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Sovereign aid in managing sovereign risk

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INTRODUCTION

Today I want to return to some concepts of capacity building as a vehicle for bilateral aid which I think seem to have lost a bit of impetus in recent times.

My central proposition is that capacity building aid can be both efficient from the point of view of the recipient, and value adding for the donor. It can also help to reduce sovereign risk (in its broadest sense), and by doing so reduce both the risk premium demanded by investors, and financing and development costs - meaning there is more in the pot to share between the investor and the relevant State.

Simply put, if Australia can assist African states in designing efficient and certain fiscal and regulatory regimes, and help them in building capacity to administer those regimes, this not only assists those recipients in attracting investment, but it makes those jurisdictions more attractive to outbound Australian investors. Australian investors will therefore be able to develop their projects more efficiently, and demand a lower risk premium for doing so. Their deeper involvement will also open up opportunities for associated METS (Mining, Equipment Technology and Services) sector companies.

Promoting the METS sector also provides a viable response to the need to broaden the base of the Australian, and particularly the West Australian, economies.

As a related point, current interventions could in some cases be more focussed and practical. A missing element in many existing and historical programs is strong investor involvement. We need to maximise collaboration between the Australian and West Australian governments, relevant African governments and investors.

CURRENT PROGRAMS

For a number of years there have been various programs involving Federal government and State government aid to Africa in the area of capacity building.

The Federal government provides financial aid to sub-Saharan African countries to assist in the development of a wide range of industries, including the agricultural and extractive sectors.

In 2018-19 an estimated \$121 million will be provided in Official Development Assistance (ODA)². Part of this ODA funding will include an estimated \$31.8 million in bilateral funding for the Africa Program managed by the Department of Foreign Affairs and Trade (DFAT).

Aid has been focussed on a targeted program of scholarships available to African students (for example, the 2018 grants will fund up to 500 short and long term awards to develop African leadership and skills) and ODA funding directed at the development of Africa's governance of its extractives sector³.

Between 2012 and 2017, \$5 million has also helped to provide both financial and technical support to the [African Minerals Development Centre \(AMDC\)](#). A joint initiative of the African Union, the United Nations Economic Commission for Africa, the African Development Bank and the United Nations Development Program, the AMDC provides a central hub to coordinate technical support to African Union member states.

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² [Overview of Australia's aid program to Sub-Saharan Africa](#) - DFAT

³ [Extractive sector support in Sub-Saharan Africa](#) - DFA

Finally, in January 2014 then West Australian Premier Colin Barnett signed a Memorandum of Understanding⁴ between Western Australia and the Common Market for Eastern and Southern Africa (**COMESA**) on Cooperating in the field of Mineral and Petroleum Resources, Agriculture, Vocational Training and Capacity Building (**MoU**). The MoU was [renewed](#) for a further six years in February 2018⁵.

While these and other initiatives are very valuable, a lot more could be done. In my view there are also some missing elements in the interactions that these aid programs encourage.

Currently there is a heavy emphasis on educational programs and training, and on technology transfer. That work is vital, but so too is the design of regulatory and fiscal regimes. And where policy work already occurs, greater involvement of investors would help in its targeting and design.

PARTICULAR ISSUES FACED BY AFRICAN JURISDICTIONS

Just as in Australia (recently highlighted with the change of Prime Minister), each government has a very broad range of stakeholders, and managing them is not always easy.

Stakeholder management is more difficult where the regulatory settings within the relevant jurisdiction are poor.

For example, sometimes investors have failed to develop resources acquired from African States in a timely manner. There may be a whole range of strategic reasons why an investor might do this, including competition between the particular project and other projects the investor owns, the investor's view of when the best time to develop the project is given relevant markets and demand, and even constraints affecting the particular investor, including its own financial constraints.

However, often the resource, particularly in the context of smaller African countries, is very significant for development of the national economy. Where this is the case, development may be tangibly linked to improved infrastructure, improved medical facilities and access and improved educational facilities. For a country with a poor population this means there is a very real sense that lives may depend on the development proceeding in a timely manner.

In these circumstances perceived delays in development of projects often creates such a groundswell of political concern that African States, whether or not strictly entitled to do so, have taken action to address the issue. That of course then lays them open to accusations of raising sovereign risk. Yet sometimes in truth the relevant government has had little choice but to do something. In many of these cases there has also been an imperative as a matter of equity that something be done.

Clearly uncertainty where entitlements can be abrogated because of these pressures is not optimum. But neither is it sustainable that parties can sit on assets that are absolutely critical to the development of a State.

Further policy development resulting in implementation at the outset of very clear, fair and certain rules that require holders of mining assets to operate under a 'use it or lose it' policy could help address this issue.

In some cases there has been a perception that investors are rorting the system to minimise tax, either more broadly or in relation to particular royalties or customs duties. This has then resulted in a very heavy handed response, which has raised issues of sovereign risk. Again policy settings that result in a clear and more easily policed and administered regime can prevent the need to take more drastic action - which is sometimes rushed and underdone because it is in response to acute political pressure.

Finally, there are examples where an investor has been granted mining tenure effectively for free, but instead of developing it, the investor has spent a small amount on the ground and then flipped the

⁴ [MoU dated 31 January 2014](#)

⁵ [MoU dated 5 February 2018](#)

investment for significant profit through an offshore transaction, avoiding the need for both State consent and any tax or duty on the transaction. While many of the loopholes allowing this type of activity have been progressively closed in African jurisdictions, this situation leads to an intolerable domestic issue for the State to deal with – namely external parties profiting from often iconic national assets when they have done very little to earn that profit, and with no material return or dividend to the State, or its people.

Not surprisingly African States have taken action in these cases. Unfortunately, where local tax and other regulatory settings have been inadequate, this action has involved asserting positions that sometimes, as a matter of strict legal analysis, are flawed. Also, it is often the purchaser that is chased for the tax, when in fact the vendor should be paying it. This again leads to allegations of heightened sovereign risk given the apparent failure to strictly apply the law as it stands (however inadequate).

Again enhanced policy and regulatory settings that tighten requirements for State consent for direct or indirect dealings in mining assets, and enhanced tax regulation so significant profits made from these transactions are taxed (and the tax recovered), is ultimately in the interests of the State but also all serious investors.

FURTHER ACTIVISM BY AUSTRALIAN FEDERAL AND STATE GOVERNMENTS

In our increasingly competitive world the concept that the State stays out of business and lets business get on with economic activity in a *laissez faire* way is increasingly untenable. Many of the most successful jurisdictions in the world have a record of considerable State involvement.

In the Western Australian context in particular there is an imperative to broaden the base of our economy. Western Australia did fantastically well during the recent resources boom, but then experienced quite a hard landing once that ended (especially in terms of gross State demand). It is now recovering, but that whole episode just highlighted that the State economy here has quite a narrow base, even by comparison to the eastern states of Australia.

If anything, with increasing success in the minerals and resources sector Western Australia has become increasingly dependent on that sector.

One of the areas in which the West Australian economy could be broadened is in the METS sector. Discussion of leveraging comparative advantage in mining to enhance comparative advantage in METS has diminished more recently, but it remains good policy.

There is considerable mining investment from Western Australia into Africa, and also considerable METS sector exports to service Australian backed projects in Africa. The size of the METS sector in Western Australia, however, is much smaller than it could and should be, and part of the growth opportunity lies in servicing the African market.

When you look at other large foreign competitors without large mining industries, it is clear that Western Australia punches below its weight in the METS sector. London, for example, is one of the most significant mining services centres in the world, and yet the United Kingdom has a small domestic mining industry. London succeeds because it has a wealth intellectual capital and is the premier global hub for mining finance.

Similarly many parts of Asia could increasingly become competitors to Australia and Western Australia in the METS sector, including Singapore, China and India. This is leaving aside more established competitors in Asia and worldwide, like Japan, the United states, the United Kingdom, Scandinavia and Germany.

The issue for Western Australia is how it ensures that it captures the METS opportunity available to it. Australia and Australian states have historically been less interventionist in supporting their companies and two way trade. You only need look as far as Singapore or indeed South Korea to realise what truly best-in-class support for two-way investment by a State is.

And as technologies become increasingly disruptive and quickly applied worldwide, so the worldwide competition grows.

Collaboration is the key to success. As with London, in Australia we need one or more physical locations – ie cities – where thousands of researchers are working on developing new technology and innovation applications in METS.

There are cities that already have that critical mass in the METS sector – for instance Brisbane or Perth, or indeed Melbourne. There should be greater promotion of them, and of connectivity between them.

Anything that the Western Australian government can do to promote collaboration between Western Australia and the jurisdictions to which the METS sector can export is also helpful. And this does not need to cut across African jurisdictions wanting development of local industry, local capacity and local processing and transformation. Their requirements that international suppliers establish a branch or presence in the African jurisdiction, and promote local capacity, do not conflict with this expansion of two-way trade.

OTHERS ARE PROVIDING SUPPORT

To the extent that Western Australia and Australia are not providing support to their investing companies and to their METS providers, this is disadvantaging them against competitors that do provide that support.

If regulatory settings for mining and resource investment in African jurisdictions are improved, it puts Australian and Western Australian investors in a much stronger position. This greater certainty will increase competition to provide services to their project, expand the pool of potential financiers, permit better financing terms, and increase the number of potential off takers prepared to accept reasonable terms. The investor does not need to potentially cede control to another foreign investor - or a financier or anchor off take party - to get the project developed.

I should at this point say that I am not suggesting Western Australia, in collaborating to improve regulatory settings, should dictate policy to African jurisdictions, rather I am suggesting a process of comparing notes so that the best elements of relevant systems can be tested and applied.

The more finely tuned and certain the investment framework the greater the reduction in sovereign risk, which will reduce the risk premium that investors require. The more that risk premium comes down, particularly where projects can be more efficiently built and financed, the more there is in the pot to share between the State and the investor.

Also, if the environment is uncertain, Australian and West Australian investors often have to look to other joint venture parties, off takers or non-traditional finance providers to help them cope with that uncertainty. That support comes at a cost – as mentioned sometimes effectively requiring control of the project to be ceded to the incoming party or financier.

In these cases Australian or West Australian investors often default to China. This is not to say that African countries should not legitimately seek to attract Chinese investment, or that there is anything wrong with China promoting that investment. However, Chinese investors often have different investment criteria. This fact, together with the strength of the relationship between their government and relevant African governments, and the greater ability of Chinese financiers and service providers to operate in more difficult and uncertain environments, gives them greater flexibility and leverage.

For Western Australia, Australia and relevant African jurisdictions, it is healthy to have a diversity of investors, and not be too reliant on one jurisdiction as the source of that investment.

AN IDEA

There are various examples of organisations that have been set up to promote collaboration and support for two-way investment and trade between Australia, Western Australia, and African jurisdictions. Some of these are quite academically focussed.

One thing that often seems to be missing is a collaboration hub that allows the West Australian government, the Australian government and African governments and investors to workshop improvements to policy settings. This would help ensure right and fair division of resource rent, and when done in consultation with investors will promote increased and more efficient investment.

Further, where issues do arise for individual investors they are often left to make individual representations to the State concerned. There is always a conflict in that interaction because they are seeking to maximise their return, while the State is focussed on maximising its own return without scaring the investor away.

The advantage of West Australian government (or indeed Australian government) involvement is that it can mediate and test the position put by those investors and in some way act as honest broker. Any collaboration between the West Australian government and African governments would clearly be aimed at enhancing West Australian investment into African jurisdictions, both as primary investors in projects, but also as METS providers. However, this does not detract from the fact that they would also be comparing notes, sovereign to sovereign, and as a collective working towards policy settings that get the balance right.

Like African jurisdictions Western Australia wants, as the original owner of the minerals, to obtain an appropriate return for them, while providing investors with enough incentive to encourage investment and an adequate return commensurate with the extent of the investors' investment and risk.

A much more active and practical two-way engagement between Western Australia and African jurisdictions in setting regulatory frameworks that achieve this, with the active involvement of investors, is in the interests of both. And for investors it provides a clearing house to raise issues legitimately affecting their investment in a way that is perhaps solution, rather than dispute, focussed.