



POLITICAL RISK IN THE EXTRACTIVE INDUSTRIES: Voluntary Tools for Risk Mitigation



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Traditionally, natural resource extraction has been an important motive driving foreign direct investment into developing countries. According to UNCTAD, high commodity prices and buoyant global demand were a key factor behind the growth of FDI flows into emerging markets in 2006, particularly in Africa.

However, natural resources are often located in developing countries with potentially risky political environments, with risks also exacerbated by volatile commodity prices. In addition to market instruments, such as political risk insurance, to mitigate these risks there exist several mechanisms or tools to enable companies in the extractive industries to manage political risks. For the most part, these are voluntary initiatives that enjoy the support of home country governments and multilateral institutions.

One of the most recently adopted initiatives is the [OECD Risk Awareness Tool for Multinational Enterprises in Weak Governance Zones](#). This tool was developed as a follow-up to the [OECD Guidelines for Multinational Enterprises](#) and is a voluntary, government-backed “code of conduct” for international businesses. The purpose of the Risk Awareness Tool is to help companies that invest in countries with weak governance become aware of the array of possible risks and dilemmas relating to social responsibility that they are likely to face. The tool aims at raising awareness on issues such as obeying the law, observing international instruments, providing proper care in managing investments, knowing business partners and clients, dealing with public sector officials, and speaking out about wrongdoing.

Weak governance zones, where many extractive projects are located, represent some of the world’s most difficult investment environments, often carrying significant political risks, such as violent conflicts. In addition to political risks, weak governance zones also pose significant issues relating to widespread solicitation, extortion, crime, abuses by security forces, forced labor and violations of the rule of law. The Voluntary Principles on Security and Human Rights which involves governments, energy and extractive companies, as well as nongovernmental organizations (NGOs), helps investors ensure the security of their worldwide operations and protect and promote human rights. The Principles are the outcome of an ongoing dialogue on security and human rights issues amongst the governments of the United States, the United Kingdom, the Netherlands and Norway, companies in the extractive and energy sectors, and NGOs. They fall into three categories: risk assessment interactions between companies and public security and interactions between companies and private security. The Principles identify a number of risks that should be taken into account when considering effective risk assessments, such as: (1) the ability to identify and understand the root causes and nature of local conflicts; (2) the possibility of misappropriation or diversion of equipment, which may lead to human rights abuses; and (3) the potential for violence to be either widespread or limited to particular regions, or develop with little or no warning.

There are a number of programs that seek to address transparency in extractive industries. Launched in 2002, the [Extractive Industries Transparency Initiative \(EITI\)](#) sets a new standard in cooperation between companies, governments, civil society and investors. By requiring transparency over both payments made by extractives companies and revenues received by governments, EITI makes it more likely that resources

will be well managed. The United Nations Global Compact initiative has also published the Conflict Impact Assessment and Risk Management, a business guide aimed at helping companies contribute to conflict prevention and to a sustainable business environment in the countries in which they operate. Other initiatives aimed at promoting transparency in extractive industries include the [Guide on Resource Revenue Transparency](#) (June 2005) published by the International Monetary Fund, which also provides an overview of generally recognized good or best practices for transparency of resource revenue management.

Finally, the “[Equator Principles](#)” are a framework for addressing environmental and social risks in project financing by the banking industry. Essentially, the Equator Principles establish a benchmark which allows the financial industry to determine, assess and manage social and environmental risks in project financing. The Principles apply to all new projects with total project capital costs of at least US\$10 million across all industry sectors. The first set of the Principles was launched in June 2003, and a revised set was released in July 2006. To-date, more the 40 banks and financial institutions have adopted the Equator Principles so that they are better equipped to miti-

gate credit risk and reputation risk associated with financing development projects. This common framework has become the standard for assessing and managing environmental and social risk in project financings.

All in all, these initiatives provide companies with tools and guidelines to identify and manage political risks, improve transparency and promote investment in extractive industries. However, since these are voluntary initiatives, their effectiveness depends upon the willingness of companies or governments to adopt them, ensure compliance and generally promote social responsibility.

The Extractive Industries Review

The Extractive Industries Review (EIR) ([Executive Summary](#)) was initiated in 2000 in response to requests by NGOs to review the World Bank Group's role in the extractive industries. The final report, published in 2004, was the outcome of a dialogue among all stakeholders, namely, NGOs, indigenous peoples' organizations, affected communities and community-based organizations, labor unions, industry, academia, international organizations and the World Bank Group itself.

The basic question addressed throughout this process was whether extractive industries projects can be compatible with the World Bank Group's goals of sustainable development and poverty reduction. The central message of the reviews was that while extractive industries investments can contribute to sustainable development, the World Bank Group should further enhance its efforts in several areas: more explicitly by identifying and tracking: poverty reduction associated with its projects; the overall quality of governance in host countries; broader inclusion of local stakeholders; transparency of revenue management and project documents; and the promotion of renewable energy and cleaner fuel alternatives.

For the Multilateral Investment Guarantee Agency (MIGA), this means the need to specifically assess the governance adequacy of the country, as well as the anticipated impacts of an oil, gas, or mining project that the agency considers issuing a guarantee for. MIGA can help clients take a responsible approach to the environmental and social aspects of projects.