The Implications of Political Risk Insurance in the Governance of Energy Projects: The Case of Japan's Public Insurance Agencies

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Contents

Abstract By purchasing political risk insurance (PRI), investors can successfully strengthen their position in the host state, allocating the burden of political risk to third parties (insurance agencies). PRI is provided by international organisations, such as the Multilateral Investment Guarantee Agency (MIGA) and state-sponsored insurance agencies, known as export credit agencies (ECAs) or public insurance agencies. This chapter focuses on the insurance schemes of NEXI, Japan's officially sponsored ECA, which plays a dominant role in providing PRI to Japanese nationals. The benefits of insurance agencies providing PRI schemes go beyond cash indemnification. PRI mechanisms include various policy requirements, operational conditions, and performance standards that not only influence the engagement of the insured investors, but also shape the regulatory authority of host governments and affect local communities. PRI plays a particularly crucial role in the governance of energy projects due to the complexity of this sector and its importance to states and local communities. However, there are policy and operational implications of PRI provision in the governance of energy projects with an adverse effect on local communities. In response, most insurance agencies like NEXI, have taken measures

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for socially and environmentally responsible investments, requiring their insured clients to comply with various social and environmental standards and establishing surveillance mechanisms and in-house grievance facilities. Even if these practices are moving in the right direction, their true functionality and effectiveness have not yet been proved.

1 Introduction

Political risk insurance (PRI) typically provides coverage to foreign investments against a host state's harmful acts (political risks), such as currency inconvertibility, expropriation, and political violence.[1] PRI is provided by international organisations, such as the World Bank's Multilateral Investment Guarantee Agency (MIGA) and state-sponsored insurance agencies, known as export credit agencies (ECAs) or public insurance agencies.[2] All major capital-exporting states support their investors through ECAs or public insurance agencies. The largest state-sponsored insurance agencies are the United States' Overseas Private Investment Corporation (OPIC), Germany's PwC Deutsche Revision, and Japan's Nippon Export and Investment Insurance (NEXI).[3]

The benefits of insurance agencies providing PRI schemes go beyond cash indemnification. ECAs are known as the "prominent victims" due to their function of assuming political risks and deterring harmful host governments' behaviour, so that their insured clients can invest in risky markets.[4] Moreover, it is not only the insurance/guarantees that mitigate political risks (direct impact), but also the insurance agencies' market-leverage (indirect impact) that influence the governance of investment projects. PRI mechanisms include various policy requirements, operational conditions, and performance standards that not only influence the engagement of the insured investors, but also shape the regulatory authority of host governments and affect local communities. PRI plays a particularly crucial role in the governance of energy projects due to the complexity of this sector and its importance to states and local communities.

However, there are general and specific implications of PRI provision in the governance of energy projects. In general, international and national insurance agencies may become indirect regulators of host states' public policy, influencing

[1] Rowat (1992), pp. 103, 122.

[2] For an analysis of the various insurance schemes provided by international and national PRI providers, see Rubins et al. (2020), chapter 3; Papanastasiou (2015), chapter 6; Salacuse (2013), pp. 246–273; Ziegler and Gratton (2008), pp. 524–548.

[3] It is estimated that together these agencies represent over 80% of all outstanding national political risk coverage, Rowat (1992), p. 119.

[4] Markwick (1998), p. 54; see also Shanks (1998), pp. 96–98.

policyholders' decisions on sensitive issues that are related to local communities' concerns about the environment, human rights, local culture and domestic laws. In specific, there are implications in the operation of PRI providers that are related to the coverage of investment projects and the criteria that define the covered political risks, the insured events and the check points for claim ascertainment.

Finally, in response to criticisms of certain PRI policies' adverse effect on local communities, almost all major insurance agencies have incorporated specific policies for socially and environmentally responsible investments, requiring their insured clients to comply with various social and environmental standards and establishing surveillance mechanisms and in-house grievance facilities.

This Chapter focuses on the insurance schemes of Japan's sponsored insurance agencies, (primarily NEXI and secondary the Japan Bank for International Cooperation—JBIC). First, it explains their role in supporting Japanese investments overseas through the provision of PRI mechanisms with emphasis on energy projects. After presenting the intense need to mitigate political risks in the energy sector and the structure of the PRI industry and market, the specific instruments provided by NEXI and how they address policy and operational implications of PRI provision are analysed, especially in relation to responsible investment considerations.[5]

2 The Complexity of Energy Projects

Aside from addressing the implications of PRI policies in general, this chapter focuses on the governance of energy projects, asserting that there is an intense need to manage political risk in infrastructure and especially in the energy sector. Political risks are more likely to occur in the energy sector than any other industry.[6] The energy sector, by its nature, requires a high level of government involvement and co-operation with the private sector, and, as a result, whenever intervention causes problems for investors or their co-operation fails, the possibility of political risks materialising significantly increases. Specifically, the high possibility of political risk occurrence can be explained due to several peculiarities that are related to the nature of the energy industry and the complexity of private sector participation in energy investments.

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[5]This chapter used sources and findings from Chapter 6 of the author's book titled "The Legal Protection of Foreign Investments against Political Risks. Japanese Business in the Asian Energy Sector" (Quid Pro Books, New Orleans, 2015). The purpose of this chapter is to consider NEXI as only an illustrative example of how most major public insurers incorporate specific standards and mechanisms for dealing with environmental and social concerns. The findings of the chapter could be addressed to all major insurance agencies which seem to adopt similar policies and practices with NEXI.

[6]Energy investors rank political risk as the most challenging factor that affects their business. See Van de Putte et al. (2012), pp. 284–299.

The opening of infrastructure sectors to foreign investment has happened much slower than in other industries.[7] Although there is a variation in the degree of openness, most developed or transitioning countries have now, for the most part, introduced foreign entities into their infrastructure industries. However, infrastructure, and particularly the energy sector, is still characterised as the most restrictive sector.[8] Access to energy resources for foreign investors is either restricted or severely limited, as most countries reserve them for their state-owned or domestic corporations.[9]

Private investment in the energy sector differs from investments in any other industry or services for various reasons. Firstly, the energy sector is characterised as socially and politically "sensitive".[10] Issues such as the price of oil or electricity, accessibility and quality of services, are always at the core of public interest and politics. Any increase in prices or deterioration of services would be noticed immediately by local communities and could result in social unrest. The operation and provision of energy services can become an even more "delicate" situation when foreign investors are involved, raising nationalistic concerns among the local societies.[11] Resource nationalism is a big factor of political risk uncertainty for foreign investors. It was named as the phenomenon according to which states confiscate or nationalise international companies in the petroleum and extracting industry, and this phenomenon is becoming more intense with resource scarcity, increasing energy prices and geopolitical tensions.[12]

The energy sector is also regarded as "strategic".[13] It not only plays an indispensable role in the economic growth and economic development of countries, but it is also related to national security and public interest concerns,[14] which is highly significant in determining whether an expropriation is legitimate or not.[15] Both western and eastern economies consider energy as one of the most strategic sectors (e.g. China,[16] the Russian Federation,[17] USA[18]). In addition, corporations operating

[7]The opening up started in the early 1990s, compared to other industries like the manufacturing sector that started much earlier in the WWII period. UNCTAD (2008), pp. 152–153.

[8]Golub (2003) pp. 87, 100.

[9]Van de Putte et al. (2012), p. 284, Figure 6.

[10]The social dimension of infrastructure is stronger in sectors like water and energy services, see UNCTAD (2008), pp. 161–162.

[11]Gomez-Ibanez (2007); see also Kessides (2004).

[12]Maniruzzaman (2009-2010), pp. 79–107.

[13]UNCTAD (2008), p. 155.

[14]UNCTAD (2008).

[15]One of the requirements for an expropriation to be lawful is the fulfilment of a "public purpose".

[16]According to Chinese foreign investment policy, power generation and electricity distribution are critical to the national economy. UNCTAD (2008), p. 155.

[17]The Russian Federation defines all natural monopolies as strategic sectors, UNCTAD (2008).

[18]The US Foreign Investment and National Security Act of 2007 requires "investigation of any transaction by a company controlled by foreign government, especially when it concerns critical infrastructure", UNCTAD (2008).

in the hydrocarbons sector are well aware that geopolitics play a major role in this business. Energy projects are particularly vulnerable to geopolitics.[19] There is great competition among western powers that are supporting their energy corporations politically and financially to win bids for energy projects and obtain access to hydrocarbons reserves, hence securing reliable natural resources for their economies. This competition is even more complex with the involvement of China and other new, large competitors from Asia.[20] Political risks in energy projects increase even more when natural resources are located in “weak governance zones” which are territories highly disputed by neighbouring states or areas where the rule of law cannot be enforced due to weak governance, political violence, civil wars and corrupt local governments, or when the energy projects raise important environmental and human rights concerns.[21]

Another factor of energy projects’ complexity is the involvement of various private actors. The private sector is increasingly needed for upstream and downstream projects, improvement, maintenance, and expansion of energy services. Most countries, both developed and developing, either need private capital to bypass public finance constraints, or look for private managerial skills in order to improve efficiency and modernise their infrastructure services. On many occasions, multinational corporations (MNCs) have proved successful at providing efficient and affordable services to both developed and emerging economies.[22]

Moreover, the role of the state as the main actor in providing energy services has changed and, to a great extent, governments’ activities have been replaced by the private sector. It is quite often found that market mechanisms successfully provide solutions to problematic public infrastructure services that were previously, traditionally and solely, operated by the state.[23] One of the most popular forms of private participation in energy projects is project finance. Especially in relation to hydrocarbon exploration and exploitation, or power plant construction, there are usually a variety of parties that are directly or indirectly involved with a particular investment project.[24]

Some of the main parties are the sponsors of the project—usually construction companies (contractors), financiers (such as big investment banks-lenders), suppliers of machinery and equipment important for the project, operating-companies (operators), and many other subcontractors.[25] The abovementioned companies are usually

[19]Hancock and Allison (2018).

[20]Sachs (2007), p. 82.

[21]MIGA (2007) Political Risk in the Extractive Industries: Voluntary Tools for Risk Mitigation http://www.pricenter.com/documents/perspectivesmena.pdf, p. 1; Webb (2012), p. 395.

[22]ADB, Developing Best Practices for Promoting Private Sector Investment in Infrastructure (Asian Development Bank, Manila, 2000).

[23]Multiple roles of government in infrastructure as: sponsor/investor, consumer/customer, rule-maker/regulator and mediator/moderator, see Doh and Ramamutri (2003), pp. 337–353.

[24]Esty and Sesia (2010–2011).

[25]Babbar and Schuster (1998), pp. 23–32.

private companies and each of them is responsible for undertaking a certain risk that is connected to the nature of their contribution to the project. For instance, the banks bear the financial risks, the contractors the construction risk, the suppliers the supply risk. This follows the basic principle of project finance that “risks should be allocated to the party that is best able to control the risk or influence its outcome”.[26] Nevertheless, in an energy project, financing risks are eventually allocated according to the will of the parties, as expressed in the contractual agreement. In developing countries, the state party [government or state-owned enterprise (SOE) purchaser] usually assumes more risks, including some types of risk that they are not in the position to control. In more developed countries where the investment climate is less uncertain, host governments assume less risk.[27] The empirical evidence for this has been strongly supported by the “neo-liberal” and globalisation movements advocating more liberalisation and privatisation of economic activities that are controlled by governments, such as infrastructure industries.[28]

3 The PRI Industry

3.1 Main Types of Risks and Mitigation Instruments

Given the special nature of foreign investment projects, and particularly of those related to the public infrastructure such as the energy sector, states and multilateral investment-guarantee agencies have developed a mix of risk-mitigation instruments that cover three broad types of risk: political risk, credit risk, and exchange-rate risk (currency-devaluation risk).[29] From a general point of view, only the first category is related to the mitigation of political risk. However, what a political risk is, is not always well defined. There are cases of non-commercial risks that can be also covered by political risk mitigation instruments.[30]

Multilateral institutions and state-sponsored insurance agencies increasingly focus on the mitigation of political risk in relation to the facilitation of infrastructure project financing. The instruments that are used to mitigate political risk are typically “termed partial risk guarantees” (PRGs), such as the guarantees provided by the World Bank Group (WB Group) or PRI mechanisms used mainly by ECAs such as NEXI. These political risk instruments mainly cover expropriation risks (“indirect”

[26]Hoffman (2008), p. 28.

[27]Babbar and Schuster (1998), p. 20.

[28]Classical economic theory has influenced and, to some extent, shaped international economic law, supported by the “North”, the capital exporting countries. It has emphasised the free movement of capital and the protection of investments through better standards of treatment and neutral arbitration tribunals for the resolution of investment disputes, Sornarajah (2004), pp. 51–57 and pp. 293–294.

[29]UNCTAD (2008), p. 171.

[30]Matsukawa and Habeck (2007), pp. 1–5.

or "creeping" expropriation was not usually covered),[31] currency inconvertibility, restriction on transfers of funds, war and civil disturbance risks.[32]

However, there has been an expansion in PRI coverage, which has come to include breach of contract, arbitration award default, and various risks related to project-specific undertakings. It is a significant shift from the traditional coverage of political risk, moving towards the coverage of specific governmental obligations that are contractually undertaken between the host state and the foreign promoter of an infrastructure investment. Nevertheless, the borders between political and commercial risks have become more blurred and, as has been said, "[o]ne may argue that some of these risks fall in between traditional commercial risks and traditional political risks".[33]

3.2 The PRI Market

3.2.1 Historical Background

One of the first PRI investment programmes was initiated by the US Government with the Marshall Plan in 1948. Its purpose was to encourage US investments overseas under the reconstruction policy in post-war Europe. Thus, it was not until the 1990s that the demand for PRI business increased significantly. After the fall of the Soviet Union, and especially as a result of the open-market policy, globalisation and liberalisation movements launched by the capital-exporting countries, unforeseen business opportunities opened up for foreign investments in many developing countries, especially in the areas of natural resources and energy. This increased the demand for PRI tools.[34] However, the 11 September 2001 terrorist attack in the United States, the Argentine financial crisis,[35] and the global financial crisis that was induced by the Lehman Brothers' bankruptcy and the US subprime mortgage crisis in 2008 affected the PRI industry significantly, changing the way investors and insurers assume political risks. The possibility of suffering extreme losses due to terrorism, but also the rising uncertainty of the global financial crisis with its potential sovereign and corporate defaults, reinforced the debate as to whether, with such unpredictable situations, the PRI market should be allowed to

[31] "Creeping expropriation" or "indirect expropriation" are also replaced by the term "de facto expropriation". Creeping expropriation means that the host state has taken a series of measures with a cumulative expropriatory effect, while indirectly emphasising the fact that the investor's formal or nominal title to the asset was not actually affected, see Shanks (1986), pp. 417 and 424.

[32] MIGA (2011), p. 56.

[33] Matsukawa and Habeck (2007), p. 5.

[34] MIGA (2010), pp. 54–55.

[35] *Standard & Poor's (2002)* The Argentine Crisis: A Chronology of Events after the Sovereign Default http://www.standardandpoors.com/europe/francais/Fr_news/Argentine-Chronology-of-Events_12-04-02.html.

continue on the same scale, or whether it should alter its policy on political risk coverage.

To date, the PRI market, or political risk guarantee market,[36] consists of two broad categories: guarantees for export or trade credit and investment insurance. This chapter, referring to the coverage of political risk in relation to overseas investment projects, focuses solely on the role of investment insurance.[37] However, potential protection of a foreign investment could also be offered by combining guarantees for political risk provided by export credit or trade tools. There are certain instruments that cover losses to exporters or lenders financing projects tied to the export of goods and services (trade coverage). For example, regarding investments in infrastructure, the export credit guarantees can cover losses due to political risk for services that are connected to engineering, procurement and construction (EPC) contracts. In addition, sovereign and corporate debt risk can be covered regardless of whether the reason for the default is commercial or political.[38]

3.2.2 PRI Providers

As mentioned above, the PRI market consists of multilateral and public (national) insurers and a significant number of private enterprises. The multilateral agencies that provide risk mitigation instruments are mainly multilateral development banks (MDBs) such as the World Bank Group, the Asia Development Bank (ADB), the Inter-American Development Bank (IrADB) and the European Bank for Reconstruction and Development (EBRD). Additionally, there are some multilateral agencies that specialise in providing political risk guarantees, such as the African Trade Insurance Agency, the Inter-Arab Investment Guarantee Corporation, the Islamic Corporation for the Insurance of Investment and Export Credit, and the most important, MIGA, which belongs to the WB Group.[39]

As far as the public or national agencies are concerned, they are generally bilateral development agencies and ECAs. ECAs are the most important type of PRI provider, existing in almost all of the big capital-exporting countries, as well as in the recently transitioning economies, such as Brazil, Russia, India, China and South Africa (BRICS), and in some other less powerful economies. ECAs can be considered a large category of national agencies including export-import banks, export credit guarantee agencies and investment insurance agencies.[40] Their

[36] As mentioned before, they are the same but their names change depending on the provider: 'PRI' is used by NEXI and 'political risk guarantees' is used by MIGA.

[37] However, the area between traditional investment and export credit insurance has become blurred, see Stephens (1998), pp. 148–168.

[38] Matsukawa and Habeck (2007), p. 4.

[39] MIGA (2011), p. 55.

[40] Matsukawa and Habeck (2007), p. 9. For a list of the major bilateral agencies and their risk mitigation instruments, MIGA (2011), appendix B2, pp. 50–84.

organisational structures vary depending on their particular country's policies. For example, in the United Kingdom it is part of the government, in Germany and France they are private entities, and in Japan and the United States, ECAs are considered to be autonomous public agencies and thus not absolutely independent from public administration. ECAs are subject to international regulation by the Organisation for Economic Co-operation and Development (OECD) and the World Trade Organisation (WTO). Most of the ECAs provide guarantees for both political and commercial risks, though it has been questioned whether their role allows them to provide long-term commercial risk insurance for infrastructure project-financing.[41] Finally, even if the objectives of bilateral agencies differ from those of multinational organisations (they pursue more nationalistic purposes),[42] their activities are often complementary in providing guarantees for many transactions related to energy project financing.[43]

3.3 Japan's PRI-Agencies: NEXI in Cooperation with JBIC

3.3.1 NEXI: Background

One of the largest state-sponsored insurance agencies internationally is NEXI,[44] which, along with the lending and guarantee function of JBIC, is Japan's export credit agency and public insurer, furnishing a variety of investment-related services for Japanese investors. Japan's investment insurance system was established in 1950 to support Japanese exports by providing guarantees against political risks such as war, currency controls and expropriation. The system was managed by the predecessor of NEXI, the Export-Import Insurance Division (EID) that was incorporated into the Ministry of Economy, Trade and Industry (METI). In April 2001, NEXI was established as an incorporated administrative agency, taking over the ministry-managed service and acquiring administrative and operational autonomy. On 1 April 2017, NEXI was transferred to a 100% government-owned special stock company, strengthening its ties with the government, so as to better support public policy in NEXI's business.[45] Thus, NEXI continues to function under the auspices of METI, which provides NEXI with its capital and reinsures insurance agreements underwritten by NEXI. As of 1 April 2019, NEXI's capital budget is JPY169.4 billion (100% state-owned) and 195 officers are employed there.[46]

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[41] Short (2001), p. 1371.

[42] ECAs usually serve their countries' national interests whereas MDBs do not tie their programmes to the nationality of exporters or investors, see Hoffman (2008), p. 295.

[43] , p. 73 and see also Matsukawa and Habeck (2007), p. 10; Moran (1998), p. 140.

[44] NEXI website https://www.nexi.go.jp/en/index.html.

[45] NEXI (2017) Annual Report FY 2016, p. 7.

[46] See NEXI's Profile https://www.nexi.go.jp/en/corporate/profile.html.

Since May 1970, NEXI has been a member of the Berne Union (the International Union of Credit and Investment Insurers), which is a forum where ECAs from various countries exchange information on common issues of export credit and investment insurance. The Berne Union announced in October 2008 a new set of Guiding Principles that mandate member-agencies to adopt a uniform policy about how to conduct investment insurance in general. NEXI is also a member of the Paris Club, an informal international group that provides solutions to sovereign debt problems between debtor and creditor countries. Finally, NEXI is a member of the OECD's working party on Export Credits and Credit Guarantees, signing the Agreement on Officially Supported Export Credits called the OECD Consensus.[47] The OECD working party issues recommendations in an effort to shape ECAs' behaviour towards export credit and investment insurance as well as issues related to fair competition,[48] bribery, corruption, and environmental protection.[49]

NEXI's mission is to facilitate the promotion of Japanese trade and investment by mitigating political and commercial risks in export and overseas investments through PRI provision.[50] NEXI provides insurance for investments and exports in both developing and developed countries. NEXI often operates in conjunction with other programmes, provided by JBIC,[51] or development programmes offered by the Japan Investment and Cooperation Agency (JICA). NEXI is especially active in providing insurance for large investment projects in several countries' public infrastructure, such as for megaprojects in the energy sector sponsored by Japanese private entities. As it is stated in the medium-term business plan (FY2019–FY2021), the promotion of infrastructure exports by Japanese companies and the support to businesses that are related to infrastructure development programmes overseas are primary objectives of NEXI in contributing to Japan's efforts to implement its national policies.[52]

NEXI has played a crucial role in protecting overseas investments against political risk. Until today, the majority of large Japanese corporations have not been willing to invest abroad without using NEXI's PRI mechanisms. When it comes to

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[47] Hoffman (2008), p. 296.

[48] Each of the member countries in the OECD Consensus has to limit export credit to no more than 85% of the contract value in order to protect competition from distortion, Hoffman (2008).

[49] Hoffman (2008). However, with regards to project financing, the OECD Consensus was amended in 1998, allowing member-countries' ECAs to support projects financed on a limited recourse basis without any limitation. This exception is very important for foreign investments in the power sector, as most of the project-financing mechanisms are related to infrastructure projects.

[50] Article 4 of Japan's Trade and Investment Insurance Act of March 1950 (No. 67/1950) and the Amendment Act of December 1999.

[51] JBIC also provides some political risk guarantees, but it mainly functions as a creditor of Japanese investments with NEXI being the main insurer providing PRI for loans and equity for overseas investment.

[52] NEXI (2018) Annual Report FY 2017, p. 60.

the protection of overseas investments against political risk, the reliance of Japanese corporations on NEXI is such, that it is conceived as a "last resort" mechanism.[53]

3.3.2 JBIC: Background

JBIC is Japan's bilateral agency that provides debt financing to Japanese investors. It was organised in 1999 as a financial institution of the Japanese Government, but it has existed much longer, since 1950, when its predecessor, the Export-Import Bank of Japan, was established.[54] On 1 October 2008, JBIC became the international wing of the Japan Finance Corporation (JFC), continuing to use its name for its international finance operations and, on 1 April 2012, JBIC was established in accordance with the Japan Bank for International Cooperation Act (JBIC Act), wholly owned by the Japanese Government.[55] One of JBIC's missions, similarly to NEXI, is the promotion of Japanese investors' "overseas development and acquisition of strategically important natural resources to Japan", as well as "maintaining and improving the international competitiveness of Japanese industries".[56]

JBIC is the main financing arm of Japan's public borrowing. Its principal operation is to provide financial assistance including loans, bonds, and concessionary long-term and low-interest funds. JBIC offers limited guarantees that cover loans and bonds but not equity like NEXI does. It mainly functions as a creditor of Japanese investments and not as an insurer, in order to avoid "operation-overlapping" with NEXI. Actually, JBIC's main role is lending operations. It can provide up to 60% of the total lending that is needed in each case. The remaining 40% is covered by commercial banks (co-financiers) for which political risk is insured by NEXI. Consequently, the practical contribution of agencies such as JBIC and NEXI is that private investors can achieve much better terms in borrowing funds from commercial markets. Without the guarantees of JBIC and NEXI, the maturity of loans offered by the markets cannot exceed a period of five, or maximum seven, years, which is very short considering that most energy-financing cases have a project-life of a period between ten to fifteen years. With JBIC-NEXI guarantees, the maturity of loans can be extended to at least ten years and, if required, to a longer period. JBIC provides financing tools such as overseas investment loans (OIL), overseas untied loans (OUL) and buyer's credit (BC),[57] whose political risks are covered by NEXI's overseas investment insurance (OII), overseas untied loan

[53] NEXI (2018) Annual Report FY 2017.

[54] Japan's Export Import Bank Law of 1950.

[55] JBIC, Annual Report FY 2018 (Japan Bank for International Cooperation, 2019), p. 3.

[56] JBIC, Annual Report FY 2018 (Japan Bank for International Cooperation, 2019), p. 101. When projects contribute to these national policies, JBIC may even apply special interest rates on borrowings. See also, JBIC Profile, Role and Function https://www.jbic.go.jp/ja/about/role-function/images/jbic-brochure-english.pdf, pp. 2–3.

[57] See JBIC Profile, Role and Function https://www.jbic.go.jp/ja/about/role-function/images/jbic-brochure-english.pdf.

insurance (OULI), and buyer's credit insurance (BCI) respectively. Therefore, NEXI is the main insurer of Japanese investors with JBIC only playing a supplementary role by providing some limited political risk guarantees and focusing mainly on lending operations.

4 PRI Policy Implications

4.1 In General

Examining the overall function of PRI mechanisms, there is a "grey-zone" about the political risk notion and how the PRI international or national agencies perceive it. First, the distinction between political and commercial risks is blurred, mainly because it is difficult to determine political risk. For example, it is not easy to distinguish whether a default in the payment by a government-operated energy utility, or a failure to deliver services, is due to political or commercial reasons.[58]

In addition, political risks emanate from the unpredictable behaviour (action or inaction) of host governments interfering with a foreign investor's business and negatively influencing its profit.[59] Such uncertainty arising from the host government's change of behaviour is exactly what political risk is all about.[60] However, this definition is problematic. Change of governmental behaviour towards private investments may often be justified as an exercise of regulatory authority, a legitimate intervention in pursuit of public policies or to protect local communities' interests.

Nevertheless, as Professor Celine Tan indicates, most PRI providers are more concerned with the financial impact of a governmental intervention than with its reasons; PRI agencies are less concerned about why a host government changes its behaviour towards a foreign investment, than with how such change "affects the financial viability of the project in question".[61] In particular, there is no solid evidence that PRI agencies properly investigate the insured investor's behaviour with respect to allegations of collusion with the host government, or the effect of an insured project on local communities' concerns about the environment, the local

[58]On commercial risk and commercial risk management, see Boyce (2003).

[59]Rubins et al. (2020), paras 1.01–1.07.

[60]Most international investment agreements are driven by the needs of the capital exporting countries which impose on their counter-parties (host states) rules and conditions of free entry into specific sectors and require host states to refrain from intervening in the operation of foreign investors, thus enhancing regulatory certainty. This phenomenon has been described as the "political economy of certainty", see Schneiderman (2008), pp. 205–206.

[61]Tan (2015), pp. 179–180.

culture, labour rights, human rights, and violation of domestic laws.[62] On the contrary, most PRI policies refer to the protection of the insured investors or projects against general acts of ill governance by host governments, without distinguishing whether these acts are taken in favour of local communities' interests that compete with the insured investor's interests.[63]

In general, PRI policies play a major role in determining both host governments' and foreign investors' behaviour. PRI providers, especially international agencies like MIGA,[64] or national credit and insurance providers such as JBIC and NEXI from big capital-exporting countries like Japan, are important actors for the successful implementation of megaprojects in the energy sector. These projects often need diplomatic support from the investor's home country to secure agreements with host states, but also credit and investment insurance in order to minimise risks and secure better terms of financing from international financial institutions and private banks. Such support is usually given when a well-established PRI provider is involved in the project through an insurance contract with the foreign investor. For this reason, foreign investors are ready to accept all required conditions imposed by public insurers' operational policies, contractual terms and underwriting criteria. In that sense, insurers may not only affect the design of the investment project, but also the relationships between the insured investor and the host government. National PRI providers, exercising the leverage of their home state's economic diplomacy, may often indirectly influence host governments to secure better terms and treatment for their insured investors.[65] Public insurers may become "covert regulators" that have an impact on the wider public policy of the host government's policyholders, through their monitoring mechanisms of the contractual agreement and by framing the risks and responsibilities between the parties.[66]

In particular, subrogation clauses and the PRI due diligence framework influence the host states' behaviour towards the insured investor, even if they are third parties to PRI contracts. PRI providers require the insured investor to take into consideration social and environmental criteria in order to cover the investment project. But at the same time, PRI policies determine the allocation of risks and responsibilities between the insured investor and the host state. As explained below, what PRI

[62]For example, it was reported by the World Bank's Compliance Advisor and Ombudsman (CAO) in its audit relating to MIGA's involvement in the Dilukushi copper and silver mine in Congo, that MIGA used its social and environmental due diligence framework to inspect the likelihood of future claims by the insured client, rather than to assess the possibility of the insured project's adverse impact on local communities, see CAO (2005), CAO Audit of MIGA's Due Diligence of the Dikulushi Copper-Silver Mining Project in the Democratic. Republic of the Congo: Final Report, pp. i–ii. 7–8).

[63]Moody (2005), pp. 6–7.

[64]For a description of the organisation's role, its rules and insurance schemes, see Protopsaltis (2014).

[65]Heimer (2002), pp. 117–129.

[66]Heimer (2002), p. 119.

providers require from the insured investor is closely related to the host state's regulatory authority.

Capital exporting states tend to insert a subrogation clause into their international investment agreements.[67] According to the subrogation clause, the foreign investor's home state has the right to take over claims of its own investor that is compensated through a PRI arrangement.[68] For example, after indemnifying the investor, NEXI substitutes the investor in all its legal rights and claims against the host government through subrogation. For this reason, before compensation is paid, NEXI requires an assignment to itself of all the investor's rights, titles, and interests. If the host state has not obtained a bilateral investment treaty with Japan, there is a theoretical possibility that the host state will not recognise NEXI's subrogation right, though such possibility is considered as a rare case scenario. Nevertheless, some bilateral ECAs and multilateral agencies offer insurance only to those investments that are sited in countries that have obtained investment treaties with the investors' home countries.

In conclusion, the possibility of the home state (through its public insurer) taking over its own investor's rights could potentially prevent host states from taking any regulatory or administrative measures.[69] When host states are not willing to make any administrative intervention or regulatory change that may affect an insured energy investment (even when such change would serve public interests), this has an adverse impact on host states' regulatory sovereignty, resulting in regulatory chill.

4.2 Operational Implications: NEXI's PRI Instruments

4.2.1 In General

In order to better understand how a PRI policy is implemented and its implications in the governance of energy projects, it is best to examine NEXI's PRI instruments and how they are used in NEXI's operations. NEXI offers insurance for loans, equity investments, assets and rights, and any other investment structure that is subject to long-term exposure to political risk. As mentioned above, NEXI's coverage is related to trade and investment and is provided for protection against both political and commercial risks.

Among the various PRI instruments that NEXI offers, the most important insurance type suitable for investment in energy projects is OII and its specification, the Investment and Loan Insurance for Natural Resources and Energy. NEXI offers this

[67] Similarly, Japan has included a subrogation clause in most of its economic partnership agreements (EPAs), see Papanastasiou (2015), Chapter 5.

[68] Konrad (2013), pp. 31–32. See also Rubins et al. (2020), para. 3.134.

[69] Tan (2015), pp. 184–190.

type of insurance as a hedge against both political and commercial risks. It covers overseas investment for capital subscription or equity, for acquisition of business rights and titles (real property, equipment, mining rights, licences, concession etc.) and it even protects reinvestments in a third country. This last function of insurance for reinvestment via an investment recipient is a unique type of investment insurance provided by NEXI. It increases the protection provided to the Japanese subsidiary in a host country by expanding the insurance to investments made in a third country (the Japanese subsidiary performs direct business without establishing its own subsidiary in the third country), and guarantees against losses suffered due to political risk not only in the host country, but also in the third country. NEXI provides supplementary contracts to address these risks, subject to special agreement.[70] However, there are some operational implications that affect the governance of energy projects. These implications are related to the clarification of political risks covered by NEXI, the events that are required by the agency's criteria to trigger political risk insurance and the list of check-points for claim ascertainment.

4.2.2 Covered Political Risks

Political risks covered by NEXI's OII include expropriation and infringement of rights, war, political violence or civil disturbance, currency inconvertibility and non-transfer of funds, as well as natural disasters (*force majeure* risk).[71] In addition to these risks, OII covers some commercial risks such as insolvency of debtor and breach of contract by the other party which, under certain conditions, could be considered to be political risks as well.[72]

In particular, with regard to an expropriation case, OII makes NEXI liable to indemnify for losses suffered by the insured investor that result from expropriation (direct and indirect) of stocks and equities caused by the host government's interference, actions, or inaction, of central or local public entities, or any similar entity such as an SOE or public utilities, e.g. an electric utility.[73] Thus, in case a host government claims that its actions are legitimate regulations, NEXI cannot compensate for the damage that the insured suffered unless an arbitration award has been issued. Similarly, in the case of an infringement of rights, investors are protected from deprivation of important rights and assets such as titles of real estate, licences, or any other right that is important in carrying out operations, e.g. power purchase

[70]NEXI (2009) NEXI Business Guide, Overseas Investment Insurance section, p. 8.

[71]Article 2 (16) item 1 of the Trade and Investment Insurance Act No. 67 of 1950.

[72]For example, if the other party to the investment contract is the host government (central or local, public agencies or SOEs), which is usually the case in energy investments, any indemnity for losses suffered due to the government's breach of contract or due to insolvency caused by the government's political interference could be considered to be a PRI tool, provided that a supplementary contract between NEXI and the insured investor is signed.

[73]NEXI, Policy Conditions for Overseas Investment Insurance, Partial Amendment of 14 March 2007, Chapter 2, Article 2, p. 1.

agreement in the supply of electricity (expropriation of rights) and equipment, or raw materials, etc. (expropriation of mobile assets).[74] Therefore, NEXI will not insure against losses due to an infringement of rights when a government's acts are in accordance with domestic or international law. Finally, the change of law or regulation risk is also mitigated by OII, which covers losses that result from the imposition of new laws. In this case, the new law or regulation should be unfair and discriminatory or against an international treaty and cause losses.

Under these conditions, NEXI's PRI instruments require a governmental measure to be discriminatory in order to cover losses suffered by the insured investor. This exclusion of non-discriminatory measures of general application from insurance coverage is followed by most international and national insurers' policy.[75] However, in the case of energy investments it is quite difficult to distinguish between a non-discriminatory governmental measure and an indirect or creeping expropriation. First, because the host state's regulatory measures usually apply to all companies involved in the industry. For example, a governmental decision about an electricity tariff adjustment or energy prices affects all market participants.[76] Second, it may be impossible to determine whether a government's measure constitutes discrimination, as energy services are, for most states, a regulated monopoly. In such a case, the foreign investor may be the only actor operating in one sector (usually that is the case for electricity or gas networks, where a single transmission or electricity utility provides services), so there is no other actor in the industry against whom to compare the treatment of the alleged measure. Therefore, with no comparison it is difficult to prove whether an act or omission by the host government that has an adverse effect on foreign investment constitutes an indirect expropriation or a non-discriminatory measure of general regulatory application.[77]

4.2.3 Insured Events

According to NEXI's policy, in order for the abovementioned political risks to be covered, there are certain events which need to occur. These events are in some cases ambiguous. For example, NEXI requires, among others, the investor's inability to operate as a result of political risk materialisation (e.g. breach of contract, infringement of rights, war risk, etc.). Thus, the suspension of operation cannot be partial, but rather there needs to be a full halt in operation. This may cause uncertainty in

[74] NEXI, Policy Conditions, p. 2.

[75] Kantor (2015), p. 179.

[76] For example, that was the case in the *CMS v. Argentina* and *LG&E v. Argentina* arbitrations, where the tribunals concluded that Argentina's conduct was non-discriminatory because it applied an across-the-board regulatory change (currency obligations and tariff adjustments) to all corporations in the gas transmission industry, *CMS Gas Transmission Company v. Argentina*, ICSID Case No. ARB/01/8, Award, paras 468–469 (12 May 2005). *LG&E Energy Corp et al v. Argentina,* ICSID Case No ARB/02/01, Decision on Liability, paras 146–148 (3 October 2006).

[77] Kantor (2015), pp. 179–180.

cases of complicated projects such as energy investments which consist of various kinds of operations (e.g. power plant operation, fuel supply operation, transmission through the grid, etc.) and it raises questions about whether a claim for insurance is valid when a partial halt of one kind of operation causes substantial damage. In this case, the insured investor will not be able to satisfy any claim for insurance of losses suffered due to breach of contract, and NEXI will not indemnify the losses if the insured company continues the operation even partially. According to NEXI's policy, the covered event can only be "bankruptcy", full "inability to operate", or full suspension of operation for more than three months.[78]

4.2.4 Claim Ascertainment

Even when the covered events occur, that does not mean that NEXI will automatically satisfy the insured client's claims. Another implication of almost all ECAs' operations is related to "check points for claim ascertainment". NEXI has developed a list of check-points for claim ascertainment in order to examine whether the insured's claim in each case of the covered political risks is valid or not. ECAs need evidence of the impact on the investment's economic interests and operation caused by the insured event, requiring a causal analysis between the event and the damage suffered. However, the foreign investor is not always in a position to prove the causality of damages when the events (e.g. government actions or inaction) are indirectly connected with its damage, such as in the case of creeping expropriation or when the overall result of the government's actions only becomes apparent much later. Several causes may coexist at the same time, for example a slump in electricity sales (commercial market risk) and the host government's unilateral increase of the agreed fuel price supplied to the investor's power company (breach of contract risk or regulatory risk). Both of these causes have an adverse effect on the company's operation, but only the second can be an insured political risk covered by NEXI's insurance.

As regards expropriation, NEXI will only indemnify the insured for the losses that are related to its equity share or for the seizure of its specific right when the investment company is a joint venture among many shareholders. As for investments in the energy sector, project-financing is the standard form of investment. For example, power project finance is implemented through a special purpose vehicle (SPV), a joint-venture company consisting of a multi-level group of shareholders, such as sponsors, lenders, operators, EPC contractors, suppliers, and many others. In such a complicated mix of shareholders, NEXI needs to identify the extent of the insured's right to the equity or assets of the particular investment, something that is not an easy task.

[78]NEXI (2009) *NEXI Introduction Brochure*, p. 16.

4.3 PRI Policy Implications and Responsible Investments

Following criticisms about PRI approaches to environmental protection, human rights, and concerns about the violation of domestic laws, and in response to allegations of the adverse effect of insured projects on local communities, most international and public insurers have addressed policies for responsible investments. The term responsible investment implies an effort by the international community to integrate into international investment law policies that take into consideration non-investment related factors, such as protection of the environment and human rights concerns. In this vein, some recent international investment treaties require responsible business conduct, including safeguards for the promotion of sustainable development, the protection of labour rights and the environment, the provision of anti-corruption policies and corporate social responsibility.[79]

According to these policies, PRI providers require their prospective clients to comply with various social and environmental standards in order to insure their investment against political risks. For example, MIGA was the first insurance provider to adopt performance standards in eight areas of business practice,[80] following up from national providers, most notably OPIC.[81] Similarly, NEXI has issued the Guidelines on Environmental and Social Considerations in Trade Insurance (Guidelines), which allow it to examine whether the potential insured project takes into account the environmental and social considerations required by the Guidelines.[82] Energy investment projects are likely to have a significant adverse environmental and social impact and, therefore, they are classified into Category A in NEXI's screening process, which means that the project-sponsor needs to comply with stricter standards.

In addition, the majority of national PRI agencies have incorporated monitoring instruments in order to assess the insured projects' performance and to verify

[79]Cotula L, 'Raising the Bar on Responsible Investment: What Role for Investment Treaties?', *IIED Briefing* (March 2018), https://pubs.iied.org/pdfs/17454IIED.pdf. See also Webb (2012) pp. 394–415.

[80]The first performance standard is named as "assessment and management of environmental and social risks and impacts", see MIGA (2013) Policy on Environmental and Social Sustainability www.miga.org/documents/Policy_Environmental_Social_Sustainability.pdf, cited in Tan (2015), p. 187.

[81]OPIC (2010) OPIC: Environmental and Social Policy Statement www.opic.gov/sites/default/files/consolidated_esps.pdf, cited in Tan (2015), p. 187.

[82]NEXI's Guidelines are identical with JBIC's Guidelines (see JBIC Guidelines for Confirmation of Environmental and Social Considerations https://www.jbic.go.jp/en/business-areas/environment/confirm.html); NEXI's Guidelines were established taking into account the Common Approaches at OECD Working Party on Export Credits and Credit Guarantees. In addition, NEXI also uses standards established by other international organisations, such as the World Bank Safeguard Policies or International Finance Corporation (IFC), which are similar to those used by MIGA. See NEXI (2017) Guidelines on Environmental and Social Considerations in Trade Insurance, p. 4 and Exhibit 1: Environmental and Social Considerations Required of Covered Projects https://www.nexi.go.jp/en/environment/pdf/ins_kankyou_gl-e.pdf, pp. 8–10.

investors' compliance with the agency's social and environmental standards throughout the life-cycle of the insured projects. Some PRI providers like MIGA, require their insured investors to establish consultative methods with local communities and all other concerned parties and to envisage the creation of grievance procedures in order to receive complaints from affected communities.[83]

NEXI confirms the appropriateness of environmental and social considerations in three stages: screening, social and environmental review, and assurance of environmental and social considerations (post-commitment). NEXI uses a screening process, according to which it implements a detailed review of each project. It reviews whether the potential insured client adopts appropriate environmental and social practices, "so as to prevent or mitigate potential impacts on environment" including "social issues such as involuntary resettlement and respect for the human rights of indigenous peoples".[84] NEXI includes the result of its assessment on the project's environmental and social considerations in its conclusion of an insurance contract, and encourages the project sponsors to take more measures in case there is a high risk of adverse impact on local communities and the environment.[85] If the measures taken are insufficient, NEXI may refuse to conclude the insurance contract.[86] In concluding its assessment process and issuing the insurance contract, NEXI also carries out project reviews requiring the insured client to submit an environmental and social monitoring report once a year[87] and the results of public consultations with all relevant parties.[88] Within the limits of commercial confidentiality, NEXI will disclose the project information in Japanese and English on NEXI's website and invite any third party that is adversely affected by the insured project to raise its objections.[89]

However, there are limitations on the monitoring of the insured investors' compliance with the social and environmental standards established by the insurance agencies. The most important weakness is the irregularity of the monitoring process that is observed in public insurers' practice. The mechanism for monitoring insured projects and their compliance with contractual obligations is inadequate. For example, NEXI's Guidelines do not make any reference to a specific monitoring mechanism. NEXI relies on information provided by the clients based on the monitoring

[83]See MIGA (2013) Policy on Environmental and Social Sustainability www.miga.org/documents/Policy_Environmental_Social_Sustainability.pdf, pp. v–vii, cited in Tan (2015), p. 187.

[84]NEXI (2017) Guidelines on Environmental and Social Considerations in Trade Insurance https://www.nexi.go.jp/en/environment/pdf/ins_kankyou_gl-e.pdf, p. 4 and pp. 8–10.

[85]NEXI (2017) Guidelines on Environmental and Social Considerations in Trade Insurance, NEXI's decisions are mainly based on the applicant's environmental and social impact assessment (ESIA) reports.

[86]NEXI (2017) Guidelines on Environmental and Social Considerations in Trade Insurance, p. 6.

[87]NEXI (2017) Guidelines on Environmental and Social Considerations in Trade Insurance, p. 6 and Exhibit 1: Environmental and Social Considerations Required of Covered Projects, pp. 8–10.

[88]NEXI (2017) Guidelines on Environmental and Social Considerations in Trade Insurance, pp. 9–10 and Exhibit 2.

[89]NEXI (2017) Guidelines on Environmental and Social Considerations in Trade Insurance, p. 7.

that they conduct themselves and mainly confirms the monitoring results through document reviews.[90] Moreover, there is no specific provision for on-site inspections of projects.

Finally, MIGA and some public insurers have created in-house public complaints facilities or an ombudsman, operating independently of the agency's direction.[91] Local communities, or any affected individual, may directly address its complaints to these facilities about the insured projects' adverse social and environmental impact. Similarly, NEXI has incorporated the Objection Procedures on Environmental Guidelines, according to which a third-party that is affected by the insured project can request from NEXI to investigate its complaints.[92] For the investigation of the complaints, NEXI appoints an ad hoc organ (up to two examiners) that is under the direct control of NEXI's chairman, but works independently from the section in charge of the underwriting business.[93]

Nevertheless, NEXI's objection procedures reveal that the examiners' case-by-case function does not constitute a permanent complaints facility similar to those established by the WB Group, which are in-house well-established offices with human and financial resources, operating independently of the agency's direction and vetted with more powers and additional functions, such as audits and mediation.[94]

In general, there are similar limitations where most national PRI providers are concerned. Moreover, all international and public insurers are only eligible to monitor the compliance of the insured projects with regards to the violation of their agency's internal rules, guidelines and standards, but they are not in a position to examine violations of international law which is more inclusive and protective for local communities.[95] However, their operation is considered far more adequate compared to new public insurers from emerging economies or private providers. It has been reported that private insurers do not include any structure of a compliance and grievance mechanism, considering such an approach as unappealing to

[90]NEXI, What is the purpose of monitoring? How will you respond to the results of monitoring? https://www.nexi.go.jp/en/environment/faq/002406.html.

[91]For example, the Compliance Advisor/Ombudsman (CAO) is an independent facility established for the WB Group. It is responsible for evaluating IFC's and MIGA's compliance with social and environmental standards and for addressing complaints regarding any adverse impact of their operations. OPIC's Office of Accountability (OA) has a similar function, CAO (2014) CAO Operational Guidelines, p. 4. See also, OPIC (2014) Overseas Private Investment Corporation Office of Accountability: Operational Guidelines Handbook for Problem-Solving and Compliance Review Services, p. 3, section 3.1 cited in Tan (2015), p. 188.

[92]NEXI (2017) Objection Procedures on Environmental Guidelines https://www.nexi.go.jp/en/environment/pdf/08b_1.pdf.

[93]NEXI (2017) Objection Procedures on Environmental Guidelines https://www.nexi.go.jp/en/environment/pdf/08b_1.pdf, Articles 17–23.

[94]NEXI (2017) Objection Procedures on Environmental Guidelines https://www.nexi.go.jp/en/environment/pdf/08b_1.pdf, Article 21, which provides that the Examiner serves for a two-year term and may be re-appointed once.

[95]Tan (2015), p. 189.

investors, which prefer to avoid additional screening, and as a competitive advantage over public insurers.[96]

5 Conclusion

With regard to the high possibility of political risks occurring in the energy sector, national and multilateral agencies perform the most crucial task in the protection of energy investments through the provision of various PRI schemes. By purchasing PRI, investors can successfully strengthen their position in the host state by allocating the burden of political risk to third parties (ECAs) that play the role of "prominent victims".

In the case of Japanese energy investments, NEXI, Japan's officially sponsored ECA, plays a dominant role in providing PRI to Japanese nationals, while JBIC is the main public financier of Japanese investments. Similarly, MIGA of the WB Group has the most important role among multilateral agencies in guaranteeing foreign investments made in developing countries against political risks.

NEXI has a unique position in supporting Japanese energy investments by applying tailor-made criteria. NEXI (including JBIC's financing support) has in principle a "nation-based"[97] purpose of supporting the economic and industrial policy of the Japanese Government by promoting and securing Japanese investment projects overseas. Multilateral agencies like MIGA apply more general criteria in order to decide which projects are eligible to receive PRI.[98] As regards PRI schemes, both NEXI and MIGA have deployed a comprehensive set of instruments covering several contingencies of a government's default on its obligations towards its counterparty.

Due to several implications of PRI policies in the governance of energy investments, investors need to consider that signing an insurance contract does not mean eliminating all cases of political risk they may face during a long-term investment project in a foreign country. Especially in relation to energy project financing, a more tailor-made and commercialised approach is required by insurance agencies. Moreover, the effectiveness of PRI protection against political risk not only depends on the insurance policy, but also to a large extent, on the specific contractual arrangement between the investor and the host state or its agencies.

Moreover, subrogation clauses and surveillance instruments constitute an operational and regulatory framework of PRI providers that influences the behaviour of

[96]Gordon (2008), p. 104.

[97]A term borrowed from the non-political concept of "economic nationalism" which is based on the idea of countries supporting their national industries and products at any cost and protecting them against "open competition".

[98]Some of these criteria are related to host states' economic development, privatisation policies, open markets and non-distortion of competition.

host governments towards both the insured investor and their own people. In response, insurance agencies have taken measures for socially and environmentally responsible investments, requiring their insured clients to comply with various social and environmental standards. However, even if these practices are moving in the right direction, their true functionality and effectiveness have not yet been proved.

PRI schemes should represent more of a bottom-up approach to the responsibilisation of energy investments. PRI providers should take advantage of the demand for their services by energy corporations in order to secure better societal and environmental performance. The *sine qua non* condition of verifying the insured clients' compliance with the investment insurance standards is carried out through two indispensable processes, the creation of a regular and specialised monitoring mechanism and the incorporation of a fully independent and permanent public complaints facility. Moreover, if PRI providers manage to increase the local communities' involvement in the monitoring of the insured investor's compliance with various standards, they can reduce the risk of social or environmental damage and enhance the project's viability by creating a more stable investment environment.

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