ASSESSING
POLITICAL RISK

By Dr. Alfred J. Boulos

A Supplement to the IPAA International Primer
7:00 a.m. Fulbright & Jaworski Breakfast Presentation
   “International Arbitration: Protecting Your Energy Investments Abroad”

9:00 a.m. IHS Energy Workshop and Panel Session
   Workshop: “Guidelines to International E&P Success”
   featuring speakers on global E&P perspectives, performance, business
   risks, and strategy profiles
   Panel Session: “Multiple Roads to International Success”
   featuring executives of Vaalco Energy, Swift Energy, and Ocean Energy

1:00 p.m. Regional/Company Presentations - Room I
   (15-minute presentations, including Q&A)
   1:00 p.m. New Brunswick Dept. of Natural Resources & Energy (Clint St. Peter)
   1:20 p.m. Nova Scotia Dept. of Energy (Paul Harvey)
   1:40 p.m. Deer Lake Oil & Gas (Newfoundland, Canada)
   2:00 p.m. Devon Canada Corporation (Canada)
   2:20 p.m. Corridor Resources (Canada)
   2:40 p.m. Teton Petroleum (Russia)
   3:00 p.m. UK Department of Trade and Industry (Jim Munns)
   3:20 p.m. INA (Croatia)
   3:40 p.m. DXN & Cassandra Interests (Gulf of Alaska)
   4:00 p.m. Ecopetrol (Colombia)
   4:20 p.m. Canadian Forest Oil (Canada)
   4:40 p.m. Monaco Petroleum, Inc. (Germany)
   5:00 p.m. Hungarian Horizon Energy (Hungary)

Regional/Company Presentations - Room II
   (15-minute presentations, including Q&A)
   1:00 p.m. New Zealand (Roger Gregg; Manager, NZ Crown Minerals)
   1:20 p.m. Offshore Australian Exploration Opportunities (Marita Bradshaw, AGSO)
   1:40 p.m. Western Australian Opportunities (Greg Carlsen, MPR)
   2:00 p.m. Exploration Opportunities in Victoria, Australia (Hywel Thomas, DPI)
   2:20 p.m. Swift Energy (New Zealand)
   2:40 p.m. Victoria Petroleum (Australia)
   3:00 p.m. Lakes Oil (Australia)
   3:20 p.m. Dyad Petroleum (Australia)
   3:40 p.m. Envoi (Italy, Scotland, Peru, Tanzania)
   4:00 p.m. Moyes & Co. (Caribbean, W. Africa, FSU)
   4:20 p.m. ETAP (Tunisia)
   4:40 p.m. Magellan Petroleum Ltd. (Australia, New Zealand, UK)
   5:00 p.m. Westech Energy Corp. (New Zealand)

About the Author
Dr. Alfred J. Boulos is President and International Counsel of Boulos International,
an international consulting practice in petroleum negotiations, agreements, joint ventures
and investments, and is an Adjunct Professor in International Energy Transactions at the
University of Houston Law Center.
Formerly, Senior Director, Exploration and Production International, for Conoco in
London and Houston, and Senior Counsel for Mobil in New York and London, Dr.
Boulos has extensive legal and business experience in building alliances in the inter-
national oil industry and in forming strategic joint ventures worldwide.
In the 1970s, he was selected by a consortium of the international oil industry to be
Chairman of the Industry Legal Committee during negotiations with OPEC.
Dr. Boulos was the founder and first Chairman and President of the European
Petroleum Negotiators Group, a professional organization in London of more than 200
companies. He also was elected President of the Association of International Negotiators
of Houston, and has the singular distinction of having been selected as President of both
industry groups. He lives in Houston with his wife and six children.
I
Introduction

At the NAPE® International Forum in January 2002 in Houston, Texas, the Independent Petroleum Association of American ("IPAA") published an "International Primer" for distribution to the industry.

The International Primer was prepared as "a suggested guide" to oil companies, independent and others, as a means to review fiscal, legal, political risk and other issues that "may be encountered by parties in international oil and natural gas operations".

Chapter III, paragraph 2 of the International Primer entitled "Assess Political Risk" stated that in the "...context of an international oil and gas venture, political risk can be defined as any factor outside the technical aspects of exploration, development and production operations...other than Acts of God, which may reduce or destroy the value of the oil and gas assets".

Political risk in any oil and gas investment in a foreign country is the possibility that the oil company investment will be expropriated, nationalized or otherwise unilaterally changed by the foreign government to the detriment of the oil company.

How do we handle political risk? How do we judge the impact of political risk on an international venture? What are the parameters for deciding whether political risk will be manageable or not in an international venture?

Do we make use of petroleum risk indices and quantitative analysis to determine the level of political risk? Do we use percentages of the level of risk to determine our decision? Who will decide political risk - Political Science experts? External Consultants? State Department? Foreign Office? Or does the company itself decide?

Let us now review the problem of political risk in an international oil and gas venture.
II
Historical Evolution of Political Risk in the International Oil and Gas Industry

1. Pre-World War II

Pre-World War II was characterized by an industry dominated by the major oil companies, known as the "Seven Sisters".

These "Seven Sisters" companies (BP, Shell, Exxon, Mobil, Chevron, Texaco, and Gulf) had secured concessions worldwide and frequently in developing countries, mainly in the Middle East and Asia.

Prior to World War II, U.S. policy was to encourage American companies to explore internationally. In contrast to today's world of U.S. sanctioned countries, the U.S. at that time encouraged an "open door" policy - a doctrine for U.S. oil companies to have equality with oil companies of other nations in its petroleum ventures in foreign countries.

Whether because of political risk or high capital costs or for other reasons, most U.S. companies, other than the major international companies, were reluctant to invest in foreign ventures. Thus, for example, companies considered U.S. major independents such as Amoco, Arco and Sinclair withdrew in the 1930s from the international consortium of the Iraq Petroleum Company that had the concession for the entire country of Iraq. Only Exxon and Mobil (and BP, Shell, Total and Gulbenkian - the original 5 percent promoter) remained.

The major event of political risk in pre-World War II that alerted the industry to the perils of political risk was the nationalization of the foreign oil companies by Mexico in 1938. As a result of the nationalization, the U.S. and other governments demanded that the nationalizing country provide prompt, adequate and effective compensation to the owners of the companies.

Pre-World War II exploration was confined mainly to the majors. Few independents were willing to assume risks, whether political or otherwise, in an international oil industry that was perceived as being reserved for the majors. At the beginning of World War II, more than 90 percent of the world's petroleum production was controlled by the "Seven Sisters"
2. Post World War II

Political risk in post World War II was concerned mainly with the risk of nationalization by the host country.

The political risk was real. Countries that nationalized international oil company concessions included Iraq, Iran, Syria, Algeria, Argentina, Venezuela, Ecuador, Libya, Nigeria and other countries.

Nationalization took on several forms. In Iraq and Iran, the entire concession was nationalized. In Libya and Nigeria, only selective foreign concessions were nationalized whether for international political reasons or otherwise.

Political risk following World War II became a major issue for a company to decide whether to invest in a foreign country for several reasons. First, the former colonial system had changed and newly emerged independent nations sought a major role in controlling their natural resources. Second, the end of the colonial period coincided with a UN Resolution in 1963 on Permanent Sovereignty Over Natural Resources recognizing the "right of all States freely to dispose of their natural wealth and resources in accordance with their natural interest and in respect for the economic independence of States..."

Thus, oil companies for political risk reasons avoided countries with a history or types of government that might favor nationalization. Notwithstanding that international law and the U.S. State Department held that nationalization required the payment of "prompt, adequate and effective" compensation, oil companies wanted to invest only in those countries where the risk of nationalization was deemed to be relatively low.

In today's world, the political risk of nationalization is no longer a major issue for the industry. There are a number of reasons for such change. Foremost are the globalization of international finance and the influence of international financial organizations in the world's economies. The roles of the World Bank, the IMF, IFC and other multi-national organizations tend to lessen considerably a foreign nation's exercise of the right to nationalize an oil concession of a foreign owner.

Another reason is that of privatization. In nationalization, state oil companies often assumed control of foreign oil companies'
assets. Privatization changes the basis for nationalization; the State transforms National Oil Companies into private enterprises to compete in the market for international oil and gas ventures and obviates the need to nationalize foreign companies.

A final reason for the lessening of political risk of nationalization in today’s world is that the objectives of nationalization have in the most part been achieved. In the OPEC takeover of production in the early 1970s, for example, host governments by nationalization, buy-in participation or by government controls have achieved the goal of control of oil and gas resources. Even with State control, the emergence of privatization and market-oriented economies further neutralized the political risk of nationalization.

III
21st Century Political Risks

3. Current Political Risks

The ending of the 20th Century and the beginning of a new era in the 21st Century have brought the issues of political risk into focus in a different setting than earlier days of the international oil and gas industry.

The new issues of current political risk are as critical as the issues of a former era. Political issues continue to play a major role today in the determination of whether or not to invest in a petroleum venture in a foreign county.

The new issues of today may be analyzed from the point of view of International Political Issues, Domestic Political Issues, International Business Practices, Corporate Responsibility and Risk Mitigation Strategies.

4. International Political Issues

We have analyzed above the lessening of nationalization as a political risk today. What has emerged is a process defined as “creeping nationalization” under which a host government by legislation or regulation may unilaterally change the terms and conditions of a petroleum agreement to the detriment of the oil company.

To protect against the political risk of “creeping nationalizations”, companies will negotiate “stabilization or equilibrium”
clauses in their agreements. Such clauses provide that if the fiscal or economic benefits of the agreement are adversely affected by unilateral legislation or regulation of the government, the parties shall adjust the fiscal and contractual benefits of the agreement to give the companies the same benefits of the agreement in the absence of the unilateral action by the government.

To protect against the risk of unilateral change, a company should provide that its agreement with the government or state company must be promulgated as the law of the country by appropriate and effective legislation or decree.

To protect against the risk of currency controls, a company should provide that there be no restrictions with respect to currency and financial transactions. The company should provide that it may freely export and import funds resulting from operations in the country. The company should also have the right to convert payments and cash flow into convertible currencies at market rates and should not be compelled to keep funds in local currencies.

To protect against the risk of partiality in a local tribunal, the company should provide for international arbitration in the event of a dispute or disagreement with the government under their agreement. The arbitration provision should be "self-executing" so that the conduct of either party will not frustrate the arbitration process. Self-executing arbitration mechanisms can be provided by institutional arbitration - the AAA (American Arbitration Association), ICC (International Chamber of Commerce), the World Bank's ICSID (International Center for the Settlement of Investment Disputes) and others. To provide for impartiality, the place of arbitration and the arbitrators should be of a neutral country. The decision of the arbitrators should be final and be given full effect by a court of appropriate jurisdiction.

With respect to the risk of the applicable law being only the law of the host country, a company should provide for international law, regulations, traditions and customs applicable to international oil and gas ventures between a company and a government to also be applicable.

With respect to exploration and production licenses from a host country, a company must take special care that there are no
boundary disputes between adjoining or adjacent countries. There are boundary disputes worldwide, often in areas where there is oil and gas potential. Thus, for example, an area of potential conflict is China’s claim to the Spratly Islands and the southern extension of the South China Sea. This area is in conflict with the Philippines, Vietnam, Malaysia, Indonesia and Brunei. There are other areas of boundary disputes in Latin America, the Middle East and Africa.

In the event a company is interested in drilling rights in areas where there are boundary disputes, the company should not assume the political risk of accepting a license until the countries involved resolve their differences themselves in direct negotiations or resolve them at the International Court of Justice or other tribunal before a company undertakes a drilling and seismic program. Otherwise, the political risks in drilling in disputed territory are too high to accept.

5. Domestic Political Issues

A company in its dealing with domestic political issues must exercise not just a common degree of due diligence but a high, even an extraordinary, degree of due diligence in dealing with political risks.

Due diligence to lessen political risks would require an in-depth knowledge of the host country’s laws, culture, traditions, religion and history, particularly in relation to the international oil and gas industry in its conduct of oil and gas operations in the country. Sensitivity to a country’s historical influences would be important for an oil company.

Other areas for the exercise of due diligence to lessen political risks in a host country would relate to the economy, business and labor laws of the host country. Thus, for example, a company should be familiar with the comprehensive economic background of the host country and ascertain the issues that are of significance to the company such as, for example, the host country’s laws that affect oil activities, the country’s dependency on oil and gas revenues as a percentage of its GNP and the country’s legislation and regulations that will affect local business and labor matters.
In a number of countries, a company will have to deal with the country’s dependency on oil and gas revenues. In some countries, such revenues may account for over half of the national economy. This could lead to a commensurate level of government scrutiny and regulation. The need to cover budget realities is a priority that assumes even greater premium during times of price volatility. A company must be aware of such risks as often quotas may be adjusted to accommodate revenue needs.

Other domestic political issues relating to risk factors must also be considered in host country relationships. They include due diligence in dealing with local business people or local potential partners, in knowing the local employment laws, in registration of a subsidiary in the country, in determining liability under local law, in understanding fiscal and legal risks of petroleum operations in the country. Such due diligence is particularly important in countries where the oil and gas industry is a source of local employment. Companies working in countries where there is hiring of local staff must be particularly diligent in complying with the local laws and regulations in dealing with local staff.

Due diligence would also be essential in knowledge of specific political risks in the country of operations with respect to its track record of orderly change in control of government. Issues such as free and fair elections, the risk of a military government taking over, the expectations of future government stability, the rule of law, property rights and corporate governance need to be analyzed in a company’s endeavors to evaluate the political landscape and potential political risks. It is essential for a company to exercise due diligence in regard to a country’s political change, institutional background, and history.

There are political risks in a company withdrawing from operations in a host country. A withdrawal is a form of defeat; neither the company nor the government welcomes the need of a withdrawal. In some countries, a withdrawal has become the basis for charges and countercharges and, in some cases, the basis for denying exit visas to the expatriate personnel and possible local legal action.

A company must avoid these risks by preparing an exit strategy. In the expectation of a withdrawal, a company should obtain exit visas and other authorizations from governmental agencies,
banks, police authorities, customs and other groups to permit expatriate personnel to leave the country. A company shall also obtain necessary permits from customs to re-export imported goods. Finally, the company should treat its local employees with special care - provide advance notice, comply with all labor laws and regulations and pay them compensation due to them.

There are other related risks that a company must be aware of in doing business in a foreign country. Among the many reasons for establishing and maintaining good relationships with the host government is to avoid operational risks that may hinder maximum access to data banks, reproduction of data, seismic, well logs or previous interpretations of the host government. Good relationships would avoid such risks and would lead to operational efficiency through access to exploration and production data from the host country’s data files.

6. International Business Practices

To avoid political risks in international oil and gas business practices of an American company going overseas, a company must conduct its international business practices not only in accordance with the law but also in accordance with the highest standards of ethical conduct and fair dealing.

Most companies generally provide a code of ethical conduct for its employees and such codes should be adhered to in international oil activities as well as in local oil activities. A typical Business Conduct Guide would generally provide that the "offering, giving, soliciting or receiving of any form of bribe is prohibited".

U.S. Law under the Foreign Corrupt Practices Act and other related legislation, the convention on bribery by the Organization for Economic Cooperation and Development ("OECD") and other international initiatives against corruption that are often the equivalent of U.S. laws and efforts of organizations such as Transparency International appear to have provided a level playing field. Other initiatives include an agreement against corruption signed by the Organization of American States similar to the OECD convention. It may be less likely now that a competing “non-American” company would be willing to engage in bribery or other corrupt practice than in the past.
To avoid the possibility of political risks in bribery and corruption in international oil and gas activities, an increasingly large number of American companies will provide seminars and instruction both in the U.S. and in overseas locations to its employees to advise them of the risks of bribery and corruption. Such seminars are believed by many companies to be an essential component of due diligence to avoid the political risks of bribery and corruption.

In agreements with either companies or directly with a host government, or when dealing with a company in a country which may have a reputation for corrupt practices, it is recommended and often normal practice to include a clause in the agreements to the effect that the parties have complied with the Foreign Corrupt Practices Act - or other codes and regulations of international organizations or of other countries - and that there have been no bribes and no other corrupt practices.

The importance for a company to establish a reputation as an honorable business company is that the company will not probably be the target of requests for bribes or other corrupt practices. Once a reputation is established that the company will not sanction any corrupt practices, the experiences of many companies in international oil and gas is that such reputation reduces if not eliminates the possibility of bribery or other requests for corrupt practices.

The company would also review the political risk of a country becoming subject to United States' unilateral sanctions. Political realities and existing relationships may be subject to abrupt change in today's world. Sanctions continue to be used by governments as a tool of foreign policy despite the continued debate regarding their political and economic value. New "smart" sanctions often freeze the assets of groups believed to be involved in terrorism, drug production or proliferation of weapons of mass destruction - and less often apply to entire nations.

7. Corporate Responsibility

Corporate responsibility in undertaking business practices in a host country will require review and analysis to minimize any political risks that may arise. A company in a foreign country in working out oil and gas activities must understand that it is an "invited guest", should avoid involvement in political matters in respect of the host government, not identify itself directly or indirectly with
any of the host government's agenda or policies and maintain a profile that creates a positive relationship in the host country between the company and government.

In this respect, a company must be alert to and exercise due diligence regarding a range of business practices that it may encounter in the host country. These may range from dealings with labor unions, staffing of activities, problems in import arrangements, visa restrictions and other similar domestic business practices.

There is no one easy answer in dealing with such business practices. They do require a policy of due diligence of the company in that it will work as a good corporate citizen, be ethical in all its dealings in the country, be alert to the culture and traditions of the country and deal with all business practices at the very highest level of good conduct and good ethical standards.

In many countries, some companies are welcomed while other companies are shunned. Relationships are thus vital for companies to prosper in their dealings with host governments. A company that conducts its business as a good corporate citizen and demonstrates its corporate responsibility in its work will derive great benefits from its perception as a good and responsible corporate citizen.

What are the practical steps for a company to be perceived as a good and responsible corporate citizen? A company should consider investing in local infrastructure projects, commensurate with the size of the overall oil and gas investment by the company in the region. Such projects may involve setting up medical clinics and medical services, programs to help eradicate diseases and ailments endemic in certain regions, installing fresh water projects and systems, training in specialized agricultural advances or providing basic educational programs. The range of corporate responsibility programs is indeed wide; a company that undertakes a program of corporate responsibility in the host country will find that it will pay huge dividends in goodwill.

A company must treat local citizens, employees and governmental workers with respect and understanding. One potential for government-induced delays occurs with bureaucratic roadblocks that may either delay or facilitate your business objectives. A tactic
of delay may be the "loss or misplacement" of requests or applica-
cations. Your local office or your visiting representatives must be
alert to the importance of local relationships. Cultivate this critical
dynamic in professional relationships with all levels of the local
population with whom you have contact to ensure that they have an
important role to play in the conduct of your oil and gas activities.

8. Risk Mitigation Strategies

In structuring its political risk mitigation strategies, a compa-
ny must first analyze a host country's varying degrees of civil sta-
bility depending on the type of government, the rule of law,
human rights, ethnic and religious divisions and other similar
demographic factors. Flashpoints involving rioting, paramilitary
activity, terrorism, kidnapping, sabotage, roadblocks, political
rallies and other forms of instability should be carefully analyzed.
Depending on the particular regions of operations, risk mitigation
strategies need to be responsive to these localized variables and
threats and factored into the operational political risk scenario.

One of the rules of international exploration seems to be that
the most prospective oil and gas reserves are in countries of high
political risk. One must be careful not to invest too heavily in a
single country or region with high political risk. The political risks
may be too great. A company should diversify its exploration
efforts - consistent with its strategic planning - to provide against
inordinate concentration in a particular country or region.

In high political risk areas, the security of infrastructure to
counter the possibility of bombing and sabotage must be provided.
Private business infrastructures have increasingly become targets.
 Pipelines, refineries and offshore rigs are especially vulnerable to
acts of sabotage. Companies should plan against such political
risks by adapting security procedures and security plans that allow for
emergency decision-making and special operating procedures.
Heightened verification, observation, security, communication and
access procedures will be essential.

The political risk of kidnapping has become larger with the rise
of terrorism. A practice of kidnapping for ransom has become more
commonplace in many countries than in the past. Kidnapping has
become a lucrative business and looks to increase in frequency and
potential harm as terrorist organizations become more active and
aggressive. Counseling and anti-kidnapping procedures can help
prevent kidnappings and mitigate scenarios if they occur. Additionally, helpful negotiating skills can be taught to employees who are working in high-risk areas.

It is common for companies to take out insurance against kidnapping. Note that most policies provide that employees must not be told that they are covered by such insurance. This is to guard against kidnappers demanding a much greater ransom if they know of the existence of such policies.

There are governmental and quasi-governmental organizations that a company may contact for assistance in its strategies to mitigate political risk in petroleum investment in various host countries. The U.S. State Department and Department of Commerce provide services and reports that would help a company in adopting risk mitigation strategies. There are also international organizations such as the World Bank that may provide help in risk mitigation strategies or the International Finance Corporation that may provide financing in upstream projects and thus a level of security and investment stability in relationships with host governments.

Insurance to provide against certain investments risks in international oil and gas ventures may also be available to mitigate political risks of expropriation, "creeping expropriation" and other forms of risks. For U.S. companies, there is available insurance coverage, preinvestment assistance programs in selected host countries and financing options from the Overseas Private Investment Corporation ("OPIC"). For non-U.S. companies, the World Bank offers an insurance program, "MEGA", to provide against similar risks.

In assessing whether OPIC or MEGA insurance is an appropriate means to mitigate political risk, a company must analyze a number of issues. A company should delineate the kinds of risks for which insurance is available to determine their advisability. Another factor is that of cost - premiums charged for the insurance add considerably to the cost of the project. Another factor to determine is whether a company's petroleum projects - often large-scale ventures - lend themselves to these types of insurance. A company should be aware of risk insurance availability from OPIC or MEGA; whether such insurances are suitable constitute important decisions for each company.
There is no absolute certainty that risk mitigation strategies will be effective. They must be reviewed constantly and adjusted to meet changing circumstances. It is inevitable that there will be changes in international risk scenarios and careful attention to such changes will result in maximum ability for effective response.

IV
Conclusions

The above analysis of political risk is intended to review for oil and gas companies the risks involved in international oil and gas ventures.

Political risk is a broad concept that is intended to encompass the "non-commercial" landscape of international oil and gas ventures.

Political risk encompasses such risks as expropriation, revolution, civil disorder, creeping expropriation, unilateral imposition of new taxes and royalties, imposition of export controls or withdrawing licenses for export or import, exchange control restrictions and other factors that reduce or destroy the value of the international oil and gas venture.

A company in deciding on political risk may make use of many sources of information and resources: governments, consultants, professors, analysts, political science experts and the like.

However, in the final analysis, it is only the company itself that can decide on political risk in the international oil and gas venture.

The company itself must judge the impact of political risk, determine the parameters for deciding on political risk, assess its own level of political risk tolerance and, in the final analysis, decide whether political risk will be manageable - as there will always be an element of political risk in any venture - as it is only the company itself that can decide whether or not to invest in an international oil and gas venture.

IPAA would like to thank Dr. Alfred J. Boulos and the members of the IPAA International Steering Committee for their continued support in expanding upon the International Primer and volunteering their time and resources over the past year.
IPAA International Committee

Business Plan

1. MISSION

The mission of the IPAA International Committee is to be the focal point of the opportunity between independent and international exploration and production ventures and to provide educational and information services to IPAA members engaged or interested in international business opportunities. Additionally, the Committee will coordinate with domestic and foreign governments to ensure maximum exposure of IPAA members to international opportunities.

2. OBJECTIVES

A. Enhance IPAA members access to and ability to take advantage of international oil and gas opportunities.
B. Improve independent's knowledge and understanding of critical issues and practices involved in managing their international business opportunities.
C. Provide platform to discuss, debate and bring consensus to key industry issues that impact current activity as well as future business.
D. Develop and maintain database of members' activities and interests in international activities.
E. Develop and maintain databases with the following information related to foreign enterprises:
   1. Names and contact information of foreign energy ministries.
   2. Functional profiles, names and contact information of US and UN agencies.
   3. Lending profiles, names and contact information of various financing sources.
   4. Names and contact information of foreign operators and service companies.
F. Conduct educational seminars.
G. Serve as a host agency for foreign dignitaries and trade missions.
H. Solicit members for participation in US sponsored trade missions.

To view the International Committee web page, go to www.ipaa.org/int

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