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When the Rules Change – the legal and social complexity of partnering

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INTRODUCTION

There has been considerable recent press about changes to investment laws in Africa, particularly in the context of Tanzania. Tanzania is not alone in suddenly and unexpectedly changing investment rules. Amongst others, Australia has form in doing so.

This paper suggests reasons why the rules change, and what investors can do to prevent or manage this.

Its central thesis is that, in our changing world, protecting investments is increasingly a multi-faceted and people related task. It was never simply a question of ensuring that the right technical investment protections were in place. Licence to operate has always been important.

But investments are now more susceptible to people pressure than ever before. And States respond to that pressure.

Projects increasingly need more than a mere social licence – mere permission or tolerance. That can be fickle. They need advocates. And you only create advocates by creating *real* relationships.

CONTEXT OF CHANGE

In Tanzania the recent changes include:

- the ability to renegotiate development agreements deemed prejudicial to the interests of Tanzanians;
- a 1% clearing fee on exports;
- a mandatory 16% free carry interest of the State in projects, and a possible State interest of up to 50%;
- local processing of minerals, rather than export of raw materials;
- no offshore determination of disputes;
- increased royalty rates;
- the ability of the State to reject commodity valuations for royalty purposes, and an option to buy at asserted value; and
- local banking of proceeds from the sale of minerals[2].

These changes not only render appropriate investment returns much harder to achieve, but for many investors also represent a change to the rules post investment decision (or at least post commitment to a project).

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[2] See *Finance Act* 2017; *Natural Wealth and Resources Contracts (Review and Renegotiation of Unconscionable Terms) Act* 2017*; Natural Wealth and Resources (Permanent Sovereignty) Act* 2017 and *The Written Laws (Miscellaneous Amendments) Act* 2017.

In some cases those changes may also give investors from countries with which Tanzania has signed a Bilateral Investment Treaty a right to bring a claim. However, the submission of this paper is that, relying solely on legal rights to challenge, significantly limits the protective armoury available to an investor.

It would be ideal to set rules for an investment in stone, and never have them change.

But this is not the concept behind a stability agreement. It is also unrealistic – and unreasonable - to assume that there will be no changes.

There will always need to be scope for evolution. External environments or circumstances alter – requiring new policy responses. An example has been evolving environmental best practice. A government that does not allow itself flexibility to respond to these necessary changes will not be doing its job properly[3].

It is reasonable, however, to expect that the fundamental rules that formed the basis for an investment decision, and which give rise to a particular expected rate of return, will not change.

Unfortunately, they often do.

The interesting questions are why, and what investors can do to prevent that occurring (or to limit its effect).

Whilst the Tanzanian experience could be held up as an outlier, it is not. It has much in common with challenges that have arisen for mining investment in Australia for instance – both in the sense of the proposed change being fundamental, and in it being a response to community pressure.

In the Tanzanian example reasons cited for a change include alleged issues with understatement of the value of mineral exports (resulting in lower royalty payments), that the State has not been receiving its fair share of tax revenue and a desire to encourage local processing of minerals.

There has been a relatively long standing view in Tanzania, notwithstanding considerable mining investment since the country was opened up after *Ujamaa*[4] socialism, that returns to the State from mineral investment have been unfairly low[5]. (Tanzania, with support from the World Bank, initially re-shaped its mining legal regime at a time when *Ujamaa* socialism had essentially failed as an economic policy, metal prices were in decline, and countries competing for foreign direct investment were finding it difficult to attract.)

This concept that the State is not getting its fair share has also been prevalent in Australia, however.

The Resource Super Profits Tax proposed in Australia was in response to perceived super profits being earned by mining companies during the recent resources boom. In its initial iteration some argued that it was an effective 30% expropriation of affected mining projects[6]. In its actual implementation, as the Minerals Resource Rent Tax[7], it was much less severe, and it has now been repealed.

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[3] As pointed out by Professor Ross Garnaut in a paper entitled "The new Australian Resource Rent Tax" delivered on 20 May 2010 at the University of Melbourne (http://www.rossgarnaut.com.au) (at p 12), whilst investors may seek stability in all areas of policy what if established arrangements are unfavourable for economic efficiency or even for future stability? Stabilisation could not completely block improvements to national productivity or inhibit activities that were damaging to the community or the environment, and if there was absolute stability unsatisfactory arrangements of any kind, once established, would continue forever.
[4] Meaning "extended family" in Swahili.
[5] See eg "The Demystification of Mining Contracts in Tanzania" published by the Policy Forum, Tanzania http://www.policyforum-tz.org/files/demystification.pdf
[6] See "Glencore likens Australia to Congo", *The Weekend Australian Financial Review,* *http://www.afr.com/news/politics/national/glencore-likens-australia-to-congo-20120607-j2m8s*
[7] *Minerals Resource Rent Tax Act* 2012 (Cth), and related legislation – *Minerals Resource Rent Tax (Imposition - General) Act* 2012 (Cth), *Minerals Resource Rent Tax (Imposition - Customs) Act* 2012 (Cth), and *Minerals Resource Rent Tax (Imposition - Excise) Act* 2012 (Cth).

The debate about a mining super profits tax centred on coal and iron ore, but particularly on the profits being made by iron ore producers.

Of course the argument that those producers could legitimately make was that, when they initially invested in iron ore production in Australia after the iron ore export embargo was lifted, those investments were 'bet the company' ones, and at times really struggled. The short window of super returns was really a payoff for the very considerable risk that had been taken at those earlier stages, and was in the context of those producers paying significant ongoing royalties and income tax.

In the iron ore space in Australia there have been additional examples of changes, or attempted changes, to the rules. When State Agreement variations were agreed in Western Australia allowing multi use of infrastructure across BHP and Rio Tinto State Agreements, the State sought and was paid a one off payment of $350 million[8]. More recently, in the context of the last West Australian election, there was a proposal that lease payments by BHP and Rio Tinto on their iron ore tenure be significantly increased.

So these types of changes are risks in developed economies as well as emerging African ones.

With populist pressures the risk of these types of changes is not likely to diminish.

What is interesting about the Australian examples referred to above, is that they were dealt with by engagement with the community and with government. They weren't dealt with by legal challenge (which is not to say legal challenge is not sometimes justified).

The mining tax was the most high profile. In that case a public campaign by major producers effectively resulted in the watering down, and then the defeat, of that proposal. But in an ideal world the need for such public campaigns, with the collateral damage they cause, is best avoided. Public campaigns are often adversarial – pitting the investor against the State or the community.

Many African jurisdictions have been looking in recent times at division of resource rent between State and investor. Unfortunately there is limited data that validly compares African jurisdictions. Comparisons that do exist necessarily have to normalise the data so that there is an "apples with apples" comparison, are often only commenting on the tax regime and comparative tax rates, and assume a common required internal rate of return (IRR).

In one study[9] comparisons were made of a potential gold mining project in four African jurisdictions. It uncovered material differences in project IRR, with only one jurisdiction an unambiguous yes to the project being developed.

Similarly, studies have looked at comparative fiscal regimes in various African jurisdictions - in one case identifying wildly different average effective tax rates (AETR) on two projects representative of an African gold mine, one low and one medium grade[10].

That information is useful in assessing whether fiscal imposts may be a bar at the outset to investment being feasible and, if not a bar, in discussions with the State regarding whether it is properly incentivising investment. The studies, however, don't (and can't) capture other complexities like potential for change, social, stability and sovereign risk, and issues relevant to the individual investor.

This leads to two follow on propositions.

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[8] See "Changes to State Agreements Finalised", Media Statement issued 3 December 2010, https://www.mediastatements.wa.gov.au/Pages/Barnett/2010/12/Changes-to-State-agreements-finalised.aspx

[9] "Over taxed? Does the tax regime encourage new mines?" *PwC Australia Africa Practice*/August 2015 www.pwc.com.au/africadesk

[10] See HAL Archives: Bertrand Laporte, Céline de Quatrebarbes, Yannick Bouterige: "Mining taxation in Africa: The gold mining industry in 14 countries from 1980 to 2015" 2017.3. 2017

First, megaphone assertions that changes to investment settings will chill investment are often a blunt instrument in seeking their reversal. There are so many complexities going to the reasons for individual changes, and in identifying the extent to which charge will chill investment, that it is hard in a public advocacy sense to compellingly make this point.

Secondly, and notwithstanding that fact, the more that States can reduce uncertainty for investors – i.e. the more they can preclude unexpected changes to the rules post investment decision - the more risk premiums come down, the lower the IRR required for investors to invest in the jurisdiction, and consequently the greater the resource rent theoretically available to the State.

SO WHAT SHOULD INVESTORS DO ABOUT UNEXPECTED CHANGE?

In a world of increasing connectivity it is worth revisiting the prism through which investment decisions are made, and in particular how relationships with Government, community and other stakeholders will be managed.

Relationships with the public are often mediated through (increasingly *social*) media. And although development of social media in Africa lags behind developed countries, getting your story out in African jurisdictions is incredibly important to winning and retaining community support.

And in this context it is worth reflecting on what that support means. If an investor is seen as sitting on an asset and not developing it, or not meeting its stakeholder responsibilities, or not paying an adequate amount of tax, social and other media now allows community dissatisfaction to be mobilised.

But that dissatisfaction can also be misconceived – whipped up by a competitor, or different political factions, or because a media story is mishandled and takes on a life of its own.

Two things flow from this.

First, it is more and more important to be able to legitimately defend an investment as well intentioned, fair and balanced, because - if it is not - that is likely at some point to be found out. Moreover, if and once that occurs the issues are likely to be widely and quickly disseminated.

Secondly, it is important to build *real* relationships with stakeholders.

From the outset (when technical robustness and available legal protections for a project are being reviewed) a realistic assessment of the stakeholder map and how stakeholder relations are going to be managed is required. For an Australian investor contemplating an African investment this includes gaining a deep understanding of cultural, language, religious, community, tribal, political, corruption, security, labour, resettlement and like issues.

This stakeholder assessment has to be integrated with the technical and legal. The investor also needs to be confident it has the resources and skill, and access to intelligence, to manage stakeholder issues - and indeed that they can be managed.

Sometimes there is no proper basis for believing they can be. This is particularly the case with difficult political, security or corruption issues. In that case the proper decision may be not to embark on the investment.

Simply stated these observations are not surprising. But obtaining hard data and an objective view is often difficult. Often, if the project is technically strong, and legal investment protections are apparently available, there is a tendency to gloss the other aspects, or leave them to be progressively dealt with over time. And in the absence of hard data it is easy to be swept along with benign or superficial assessment of stakeholder risk.

However, even with robust fiscal settings and apparently secure tenure, governments have shown time and time again that they are sovereign and can come in over the top of investments. And quite

apart from this macro risk, local issues can also cause a whole range of operating problems - including security, industrial relations and resettlement issues.

Of course nothing remains static, even after initial investment.

Stakeholder relations therefore also require a “finger on the pulse”, and an ability to be nimble and responsive to a landscape that will inevitably change.

Really the imperative is to assess, price and manage stakeholder risk just as technical and legal risk needs to be assessed, priced and managed. In each case it’s about reducing uncertainty. It’s just that with stakeholder risk there are fewer absolutes, hard data is more difficult to come by, management of the risk requires a different skill set, and solutions are more qualitative.

PARTNERING APPROACH

The mindset the investor brings to an investment can be critical to effective management of adverse stakeholder action.

The term ‘licence to operate’ only goes so far. That term (as opposed to what is truly involved in any licence to operate) connotes a permission for the investor to operate, provided it pays its dues and behaves as a responsible corporate citizen.

But public expectation seems to have moved beyond this. There is an increasing expectation that the investor will do and stand for the right thing, plus contribute to and be part of the community in an active and engaged way.

Seeing investment as a kind of partnership helps in responding to this expectation.

Consider a greenfield mining project in Africa as an example.

The investor (particularly in mining as opposed to oil and gas projects) has often received initial exploration tenure essentially for free, subject to application fees. The basis for this is that the investor, with its capital and skill, will be able to develop that mineral asset (generally an asset of the State) for the benefit of the State and its people, and earn a reasonable return in doing so.

This then is really a kind of collective endeavour – a partnership between investor and State (and those the State represents, namely the community and other stakeholders) – for the development of State assets.

And in an African context, depending on the country, the State asset may be very significant relative to the national economy and national GDP. So the way in which the State marshals, as it is required to do, the proper development of these State assets is obviously going to be a sensitive political issue.

For the health of any relationship certain things are key.

First, a commitment to genuinely seek to look out for each other’s best interests – to strive to balance the fiscal and other interests of the State, community and investor so that all may benefit.

Secondly, transparency. If there is going to be a respectful discussion about division of resource rent then the parties are going to need to have some degree of trust in one another. If one party is withholding information because it is concerned about where it might end up or how it might be used, then that is obviously going to degrade the quality of the interaction.

Thirdly, a genuine understanding between the parties. So, as previously mentioned, genuine investment by the investor in getting to know the community it will operate in. But also an ability to articulate, in a way that is accessible locally, what it is bringing to the table, and why that is a good thing for relevant stakeholders - and to prosecute this case on an ongoing basis.

Finally, any quality relationship needs to be *real,* and two way. To be seen as credibly standing for something good investors need to have ongoing open dialogue with stakeholders. They are not the government, but they are often very important to the government's ability to deliver social services, reduce poverty and increase employment - ongoing challenges the government will face.

The age of social media is heightening emphasis on *interaction*, rather than investors broadcasting facts. The greater scrutiny also makes insincerity harder to hide. If investors are not part of online and other community relationships, then they risk simply being the object of discussion by those who are.

ILLUSTRATION OF COMMON PITFALLS

In an African context the practice of flipping investments for a profit illustrates some of the points that have been made.

What has historically sometimes occurred is that a smaller, entrepreneurial company, will put its foot on a mining development through the free grant of tenure and will then, when it has proved it up to an extent necessary to engage larger investors, sell that on, generally by way of an offshore upstream share transfer, often at huge profit.

One might argue that this nonetheless encourages the discovery of deposits that might not otherwise be discovered.

It is useful though to look at what is happening from the point of view of the State, and the stakeholders it represents.

Although tax systems within Africa are modernising, sometimes these sales of the upstream holding company do not attract tax or land duty – essentially because of outdated regulation. Further, sometimes the legislation does not technically require government consent to the transfer (because it is upstream and not of the asset itself).

In those cases the investor, in particular the purchaser, needs to ask itself what position a government is in if a locally significant State asset has been given to a party for free, and is then sold for a considerable sum - without notice, or any return, to the owners of that asset. Whilst it may be that technically no return is due, that government will no doubt come under considerable pressure to do something about that.

If it responds to that pressure it will often look to the purchaser, now the incumbent in country, for something face saving. Often that results in a State demand of that purchaser to pay tax, whether or not technically due.

Consequently, even where not required by law, a prudent purchaser will assume that it must consult with the government before concluding the deal, rather than rely on there being no formal requirement for government consent. It could reasonably predict that, if it does so, the government may raise the issue of a return to the State. However, at least in those circumstances there is some upfront certainty and perhaps an ability (eg in the context of the relevant State agreement), to negotiate something acceptable.

Where this is not done, and the State demands a tax or some quid pro quo for its acquiescence, the investment will be commencing with an already antagonistic relationship between the investor and stakeholders on which it will be significantly reliant.

DANGERS OF RELYING ON RELATIONSHIPS

Commentary about the importance of relationships is not to say legal protections are not important. Sometimes they need to be relied on, and the threat of them helps to focus the mind.

But legal protections often only take an investor so far. There are issues with proceeding with an arbitration, and issues with recovering any arbitral award, particularly in respect of poorer jurisdictions.

But there are also dangers in relationships.

From the State point of view there may be a whole range of pressures to be managed. An incoming Head of State may have drawn support from his or her own community or tribal group and may be under considerable pressure to extend patronage either to those supporters or, for cultural reasons, to family members.

Also, because of the way in which the colonial boundaries were drawn in Africa, in some African countries it is often only possible to lead a government by forming a coalition of sometimes quite disparate political groups. Where that occurs the coalition partners may not make great bed fellows – yet there may be no choice if there is to be any form of stable government. Those coalition members may have their own demands in return for their support of the government.

Investors need to understand these pressures, and form a realistic assessment of how they can be managed. There is no point putting the government in a more difficult position than it might already be in.

Part of that is obtaining sufficient intelligence at an early stage.

But in addition to obtaining good intelligence, investors will often have to work with local agents of sufficient seniority to manage government and stakeholder relations. Often the wider connections of people taking that role will not be immediately apparent, particularly where they may be related to government officials or have commercial relationships with governments or government entities.

There are extensive materials available in relation to appropriate due diligence which must be undertaken in these circumstances[11].

However, from an investor's point of view it is not just a matter of complying with the law. To the extent that an issue arises because of a relationship the investor has struck, even if that investor has done all the right things, and could not reasonably be accused of seeking to engage the person for any corrupt purpose, it will still have to deal with potential reputational and other fall out once, and if, any improper connection is discovered.

Ultimately an assessment has to be made of whether the operating environment is too dangerous, or whether, with appropriate investment in policies, due diligence capacity and other processes, there can be a reasonable level of confidence about complying with anti-corruption requirements.

INSTITUTIONAL FRAMEWORKS/RULE OF LAW

As has been mentioned, by concentrating on relationships and partnership this paper is not suggesting that legal protections are not important.

However, it has to be recognised that to submit to legal rules justiciable offshore is to cede sovereignty to an extent. Developed countries are much less likely to do this. For instance modern State Agreements in Australia do not stabilise the fiscal regime (investors rely on the rule of law and the need for Australia to retain international investor confidence)[12].

Progress is being made across Africa in relation to modernisation and harmonisation of laws relating to investment, and in relation to the rule of law. As this occurs African countries will become less amenable to ceding sovereignty and so, if anything, the matters discussed in this paper will become even more important.

OHADA[13] is a good example. That is a grouping of seventeen countries across Francophone West and Central Africa which has as its purpose the harmonisation and modernisation of business laws.

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[11] See eg "Good Practice Guidelines on Conducting Third-Party Due Diligence" *World Economic Forum*, Geneva, 2013

[12] See for example Wälde, T.W. "Renegotiating acquired rights in the oil and gas industries: Industry and political cycles meet the rule of law" Journal of World Energy Law & Business, 2008, Vol.1, No. 1, 55-97 at p.58 and generally.

[13] *Organisation pour l'Harmonisation en Afrique du Droit des Affaires.*

Historically, for investors from a common law jurisdiction like Australia, investing in Code jurisdictions in Africa presented some challenges, including in relation to the taking of security. Increasingly minerals regimes across Africa now have common elements.

Indeed there has been talk of a common mining code, although none has yet been enacted.

The Western Australian government has been helping in relation to tenure and other regulatory systems and processes[14]. Unfortunately, in more recent times that help has fallen away to some extent.

Better systems lead to better certainty. Consequently foreign aid that has as its objective the improvement of legislative, regulatory and tenure systems in African jurisdictions is money well spent. It smooths the path for Australian investors in those jurisdictions, promotes FDI in those jurisdictions, and allows for better sharing of resource rent.

CONCLUSION

This paper has spoken about relationships as an important adjunct to making sure that necessary technical protections are in place. It has also spoken about the need for those relationships to be fair, balanced, transparent and respectful – relationships between equals or, in the case of the State, with a sovereign.

Justice Neville Owen, in his more than 1,500 page report into the collapse of *HIH Insurance* in Australia, neatly summarised its failings when he said:

"*Did anyone stand back and ask – is this right?*"

Similarly communities in Africa and elsewhere are increasingly passing judgment on whether investors are doing the right thing. And they make judgments on the basis of the information they have, and their level of engagement with each investor.

Investors increasingly need to be able to justify that they are indeed doing the right thing, and why. But a necessary precondition is that they have real relationships with the community and other stakeholders, otherwise they run the risk that nobody will be listening.

[14] See eg "WA mining expertise to help African nations" Media Statement issued 18 February, 2016 https://www.mediastatements.wa.gov.au/Pages/Barnett/2016/02/WA-mining-expertise-to-help-African-nations.aspx