights of current surface users, such complexities as cultural resources, national parks and reserves, and even cross-border and boundary disputes may be involved.

[c] Use of Infrastructure.

The host government agreement can confirm that the investor or the project company will have adequate access to transportation, utilities and other infrastructure. Such provisions might give the investor company shipment priority, or guarantee non-discriminatory transportation tariffs for facilities controlled by independent agencies or public utilities.

[d] Facilitation of Project Finance.

Investment agreements may also contain provisions to facilitate project finance. A typical lender requirement is that the lender have an opportunity to cure project company defaults. The investment agreement may therefore contain an express consent to assignment of the agreement and proceeds for security purposes, and a covenant on the part of the host government not to rescind or terminate the agreement without first giving project lenders notice and opportunity to cure. Alternatively, the agreement may obligate the host country to execute a separate consent and agreement reasonably requested by the project lenders. Investment agreements also frequently contain provisions that address certain governmental approvals relating to financing, such as central bank or exchange control approvals of loans, foreign currency accounts, and lender insurance. These provisions range from host government covenants of support to political force majeure protections, triggered in the event of failure to obtain or lapse of such required governmental approvals.

[e] Additional Investments.

It may be in an international energy company's interest to include provisions allowing for additional, discretionary investments. Hardwiring an agreement with approvals for expansion, additional infrastructure, or increased transport capacity such as additional trains can increase an energy investment's continuing stability, and give an investor the ability to adapt to changing conditions. Lawyers can help frame these provisions to highlight the benefits to the host country as well as to the investor. A cautionary note, however: a simple clause declaring that an expansion is pre-approved may not be self-executing, given the vast number of environmental permits, commercial approvals and other discretionary acts that may be required of government officials at all levels.

[4] Regulatory Standards or Exemptions.

Another subset of host government agreement clauses consist of provisions that either exempt the project and its investors and stakeholders from existing regulation that is unfavorable, or fix a standard by which ongoing regulations will apply to the investment.

[a] Legal Baselines.

It is often useful for an investment agreement with a sovereign entity to recite the law that was applicable at the inception of the investment and that was contemplated in the bargain represented by the investment contract. The investor should endeavor to establish baselines—non-discriminatory levels of enforcement in that country, or the standards of an international organization. Those baselines should be capable of clear definition, both as of the investment date and at later dates.

[b] Tax Baselines.

Similarly, the agreement can recite tax treaties or describe the applicable tax treatment, or provide a hypothetical set of examples that are expressly incorporated as exhibits. Such provisions can document the parties' intent on how such taxes are to affect the overall government take.

[c] Currency Conversion.

The investment contract can include a currency conversion provision guaranteeing that funds received in local currency can be exchanged for another currency. Many nations already have laws that allow free conversion of currency, but international contracts regularly include such a provision. Such clauses can help protect against possible changes in the law, and ensure that investors can meet their obligations to foreign lenders and stakeholders.

[d] Local Content and Technology Transfer.

At a minimum, the investor should seek clarification on what local content and technology transfer is required for the project. Ideally, the investor should seek a commitment to use reasonable efforts to seek local resources (e.g. through advertising and bidding), but not to guarantee that local resources will always be hired or used.

[e] Immigration Rules.

Complex energy projects often require foreign nationals to come to the host country, either for the construction and development phases or for a longer term to conduct operations. Ordinary worker visa requirements can delay or prevent the efficient flow of project services and transfers of technology. The host government agreement can require that these processes be streamlined.

[f] Profit Repatriation.

If the host country has or is likely to impose restrictions on the repatriation of earnings and profits, it may be lawful for the host government agreement to exempt the project and the investor from those constraints. Often, it is the central bank or independent monetary authority that must provide the waiver, so the host government can be enlisted to use its influence to cause the exemption to be granted.

[g] Offshore Bank Accounts and Fund Transfers.

Some host countries are associated with the risk of current or likely constraints on the opening of foreign bank accounts by a domestic party, or on the transmission of funds to such accounts. Those restrictions often can be lifted by action of the government or action of the central bank as prompted by the government, and the investment agreement can so provide.

[h] Technology Restrictions.

Either the host government or the investor's home country may prohibit or impose conditions on transfer of technology required for the energy project. Such a transfer of technology can even be deemed to occur when a home country national possessed of certain know-how simply enters the foreign country. Clearances may need to be sought from either or both countries to assure that technology necessary for the energy project is properly utilized, while safeguarding both countries against any unauthorized use of the technology (e.g., for military purposes).

[i] Customs Duties and Processes.

Energy projects typically require massive imports of equipment, both to be incorporated or consumed in the facilities themselves (e.g., plate and rolled steel, pressure vessels) and to be used and then re-exported in the construction and operational process (e.g., cranes, rigs). It is essential that the process of importing and re-exporting such equipment be streamlined to the fullest extent permitted by law, both in the host country and in any countries of origin. Any customs duties or fees associated with these movements should not have the effect of increasing the government's overall take. These assurances are often found in the host government agreement.

[j] Excise or VAT Taxes.

The acquisition of equipment and raw materials can trigger large obligations under value-added tax (VAT) regimes or similar sales, use or related excise taxes. In some cases, the host government agreement can exempt the energy project from such impositions; in many others, the agreement can clarify that such taxes are in fact payable, but are then creditable against other obligations such as income tax, royalty obligations or other distributions from the project company.

[k] Income Taxes.

The host government agreement can confirm the applicability of bilateral tax treaties, tax holidays, rules on amortization and depreciation, and rules on deductions, credits and other income or profits tax attributes. Some of these confirmations may require further acts by other jurisdictions, agencies, or branches of government. Again, the agreement can at a minimum confirm the executive branch's obligation to seek such assurances from those entities.

[l] Other Regulations.

The host government agreement can address a wide variety of other regulations, either by confirming that they do not apply at all to the energy project or by clarifying how the applicable ones will be implemented. Thus, the government might confirm that a pipeline project is not to be considered a common carrier or otherwise subject to regulation by a public utilities or monopolies commission. The agreement might prohibit local authorities from issuing, interpreting or enforcing regulations that are at variance with the benefits confirmed at the national level or that have the effect of increasing the government's overall take. The agreement might further confirm that all personnel, at all government levels and agencies, are prohibited from seeking or exacting any unauthorized payments (as defined in local law, the FCPA, or the OECD Anti-Bribery Convention).

§ 1.07. Remedies For Deprivation Of Investment.

[1] The Hanging Sword of Legal Remedies.

Unfortunately, legal "remedies" are invoked when something has already gone wrong. If a company is seeking remedies, it likely means the primary goal of the project has failed over some extended time period. Additionally, obtaining a final decision on a remedy and executing on any judgment or arbitration award can take many more years.[52] The actions suggested in the previous sections can be seen as steps to avoid ever reaching

[52] *See*, *e.g.*, Compañía del Desarrollo de Santa Elena S.A. v. Republic of Costa Rica, ICSID Case No. ARB/96/1 (Feb. 17, 2000) (legal and arbitral proceedings lasted twenty years before the tribunal issued a decision).

this point. The hanging sword of international dispute resolution can, nonetheless, strengthen the impact of the preventative measures.

[2] Benefits of Negotiated Settlement.

We start the discussion of remedies by emphasizing the benefits of negotiation in response to an emergent dispute. If good faith discussions are possible, both sides avoid further losses by eliminating the externalities of a failed project and of formal dispute resolution.

> "A failure of an investment project usually is detrimental to the good-will and reputation of both parties—a government will see its investment climate deteriorate and its political risk rating rise, a company may find it gets criticized by the industry and financial press and confidence in its management capability diminishes with a negative impact on its ability raise capital and its share price."[53]

Accordingly, both parties often have a strong interest to negotiate if it will keep a project viable. Negotiating at the outset the structure and the triggers for renegotiation can ease the tension between an investor's desire for contractual certainty and a host country's goal of maintaining flexibility and sovereignty. Controlling the structure and setting the tone for such negotiations can increase the chances of efficient and favorable adjustments.

All that being said, the volumes of investment cases and arbitrations confirm that good faith negotiations may not always be possible. If not, the private investor must consider invoking legal remedies—either under the host country's investment protection laws, under the investment contract itself, or under bilateral or multilateral treaties and conventions. Each of these options is discussed in turn.

[3] National Status of Claimant.

At the outset of evaluating the available remedies, the investor must determine which legal entity—the project company, an investor affiliate or some other contract party—will be the claimant. A company's domestic or international status may affect its legal remedies. For example, a project company registered locally, even if wholly owned by foreign persons, may be subject to the host country's domestic law and in some cases may be unable to seek international arbitration. That is why it is useful to have an offshore parent entity be a party to, or a third-party beneficiary of, the principal investment protection agreement.

[4] Host Country Legal Protections.

The host country may offer foreign investment protection that is currently attractive. However, the legal landscape can be difficult to maneuver, regardless of favorable appearance of the legislation. For example, Kazakhstan has enacted a law that guaranteed treatment of foreign investment on terms no less favorable than those afforded

[53] Abba Kolo & Thomas W. Wälde, "Renegotiation and Contract Adaptations in the International Investment Projects: Applicable Legal Principles and Industry Practices," 1 Oil, Gas & Energy Law Intelligence 2 (2003) at http://www.gasandoil.com.

domestic investors, provided redress for illegal actions by state agencies, and prohibited nationalization or expropriation except for important public purposes and accompanied by effective compensation. Importantly, it stabilized the agreement stating that any detrimental changes to law or treaties would not apply to an investment for ten years, or for long-term contracts for the duration of the contract. Subsequently, the nation's constitutional council and Supreme Court issued decrees suggesting that international arbitration awards could be subject to review on the merits by Kazakhstani local courts, either now or with the passage of later legislation.[54] Thus, no matter how ironclad current local legislation may appear, narrow interpretations of or changes to those protections may later impair the investor's expectations.

[5] Investment Contract Remedial Clauses.

[a] Stabilization.

Stabilization clauses generally provide that a contract between a host government and a project company and foreign investors will be governed throughout the life of the project or investment by the law as in effect at the time of contract.[55] This commitment can extend to tax, commercial, environmental, and financial laws. Though countries often assert that these clauses infringe on national sovereignty, courts and arbitrators have strongly rejected that argument.[56] As one tribunal forcefully put it, in entering into a concession contract with a foreign investor, the state "did not *alienate* but *exercised* its sovereignty."[57] As commentators have noted, a stabilization clause does not prevent a state from enacting legislation, only from enforcing new legislation against a particular concessionaire or licensee.[58]

It is possible that an arbitrator will decline to order specific performance against a public entity, whether due to lack of authority, respect for state sovereignty, or the realization that the state will simply refuse to honor such an order.[59] In those cases, the focus will be on the measure of damages. Damages for breach of a stabilization clause can either be lost profits plus unrecovered investment, or be limited to the invested funds. Including a stabilization clause in the investment contract increases the chances a court will award damages beyond recoupment in the event of breach or expropriation.

[b] Commercial Indemnity.

Some drafters require an indemnity from the government, indemnifying the foreign investor against any loss or liability resulting from a breach of the stabilization

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[54] *See* Republic of Kazakhstan Law on Foreign Investments, Dec. 27, 1994; Normative Decree of the Supreme Court of the Republic of Kazakhstan, June 28, 2002.

[55] *See* Thomas W. Wälde & George Ndi, "Stabilizing International Investment Commitments: International Law Versus Contract Interpretation," 31 Tex. Int'l L.J. 216, 220 (1996).

[56] *See, e.g.,* Timothy B. Hansen, "The Legal Effect Given Stabilization Clauses in Economic Development Agreements," 28 Va. J. Int'l L. 1015, 1028 (1988); Revere Copper & Brass v. OPEC, 17 I.L.M. 1321, 1342 (1978); AGIP v. Popular Republic of Congo, 21 I.L.M. 726, 735 (1982); Kuwait v. Aminoil, 21 I.L.M. 976, 1021-22 (1982).

[57] Texas Overseas Petroleum Company and California Asiatic Oil Company (TOPCO) v. The Government of the Libyan Arab Republic, 53 I.L.R. 389, 482 (1979) (emphasis added).

[58] *See* Noah Rubins & N. Stephan Kinsella, *supra* note 36, at 54.

[59] *See* Amaechi David Nwokolo, "Is There a Legal and Functional Value for the Stabilisation Clause in International Petroleum Agreements?" CEPMPLP Annual Review 8 (2004) § 5, at http://www.dundee.ac.uk.

clause. Some companies and lawyers believe that such a commercial indemnity, often set forth in a separate document from the investment contract, provides independent protection in the event that the host government seeks to repudiate the stabilization clause itself.

[c] Prohibition of Expropriation.

It is very difficult to contract around possible nationalization. As long as a government is not discriminatory and is willing to pay just compensation, there is little a company or tribunal can do to stop it. Courts and arbitrators are less likely to condemn an expropriation of resources or industries if they believe the nationalization is non-discriminatory and reasonably characterized as vital to the host country's interests. Some commentators believe that referring specifically to prohibition of nationalization or expropriation in a stabilization clause can increase the chances of an award for damages.[60] The more that a contract evidences a country's original intent to confer a specific bargain, the more likely the investor is to recover for its expected earnings, not just its original investment.

[d] Renegotiation.

An alternative or supplement to a stabilization clause is a renegotiation clause. In this approach, certain events such as tax increases or changes in the price of raw materials can trigger and mandate renegotiation of other terms of the investment contract, with the purpose of restoring the economic expectations of one or both parties. Renegotiation can be limited to certain key provisions, leaving most of an agreement untouched. The clause can also address direct acts by the government itself, such as cancellation of a project by executive decree.[61]

Renegotiation clauses mandate a good faith negotiation process, not any particular result or solution. Recovery of damages would likely occur in exceptional cases, such as unjustifiable delay or intentional obstruction of negotiations, or rejection of proposals for reasons other than normal commercial judgment. Even in those scenarios, damages may be limited to costs of delays or reliance on reaching an agreement.[62]

An important feature of the renegotiation clause is that both parties submit to principles of good faith negotiations, which may be more susceptible to reviews and orders by arbitral panels under international law than are stabilization clauses limiting the effect of new legislation.[63] It may also be a more realistic approach to changes in host country laws. An investor may try to keep contract terms ironclad, but the reality is that a host country can often force renegotiation by threatening expropriation, withholding

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60 *See* Timothy B. Hansen, *supra* note 56, at 1036.

61 *See, e.g.,* Kraha Bodes LLC v. Perusahaan Pertambangan Minyak Dan Gas Bumi Negara [Pertamina], UNCITRAL Final Award of Sept. 30, 1999, Mealey's Int'l Arb. Rep. (March 2001), at ¶ 54.

62 *See* Klaus Peter Berger, *supra* note 26, at 1369.

63 These principles include making serious efforts to reach an agreement, respecting the remaining provisions of a contract, responding promptly to adjustment offers from the other side, avoiding unnecessary delays, avoiding detriment to the other side, and paying attention to the interests of the other side. *See* Klaus Peter Berger, *supra* note 26.

needed additional cooperation, increasing impositions, or otherwise impairing the likely recovery of sunk capital and future profits.[64]

The renegotiation provision often goes both ways—opening discussions if either the investor or the state is adversely affected by the triggering events. The foreign investor can earn credibility in arbitration with such a bilateral clause, as this type of provision allocates both burdens and benefits between the host country and the investor.

[e] Governing Law.

Absent binding provisions to the contrary, investment agreements between a foreign investor and host country are usually based on the national law of the host country.[65] A clear choice of a law of a different jurisdiction is desired by the foreign investor, whether that of its home jurisdiction or a neutral country (particularly one well suited to governing financial transactions).

[f] Sovereign Immunity Waiver.

The dispute resolution provisions should feature a comprehensive waiver of sovereign immunity, not only for suits or arbitration proceedings, but also for enforcement of any resulting judgments and arbitration awards.[66] Courts in particular are often reluctant to challenge a state's sovereign immunity over its own natural resources, which makes obtaining a judgment or award more difficult.[67] A clear statement that a host government signatory waives sovereign immunity with regard to arbitration and awards mitigates future difficulties. The waiver should also be obtained from any stakeholder organizations that are owned by or affiliated with a government entity.

[g] Arbitration and Enforcement of Awards.

Drafting an arbitration clause is a complex undertaking and implicates a multitude of issues well beyond the scope of this paper.[68] An investor must choose from among a host of international arbitration bodies—as administrative bodies, sources of appointment of arbitrators, promulgators of arbitration rules, and forums for the arbitrations themselves.[69] The clause should specify what laws will govern the arbitration[70] and what rules of procedure the arbitral panel will use.[71] The clause may

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[64] *See* Abba Kolo & Thomas W. Wälde, *supra* note 53 (noting a number of examples of renegotiation despite the absence of a renegotiation clause).

[65] *See* Rudolf Dolzer, *supra* note 8, at 67, citing W. Michael Reisman, "The Regime for Lacunae in the ICSID Choice of Law Provision and the Question of its Threshold," 15 ICSID Rev. – Foreign Inv. L.J. 362, 370 (2000).

[66] *See, e.g.*, Libyan American Oil Co. v. Socialist People's Libyan Arab Jamahiriya, 482 F. Supp. 1175 (D.D.C. 1980), *vacated after settlement*, 684 F.2d 1032 (D.C. Cir. 1981).

[67] *See, e.g.*, Ohntrup v. Firearms Centre Inc., 516 F.Supp. 1281 (E.D. Pa. 1981); Libyan American Oil Co. v. Socialist People's Libyan Arab Jamahiriya, *supra* note 66.

[68] *See, e.g.*, Michael P. Darden, *supra* note 22, at 54-59; Noah Rubins & N. Stephan Kinsella, *supra* note 36, at 321-329; John S. Dzienkowski, *supra* note 24, at 127-169.

[69] Arbitration administrative bodies include the London Court of International Arbitration, the International Chamber of Commerce, the International Centre for Settlement of Investment Disputes, and the European Court of Human Rights, to name just a few.

[70] An arbitration clause can specify the laws of the host country, including any bilateral or multilateral investment treaties between the investor's country and the host country, or the laws of a neutral country. Choice of law can even be left to the arbitrators or the arbitrators can be

also define the site and language of the arbitration, the number of arbitrators, payment of arbitration fees, the availability of discovery, time limits for arbitrator appointment and decision-making, enforcement of awards, and accrual of interest on awards.[72]

[6] Bilateral Investment Treaties.

Bilateral investment treaties ("BITs") between nations, most often between a Western and a developing country, usually address expropriation explicitly.[73] These treaties may afford remedies for expropriation beyond those available under the host country's law or the investment contract.

For example, the United States 2004 Model Bilateral Investment Treaty states that neither country may expropriate or nationalize "either directly or indirectly through measures equivalent to expropriation or nationalization," unless the country's action meets certain criteria: it must be taken "for a public purpose," "in a non-discriminatory manner," "on payment of prompt, adequate, and effective compensation," and "in accordance with due process of law" and an article entitled "Minimum Standards of Treatment."[74] BITs are often enforceable in a variety of forums, including the International Centre for the Settlement of Investment Disputes ("ICSID") and arbitral systems to which the parties may have committed in the investment protection agreement.

[7] Multilateral Conventions: The Energy Charter Treaty.

Another source of investor protection comes from multilateral conventions. A prime example is the 1994 Energy Charter Treaty. Nearly all the nations of Europe and northern Asia are members, while a number of other countries such as China, Saudi Arabia, and the United States remain signatory observers.[75] The Treaty states that investments may not be nationalized or expropriated by "measures having effect equivalent to nationalization or expropriation" unless "for a purpose which is in the public interest," "not discriminatory," "carried out under due process of law," and "accompanied by the payment of prompt, adequate and effective compensation."[76] The Treaty mandates review under the laws of the expropriating party and in that nation's domestic courts, but another provision states that parties may contractually determine alternative dispute resolution procedures.[77] If the parties have not contracted for another arbitration system, ICSID would be the international tribunal for claims of Treaty violations.

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directed to use "fundamental and universal" legal principles or to act equitably, rather than being bound to any particular legal system.

[71] An investor might specify procedural rules from a formal arbitration body, such as those cited in note 69 *supra*. Alternatively, rules for ad hoc arbitration such as those of the United Nations Commission on International Trade Law ("UNCITRAL") are available for selection, in which case the arbitrators are appointed privately and act independently of any such body.

[72] *See* Robert D. Fischer & Roger S. Haydock, "International Commercial Disputes: Drafting an Enforceable Arbitration Agreement," 21 Wm. Mitchell L. Rev. 941 (1996); Noah Rubins & N. Stephan Kinsella, *supra* note 36, at 43.

[73] *See generally* Rudolf Dolzer & Margrete Stevens, *Bilateral Investment Treaties* (1995).

[74] The U.S. Model Bilateral Investment Treaty is available at http://www.state.gov/e/eb/rls/othr/38602.htm.

[75] For a complete list of current member states, visit www.encharter.org.

[76] Energy Charter Treaty, Art. 13.

[77] Energy Charter Treaty, Art. 26.

The Energy Charter Treaty is not the only multilateral convention affording investor protections. The OECD convention[78] and the American Convention on Human Rights[79] also have similar provisions.[80]

[8] Documenting Investment Undertakings.

In any remedial setting, the court or arbitrator will examine the degree to which the sovereign has interfered with reasonable investment-backed expectations. An investor should be able to show that its investment was based on bargained-for assumptions that did not contemplate the new regulations. Evidence of the contents of the bargain allows courts and arbitrators to reconcile contract stability with sovereignty.[81] Expectations are more likely to be adjudged reasonable when the government, through contracts, licenses, permits, or other permissions or laws, has expressly created or sanctioned them. Finding subtle ways to make agreements evidence this intent is part of the art of creating a more durable contract.

The utility of spelling out the government undertakings and assurances cannot be overemphasized. The more that a government commitment not to interfere with an investment is explicit, the more likely it is that a later adverse regulation will be deemed a prohibited act or at least a compensable indirect expropriation. As one arbitration panel recently expressed this point:

> [A]s a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and, which affects, inter alios, a foreign investor or investment is not deemed expropriatory and compensable *unless specific commitments had been given by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulation.*[82]

§ 1.08. Conclusion.

The discussion of memorializing the parties' bargain brings us full circle. In an integrated approach, the entirety of the project—from selection through structuring, drafting, negotiation and administration—evidences the variety of benefits that the host country will derive from respecting the integrity of that bargain. Using the investment contract not only to supply legal remedies and other mandatory terms, but also to confirm the incentives for successful cooperation, will enhance the value of the investment and the contract to the investor as well.

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[78] OECD Negotiating Group on the Multilateral Agreement on Investment (MAI), the Multilateral Agreement on Investment Draft Consolidated Text 56, OECD Doc. DAFFE/MAI(98)7 (Apr. 22, 1998), at http//www1.oecd.org.

[79] American Convention on Human Rights (Pact of San José, Costa Rica), Nov. 22, 1969, art. 2, ¶¶ 1-2, 1144 U.N.T.S. 143, 150, at http://untreaty.un.org/ENGLISH/series/simpleunts.asp.

[80] *See also* Restatement (Third) of Foreign Relations Law of the United States § 712(1) (1986).

[81] *See* Andrew Newcombe, "The Boundaries of Regulatory Expropriation in International Law," 20 ICSID Review 1 (2005).

[82] Methanex v. U.S. (NAFTA Tribunal Final Award, Aug. 3, 2005) at ¶ 7 (emphasis added), at http://ita.law.uvic.ca.