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Risk Gaps: Policy Risk Instruments

Climate Policy Initiative

Valerio Micale
Gianleo Frisari
Morgan Hervé-Mignucci
Federico Mazza

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Contact	Gianleo Frisari gianleo.frisari@cpivenice.org
	Valerio Micale valerio.micale@cpivenice.org

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1 Introduction

Investors weigh a variety of factors when they make choices. One of these factors concerns how risky an investment is. While risk can come in many forms, one form that seems to be of utmost relevance for renewable energy and clean technology investments is policy risk. Policy risk, or regulatory risk, concerns the risk that unexpected changes to government regulations and policies will change the investment environment.

Traditionally, policy risk has been managed by investors with their own internal resources¹ or partially covered under traditional political risk insurance products.² However, recent unprecedented retroactive cuts and amendments to public policies such as Feed-in-Tariffs (FiTs) have significantly increased perception of policy risk (MIGA, 2012e) and dented investors' confidence in the renewable energy sector. The fact that demand for policy risk coverage is, so far, only partially met (Frisari et al., 2013), suggests that conventional practices may no longer be adequate to mitigate this risk and new mitigation instruments are needed.

In this paper, we highlight elements integral to the effectiveness of instruments which seek to address policy risk, paying special attention to issues likely to challenge their implementation, and we try to understand whether new instruments could themselves create additional risks. We provide a framework for a more accurate definition of policy risk in chapter two. In chapters three and four, we describe how existing and recently proposed (or launched) insurance instruments provided by the public sector are addressing retroactive policy risk. Finally, in chapter five, we identify good practices and emerging needs for new instruments, with a particular focus on the mechanisms addressing FiT policy changes.³

- 1 We refer to due diligence practices for the assessment of the investment, which take into account potential future changes in legislation, and defence of private interests with the local authorities. Other solutions may entail engaging in social activities to involve local communities (Bremmer, Fareed, 2006), co-financing of projects with host governments, or use of joint ventures and alliances with local companies (MIGA, 2012e), which ultimately reduce the likelihood of governments' breach of contract.
- 2 Policy Risk can fall within traditional political risk insurance coverage if changes are large enough to qualify as Expropriations or Regulatory takings (OPIC, 2012f).
- 3 Most of the recent reviews and amendments to support policies have concerned FiT schemes, especially in developed markets. Regulatory changes in the FiT regime are the result of democratic process and political will, and are more probable to occur when: (1) Incentives per electricity generated are high, and more than cover market costs or the value of total generation (IEA, 2011b); (2) Subsidies represent a significant share

Like the other *Risk Gaps* reports (Frisari et al., 2013), this work draws from a literature review and, most importantly, direct conversations with investors, insurers, researchers, and financiers participating in workshops focused on investments in green infrastructure projects and related risks (CPI, CBI, 2012), and on the key issues that a policy risk insurance facility should be able to face.

2 Definitions and challenges of policy risk

Policy risk, in the form of retroactive changes to policies that financially support investment, has emerged as a key obstacle to private investment in the renewable energy sector.

Policy risk concerns the possibility that national governments — acting in their sovereign capacity — amend policy environments in ways that adversely impact the financial stability of renewable energy projects.

We define two main types of policy risks:

- **Prospective policy risk refers to the overall uncertainty and instability of the regulatory framework (i.e. frequent, unpredictable, and irregular changes in the policy), which negatively influences the planning of new projects, resulting in higher rates of return required by investors.** For example frequent changes of legislation in Italy, such as a plan ("*Quarto Conto Energia*") introduced in 2011 for a revision of solar photovoltaic tariffs up to 2016, followed in 2012 by a new law introducing a new revision of tariffs, have resulted in an uncertain outlook for the photovoltaic solar sector (EPIA, 2012).
- **Retroactive policy risk refers to policy or regulatory changes which adversely affect the financial stability of existing projects.** Spain and most recently Bulgaria provide examples of where retroactive policy changes have negatively affected investment environments for renewable energy. In December 2010 Spain

of public budget (Abos, 2012; Wilkins, 2012); (3) Countries are subject to economic restrictions; (4) Countries are more generally subject to political instability (i.e. frequent government changes).

introduced two royal decrees terminating the right of subsidization after a project's 28th year and slashing the entire industry's tariffs by 10% and 30% for existing projects until 2014 (Green World Investor, 2010 and 2011). In 2012, the Bulgarian state regulator has introduced a retroactive renewable energy grid fee proportional to the amount of the feed-in-tariff received. The fee will penalize, in particular, solar photovoltaic operators, who will have to pay back up to 39% of their feed-in tariffs (PV Magazine, 2012a; BPVA, 2012).

In particular, retroactive changes to Feed-in-Tariff (FiT) regimes constitute the focus of our analysis in this paper, regardless of whether they are agreed on bilaterally or specified by laws or decrees. In our characterization of Feed-in-Tariff changes we include direct mandatory changes to the stated level of the tariffs, and also indirect acts such as the introduction of a retroactive connection fee for those benefitting from the tariff.

Of the two types of policy risk, retroactive changes appear to be investors' main concern because they directly impact projects' expected revenues and lower investor confidence about the stability of the financial support available over the investment's lifetime (see Box 1 for an estimate of the impact of policy risk on investors). An unexpected change in the level of support can compromise projects' ability to service debt and increase the cost of capital when refinancing (Abos, 2012; Varadarajan et al., 2011). It can also carry potentially high litigation costs (Green World Investor, 2010).⁴

Box 1. Estimates of the financial impact of policy risk.

A study by the Institute for Economy and the Environment for the International Energy Agency (IEA, 2011b; Müller et al, 2011; Lüthi, Wüstenhagen, 2012), based on conjoint analysis methodology simulating preferences over real decision situations between different investment possibilities, attempted to assess the willingness of business to accept risks related to policy changes impacting renewable energy subsidies by estimating the risk premium that investors would require to accept such changes. According to the study, a 50% risk of changing support to FiT within the next two years could be compensated by a risk premium of about 10 USDc/kWh (or 43% of the highest premium obtainable). In another study, Climate Policy Initiative (Varadarajan et al., 2011) analysed the impact of policy changes on generation costs in six renewable projects in Europe and the United States. Climate Policy Initiative found that financing costs increase by 11-15% of the cost of renewable electricity generation if policy support is reduced by 10 years, while a shift from a Feed-in-Tariff (FiT) or power purchase agreement (PPA) to a combination of a Feed-in-Premium (FiP) plus market prices (normalized to maintain equity returns), leads to additional financing costs of 4-11% (Varadarajan et al., 2011).

⁴ In response to the changes in the FiT regimes observed in Europe, several companies have filed complaints for the breach of Bilateral Investment Treaties or multilateral treaties such as the Energy Charter Treaty (ECT). Measures interfering with the amount, or the duration, of the price support are likely to be challenged as a breach of the fair and equitable treatment (FET) standard, interpreted as a protection of investor's legitimate expectations based on the principles of the state ensuring a stable business environment. (IISD, 2012)

3 Existing instruments for the mitigation of policy risk

While not specifically designed to cover policy risk, some examples of established political risk insurance products and guarantees have been used to some extent to protect against retroactive changes to revenue support policies. These can provide insights to inform the design of new dedicated instruments (e.g. including the OPIC FiT insurance discussed in chapter 4). We focus here only on instruments offered by the public sector as evidence suggests that new products and solutions for policy risks need (at least initially) to come from public institutions.⁵ In particular, we discuss political risk insurances from MIGA and OPIC in section 3.1 and partial risk guarantees offered by the World Bank in section 3.2.

3.1 MIGA and OPIC political risk insurance instruments

Political risk insurance instruments can partially cover the impact of policy change, providing that the change qualifies as an expropriatory breach of investor's rights. For clarity, with expropriation under these insurance contracts we refer to government measures, including policy changes, which deprive investors of their main rights to operate the asset and to receive compensation for their services, jeopardizing the profitability of their investments and leading to a confiscatory effect that essentially forces them to abandon their venture.

The Multilateral Investment Guarantee Agency (MIGA), a World Bank Group agency established in 1988 to offer political risk insurance to investors in the poorest countries, can cover a tariff reduction for the equity and debt provider⁶ if the client can prove that the change qualifies as an expropriatory change in the regulatory scheme (MIGA, 2012f), or as an expropriatory breach of the Power Purchase Agreement (PPA) between the investor and the public off-taker.⁷ Similarly,

- 5 During our consultations, private insurers (CBI, CPI, 2012; UNEP, Parhelion, 2012) have expressed a high degree of skepticism regarding their ability to provide coverage for the legitimate actions of governments, unless there is a sufficient alignment of interest with the host government.
- 6 MIGA covers up to 90% of equity investments, plus an additional 500% as a contribution for earnings' losses attributable to the investment; for loans, the guarantee rises to up to 95% of the principal, plus 135% of the principal to cover accrued interests' loss (MIGA, 2012b).
- 7 A IEG-WB report shows the case, in 2000, of a local government in an African country attempting to revise a PPA with a geothermal power plant which was insured against expropriatory breach of contract. Strong efforts

the **Overseas Private Investment Corporation (OPIC)** provides policy risk coverage⁸ to US investors when the policy change causes a breach of the PPA and constitutes an expropriation of investors' rights (or regulatory taking) originating from the contract.⁹

Nevertheless, according to practitioners, a significant degree of uncertainty around the approval of each claim and the timing and requirements of the procedures for political risk insurance instruments, seem to have prevented their wider utilization (UNEP, Parhelion, 2012). Data from MIGA and OPIC show that timing¹⁰ for reimbursement may vary significantly, ranging from one to almost five years depending on efforts to find amicable solutions.

More importantly, from an investor' point of view, the change of policy does not trigger a systematic application of the coverage, and **it is the client's responsibility to demonstrate that the specific policy change caused an expropriatory violation of an existing contract**

by MIGA in facilitating negotiations over 5 years, aimed at allowing the investor to keep its project running, resulted in the public off-taker eventually agreeing to honor the existing contract (IEG-WB, 2010). MIGA also covers non-expropriatory breach of contract, in case of denial of justice, arbitral award default, or when the Government renders the Dispute Resolution Procedure impossible, hazardous or commercially impracticable to proceed (MIGA, 2011a).

- 8 OPIC can insure up to 90% of an equity investment, plus an additional 180% to cover future earnings; for third party loans coverage is 100% of principal and interest (OPIC, 2012g).
- 9 OPIC has paid claims following violation of contract due to a change in legislation. In the case of Ponderosa Project in Argentina OPIC determined that a change in the legislation of the Government of Argentina under its sovereign capacity (Emergency Law) had resulted in a repudiation of a contractual obligation with the foreign company, depriving the investor of its rights in the insured investment (expropriatory effect) for more than six months. OPIC accepted the claim of the investor paying the amount of the insured investment (USD 50 million) (OPIC, 2005). OPIC has also paid similar claims in other cases such as MidAmerican in Indonesia, Bank of America- Dabhol project in India (OPIC, 2012f).
- 10 MIGA aims to provide compensation within 6-14 months following the date of loss (MIGA, 2011a). Historical evidence made available by the Agency (MIGA, 2012c) shows that so far claims have been paid after 2-3 years from the event date, and no later than one year from the date of claim's submission. Timing is strongly influenced by MIGA's pre-claim efforts to facilitate negotiations for reaching amicable settlement of disputes (MIGA, 2012f), which aim at preserving both the value for the investor and projects' constant contribution to the local economy (MIGA, 2012d). Such pre-claim efforts can only be undertaken with the participation and consent of the claimants (MIGA, 2012f). OPIC data based on 13 available observations (OPIC, 2012e), out of about 70 projects determined under total expropriation clause show that claims are resolved on average 3.5 years after the event date and 1.5 years from claim's submission. Timing of reimbursement process is uncertain and varies significantly from case to case.

(OPIC, 2012d).¹¹ In this context, a clearly written contract that safeguards the agreed-upon tariffs and related obligations is a necessary precondition to initiate this remedy, but it requires significant negotiation skills and legal expertise, which not all project developers have.

3.2 The World Bank's partial risk guarantee

Partial risk guarantees offer risk mitigation to the private sector for specific government obligations contained in laws, regulations and agreements. They can thus cover a retroactive policy change if it is explicitly included in the guarantee's clauses.

Partial risk guarantees were introduced by the World Bank in 1994 to support the mobilization of commercial debt during the initial phase of infrastructure projects in developing countries. Risks that can be mitigated include, among others, changes in law, expropriation or breach of "quiet enjoyment" of the site, and payment default by the national power company under the power purchase agreement.

Partial risk guarantees can be used to guarantee full debt-servicing payments of a debt tranche (WB, 2012b) by covering commercial debt instruments against changes to specific sovereign contractual obligations to the private sector investor (commercial and other project-related risks are not covered). Partial risk guarantees are three-party agreements under which the World Bank issues a guarantee to a commercial lender and signs an indemnity agreement (a counter-guarantee) with the host country (Mostert, 2010). By wrapping the government into the deal, with the World Bank playing the role of debt payment guarantor and enforcer of the government's compliance to its commitments, the instrument provides significant comfort to project lenders and sponsors. **Payment is made if the debt default is caused by risks specified under the guarantee commitment of the host country (Matsukawa et al., 2007), including those affecting the stability of the agreed regulatory framework, such as a FiT scheme (Mostert, 2010).**¹²

11 Clients have to demonstrate that policy change, while possibly not discriminatory in face, is discriminatory in substance, or that it has been implemented for non-commercial reasons (OPIC, 2005).

12 In 2005 the World Bank has approved a partial risk guarantee for a Hydroelectric Project in Sierra Leone. The partial risk guarantee covered, among others, defaults of the project developer (borrower) in the scheduled payment of principal and interest resulting from a breach of PPA by the public off-taker caused by a change in law - or breach of the government guarantee obligations under the PPA (WB, 2005).

However, a number of factors have limited a greater adoption of partial risk guarantees, which have only been issued 23 times since their inception (eight times for renewable energy projects) (WB, 2012c).

The World Bank's choice in the past to promote the use of partial risk guarantees mainly for large and complex projects (such as large hydro investments and cross-border projects) (WB, 2013), along with the need for an indemnity agreement from the host government, not necessary in the case of insurance (MIGA, 2012b), have increased market perceptions about product complexity, length of procedures and associated transaction costs (Parhelion, 2012). Furthermore, partial risk guarantees directly cover only debt holders, while tariff reductions usually affect many other parties including equity owners, providers of operations and maintenance services. This last issue can be addressed by complementing the instrument with other insurance tools and guarantees, such as MIGA insurance,¹³ albeit at increased complexity and transaction costs.

Interestingly, the World Bank has noted an increase in demand for the partial risk guarantee instrument in recent years, especially in the energy sector, and is striving to extend the scope of this instrument to smaller projects and programs of activities.

13 An example of a quite effective approach is Kenya's Independent Power Producer Project in 2012 with a structure combining a partial risk guarantee with a MIGA guarantee. The partial risk guarantee covers a letter of credit provided by a commercial bank (the short-term debt holder) which can be drawn in case of a PPA payment default from the off-taker to the project company. Once this partial risk guarantee is depleted, the holders of equity shares and outstanding commercial loans can seek coverage from MIGA's Breach of Contract guarantees that insures the risk of termination of payment obligations by the off-taker under the PPA and the risk of default by the Government of Kenya under its Letter of Support (MIGA, 2012f; WB, 2012d).

4 A new instrument for addressing policy risk: OPIC FiT insurance

OPIC FiT insurance directly covers retroactive changes to FiTs that affect the economic viability of projects financed by US investors in developing economies. It provides more direct coverage of both extreme and marginal policy changes, aims to improve timing of compensation, and provides more certain remedies.

With the aim of addressing some of the limits characterizing currently available instruments, in 2010 OPIC launched a new complementary insurance product which specifically addresses **retroactive policy changes to FiTs** in developing economies (Project Finance, 2012). OPIC identifies 'policy risk' as an enhancement of its existing **expropriation clause**, and has enlarged the scope of insurance to include:

- **total expropriation** covering investment losses¹⁴ that result from significant FiT reductions which jeopardize the overall commercial viability of the project (OPIC, 2011); and
- **partial expropriation** covering business income losses¹⁵ for a period of one to two years.¹⁶ The purpose is to allow project owners the time to restructure the project's finance in agreement with lenders and authorities (Project Finance, 2012; OPIC, 2012a, 2012b). If restructuring is not successful within the two-year period the client may then apply for total compensation.

To be eligible, projects must be assessed commercially viable and have a well-structured PPA in place with a public off-taker at a guaranteed FiT rate. This is necessary for any subsequent policy changes to be configured as breaches of contract (OPIC, 2012a).¹⁷ Claims are

expected to be resolved within seven to 15 months from the effective date of political action or decree (OPIC, 2012b).¹⁸

Figure 1 illustrates the interactions between the different actors involved in the mechanism. The **Foreign Enterprise** operating the project — directly or indirectly owned by US equity holders — signs a PPA contract with the **Foreign Governing Authority** at a guaranteed long-term FiT rate (Project Finance, 2012; OPIC, 2012a). **OPIC** offers insurance covering up to 90% of the investor's share in the foreign enterprise.¹⁹ If an adverse FiT revision occurs, breaching the tariff clause in the PPA, clients must inform OPIC and seek redress from the host government to undo its actions (OPIC, 2012f) before they submit a claim.²⁰ If OPIC accepts the claim, it pays compensation to the investor and acquires all rights in the project's economics. With these in hand, OPIC then pursues the local government for redress (OPIC, 2012b). OPIC has approximately USD five billion in reserves with which to pay claims, and is also guaranteed by the full faith and credit of the U.S. Government (OPIC, 2012f).

14 Computed as the project's book value on the day before the policy change occurs.

15 The difference between revenues at the predefined FiT and returns at the revised FiT.

16 Provided that the amount does not exceed the book value of the investment (OPIC, 2012b).

17 Desirable features for the PPA are: a) Clear obligation to take the power delivered, b) Fixed tariff rate based on cost of power generation plus reasonable rate of return, c) Guaranteed grid connection, d) Adequate term for cost recovery (15-20 years), e) Tariff payments linked to currency of project debt, f) Acceptable dispute resolution mechanism, g) Off-taker

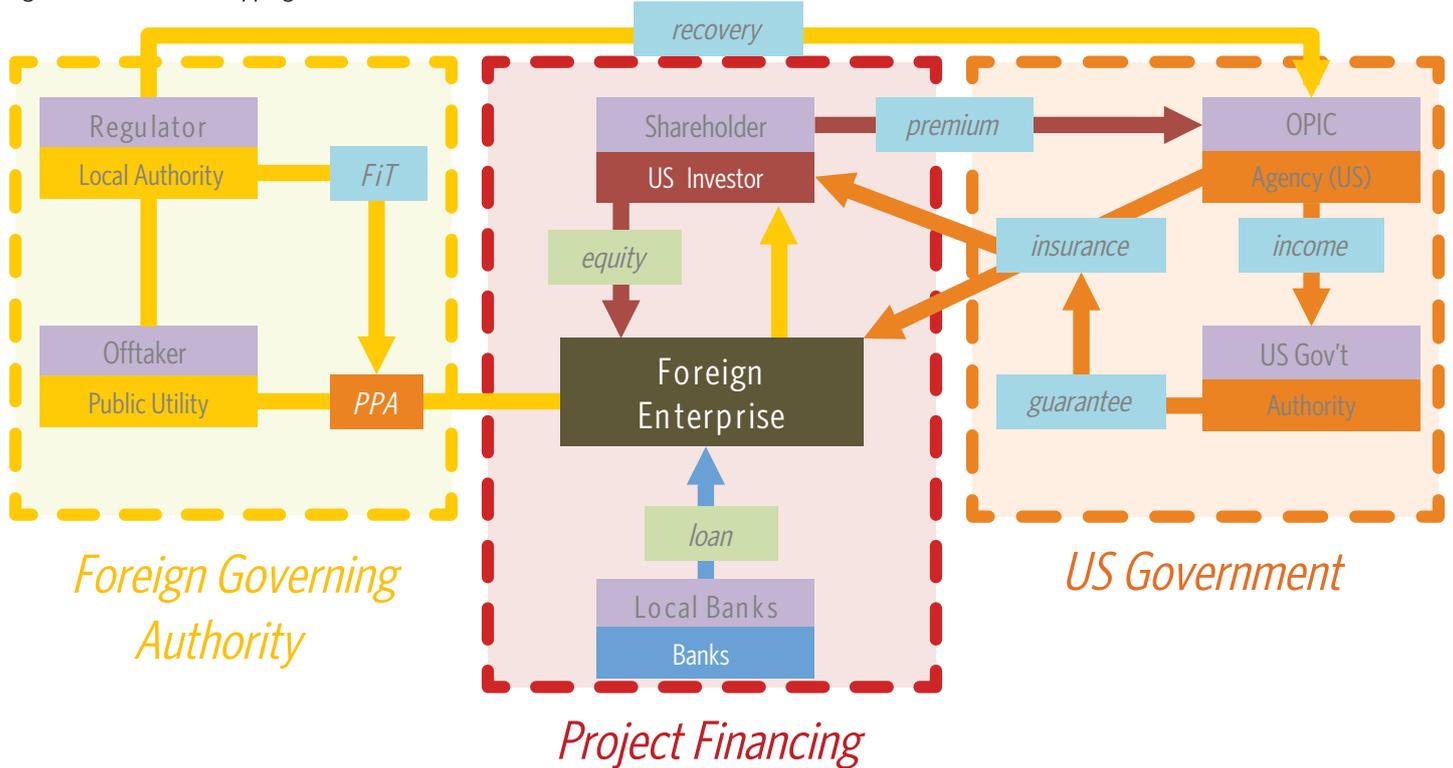
accepts change in law risk, h) Acceptable force majeure provision excusing performance, i) Acceptable termination provisions, j) Ability to assign PPA as collateral (OPIC, 2012a).

18 Claims can be submitted once a FiT revision is enforced for 6 consecutive months without an adequate compensation by the local authorities.

19 The product does not cover future revenues.

20 OPIC does not require that the investor go to arbitration or utilize other dispute resolution procedures (OPIC, 2012f).

Figure 1 - Stakeholder mapping for the OPIC feed-in tariff insurance (as of June 2012)



5 Key lessons for an effective policy risk insurance

To be effective, policy risk insurance instruments should:

- streamline and systematically define the risk and the conditions for coverage;
- be backed with strong enforcement power from the insurance provider;
- include developed markets and smaller projects;
- reduce transaction costs implied by currently available instruments, and
- improve project’s creditworthiness.

One-on-one interviews and other engagements with stakeholders including practitioners, investors, and insurers, as well as a review of the relevant literature, helped us identify lessons for designing an effective policy risk insurance mechanism. We summarize these lessons here, focusing on the mechanisms addressing FiT policy changes.

5.1 Promoting systematic and streamlined protection

In order to facilitate the systematic application of the coverage once policy changes occur, insurance instruments should contain a clear characterization of policy risk, and clearly identify which negative changes in the support policies could be classified as violations, breaches, or expropriation of pre-existing obligations.²¹ Conversely, the client has the burden of demonstrating that the specific policy change represents violations of contractual obligations (OPIC, 2012d).

Policy insurance should be supported by well-drafted and effective contracts that clearly articulate the level of support to which the government has committed.

This is often true for FiT schemes, whose specifications are normally detailed in the long-term contracts and purchase agreements (Couture et al., 2010) governing the sale of the electricity generated from the projects to off-takers or back to the grid (NERSA, 2009; OPIC, 2012b). However, policy change can take different and more articulate and creative forms,²² hence challenging

21 The specific mandate for climate-change policies of the new OPIC FiT insurance is the first of its kind. Other insurance providers such as MIGA, for example, lack a specific strategy to cover climate related investments (Venugopal et al., 2012).

22 Such as a new connection fee, as in the case of Bulgaria (please see chapter 2 for reference).

both investors and insurance providers on drafting complete and effective contracts.

5.2 Ensuring the backing of strong enforcement powers and alignment of interest

For policy risk insurance to be effective, providers should have a strong enforcement power over governments. This involves the ability to discourage political decisions that revoke previous commitments, or in the event of such decisions, the ability to enforce remedies against public authorities.

For this purpose, **public providers are better placed than the private sector when it comes to discipline and influence governments' legitimate (although harmful) retroactive decisions.** MIGA and OPIC, for example, have demonstrated capacity to enforce political risk insurance as their ties with the World Bank and the US Government respectively, appear to have significantly limited moral hazard behaviors by host countries, namely the situation in which an agent (such as a government) is incentivized to behave in an opportunistic or riskier way as the negative effects of her actions are covered by an insurance. MIGA has paid out only six claims from more than 620 guaranteed projects. Of the 292 claim settlements disbursed to its investors since 1971 (OPIC, 2012h), we estimate OPIC has recovered up to 92% from host governments. Similarly, for partial risk guarantees, the pressure to avoid triggering a repayment claim with the World Bank – with the high visibility this event entails – induces host governments to honour their sovereign contractual obligations (WB, 2013).

Conversely, **the many private insurers already present in the political risk insurance landscape²³ are less likely to offer policy risk coverage** in the absence of underwriting data to help assess and price this type of risk, such as ratings and rankings of countries' regulatory framework stability (CBI, CPI, 2012). In addition, it is usually difficult for private insurers to meet, or better, the very long coverage tenors required by project developers and already offered by MIGA and OPIC,²⁴ as they operate under a different business model (MIGA, 2012f) and a different mandate than those of publicly backed entities.

23 Gordon (2008) surveyed 63 private political risk insurers with accessible websites (four of them only provide consulting services. 82 private and public PRIs are listed on MIGA's PRI Center website (PRI Center, 2012)

24 Both MIGA and OPIC offer coverage for up to 20 years of project life.

5.3 Extending scope and coverage

To increase their effectiveness and value, policy insurance mechanisms should expand coverage to a wider range of policies. If, on one hand, feed-in tariff insurance represents a significant achievement in terms of mainstreaming insurance protection related to a specific policy, on the other hand, such an insurance instrument would be more effective and valuable if it is able to cover other policy instruments, and deal with cross-border variations as well (Parhelion, 2012).

The availability of insurance solutions for policy risk mitigation needs to be significantly expanded across countries. Both OPIC and MIGA products cover only developing economies and emerging markets, but the perception of policy risk has increased significantly in some developed countries as well. Furthermore, OPIC provides coverage for US investors and project developers only,²⁵ while MIGA Expropriation Coverage protection does not extend to cover local project developers.

In this regard, the industry has put forward multi-government co-insurance schemes²⁶ as a suitable instrument for providers of policy risk insurance in developed countries where the scope for action of multilateral development banks is limited (CBI, CPI, 2012). A group of governments would provide the financial backing of a pooled insurance scheme aimed at protecting investors from policy changes by those same governments.²⁷ This would have the additional outcome of actually aligning the interests of the risk provider and the risk influencer under the same entity. However, without sufficient enforcement power over governments responsible for policy change, or some ability to seek redress from non-compliant governments, moral hazard behavior would likely represent a serious threat to the effectiveness of the scheme.²⁸

25 Conditions for project eligibility are project ownership by a US citizen or by a US corporation with more than 50% interest owned by US citizens, or a foreign corporation with more than 95% of interest owned by any of the previous entities (Project Finance, 2012).

26 Ideally assisted by multilateral development banks or supranational institutions, and possibly involving the participation of private insurers.

27 A similar structure for the coverage of catastrophe risks from extreme events has been set up by a coalition of governments in the Caribbean, the Caribbean Catastrophe Risk Insurance Facility. The facility took 2 years of design and negotiation efforts with issues of reciprocal trust between the governments arising along the process.

28 Knowing that most affected parties will be compensated by insurance, and that the cost of this insurance is shared across different parties, a single government may perceive an advantage in non-complying with its commitments and benefit from insurance provided by other countries. To mitigate this risk the facility may, for example, force this government to sustain a first tranche of the losses or to impose penalties and higher costs

5.4 Reducing costs, complexity, and compensation time through standardization

The existing instruments have costly compliance requirements, which limit their application to large (and well-resourced) projects only. The instruments are largely unaffordable for smaller projects and programs dedicated to wide-spread, small-scale installations (UNEP, Parhelion, 2012) due to high costs implied by complex negotiating and drafting processes, the availability of resources needed to seek justice locally, and the need to keep investments solvent before compensation is paid.

It is difficult to define the exact cost of providing policy risk insurance, as it varies from country to country. However, two main cost components are common to all insurance structures:

- **Explicit costs**, or known costs, relate to the premium itself. The lack of track records specific to policy risk (the “loss histories”) makes it difficult for insurers to price this risk — a concern expressed in particular by private insurers. As a general rule, those providers who currently price this risk link it to the host country’s political history and stability (OPIC, 2012d; WB, 2013). The development of more products and expertise in the sector will, naturally, increase the accuracy of the pricing and, if more providers enter the market, make it more competitive.
- **Implicit costs** refer to the transaction costs related to the insurance: negotiation and drafting of PPAs, claim filing procedures, self-insurance,²⁹ and eligibility conditions. While aimed at discouraging investors’ moral hazard, and increasing the chances of the insurer to receive compensation from the host government (OPIC, 2012d), they increase the overall costs of the instrument for the end user and impact the certainty of the coverage.³⁰

to its participation in the scheme (CPI, CBI, 2012).

29 This is the amount of losses that the insured party has to sustain before the insurer pays any compensation.

30 For a single project developer, drafting PPAs to ensure that adverse policy changes will systematically trigger breach of contract requires expertise and further increases transaction costs (UNEP, Parhelion, 2012). Negotiations of the PPA can last a very long time, determining an increase of overall project costs. This is the case, for example, of Lake Turkana project (WB, 2011), where negotiations lasted 4 years despite the financial soundness of the off-taker (WEF, 2012). In general PPAs need to be assessed taking into account the sustainability of the off-taker in the long

Importantly, efforts to streamline the adoption of standardized clauses, procedures, and documentation would reduce implicit costs and accelerate the verification and settlement of claims. OPIC FiT seems to move in the right direction by not only formally recognizing retroactive FiT change as a specific clause within expropriation, but also by setting the contractual requirements for eligible PPAs before coverage is granted. This clarity is necessary to ensure contract effectiveness and strengthen its enforcement in case of litigation.

To speed up the proliferation of these kinds of instruments, international agencies providing them could encourage the adoption of standardized PPAs that meet all requirements (Couture et al. 2010). A standardized PPA, such as that proposed under an initiative of the World Economic Forum and being currently tested in Kenya, would reduce the complexity of negotiations which would, in turn, reduce time, costs and uncertainty, encouraging wider deployment (WEF, 2012).³¹ Nonetheless, previous attempts to harmonize PPA specifications across different countries as in the Global Africa Power (GAP) initiative have proved challenging and faced strong resistance from local authorities (UNEP, Parhelion, 2012).

5.5 Engaging credit rating agencies to promote a transformative impact on financial investors’ behavior

To unlock the level of finance needed to drive a systemic and transformative change in green infrastructure investing, policy risk insurances need to improve underlying projects’ credit worthiness as assessed by credit rating agencies. Notwithstanding the many circumstances that affect banks and institutional investors’ decisions to commit resources to green projects, Standard & Poor’s has summarized the key barriers for large-scale, low-carbon investments as “the small [size of the] secondary debt market, [and the] absence of liquid, *investment grade* asset-backed securities” (Wilkins, 2012). Since most institutional investors seem to rely on credit rating for their investment decisions, the ability of policy risk insurance to improve project ratings becomes relevant for the product’s overall effectiveness, just as the stability of the policy framework

run (MIGA, 2012f).

31 If standardization receives widespread agreement, it may also reduce explicit costs, such as premium rates. When a new policy is done, insurance pricing is high because the policy is new and related uncertainty is significant (Sirr, 2012).

and sovereign credit rating is a key driver of project's credit worthiness (S&P, 2007).³²

However, certain features of policy risk insurance may fall short of improving credit worthiness from the bondholders' perspective, as assessed by credit rating agencies. From the latter's perspective indeed, once the unfavorable event occurs a significant degree of uncertainty remains on whether the insurance will cover losses, and on the timing and amount of the final compensation. This translates into high uncertainty over the project's ability to service its debt obligations. For these reasons, when assessing the credit worthiness of a security, rating agencies have a strong tendency to demand a "pay first, investigate later" approach, as in the case of the full financial guarantee offered by mono-line insurers.

On the other hand, insurance providers ask rating agencies to expand the scope of their methodology to include the impact of all available mitigation instruments (beyond the straightforward insurance of lenders' cash-flows) able to improve the overall risk profile of the project³³ (Sirr, 2012). The new partial expropriation feature of OPIC FiT, while not designed with the specific objective of improving ratings, is specifically geared to shorten lag-times and improve prospects for refinancing, and should be well received by rating agencies (OPIC, 2012a).³⁴

Notwithstanding these issues, the recognition of political risk insurance and risk guarantees as credit enhancement tools (especially for emerging market debt) offers a useful precedent in the right direction for policy risk insurance.³⁵ We note in fact that, as a general rule, without political risk coverage, investment ratings are strongly constrained by the host country perceived risks (MIGA, 2012a). Besides, for projects in high-risk countries, lenders and investors frequently demand political risk coverage as a

necessary pre-condition for their involvement (OPIC, 2012d). Finally, the ability of publicly-backed political risk insurers to provide coverage with terms longer than the typical maturity of project loans (five to seven years) significantly improves projects' creditworthiness (Venugopal et al., 2012).

6 Final remarks

At present, policy risk in developing countries is, to some extent, covered by partial risk guarantees and political risk insurance (expropriation coverage) offered by organizations such as The World Bank, MIGA, and OPIC, whose public nature and strong government backing improves their ability to enforce remedies against host governments. However, **related uncertainties about timing of compensation, significant transaction costs, and compliance requirements on the insured party reduce the ability of these instruments to address policy risk and limit their scope to medium and large projects only.**

Building on the positive features and the limits of those political risk insurance products, **the design of dedicated instruments, such as policy risk insurance is a step in the right direction. Furthermore, efforts to streamline and standardize procedures and contracts could significantly enhance certainty and improve the timeliness of remedies.** The new FiT insurance coverage recently launched by OPIC (the OPIC FiT), for example, improves the expropriation clause of political risk insurance by providing direct coverage for retroactive changes to national policies that would harm the financial stability of existing projects. The product also aims at standardizing documentation and procedures by setting upfront the guidelines for the eligible PPAs.

However, **more needs to be done to extend coverage of instruments to developed countries, and to bridge the gap between the coverage demanded by investors and the coverage supplied by available instruments.**

In particular, letting credit rating agencies acknowledge the ability of policy risk insurance in improving investments' creditworthiness will be crucial to unlock the full transformative impact of these instruments in changing mainstream institutional investors' behavior towards green infrastructure investments.

32 More significantly so whenever the government is also an off-taker of the project's output.

33 A lot of risk management work for the whole project - for example - is done in construction insurance lowering the probability of occurrence and expected severity of losses from construction risks (Sirr, 2012).

34 Under partial expropriation coverage, policy risk is partially mitigated by the possibility of restructuring project's financing in order to preserve its economic viability under the new FiT.

35 Meaningful is the case of MSF Holding in 2000, a Brazilian loan and lease company financier of medical equipment which, after purchasing a MIGA guarantee against Transfer Restrictions and Expropriation of Funds, got an unprecedented 6 notches rating enhancement above the Brazilian sovereign rating, from the three main rating agencies (Fitch, S&P and Moody's) (MIGA, 2005).

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