AFRICA DOWNUNDER CONFERENCE

SESSION SEVEN

RULES AND EXPECTATIONS: SHARING IN AFRICA'S OPPORTUNITY

7 - 9 September 2016
Perth, Western Australia

GILBERT+TOBIN

presented by
Phil Edmands

SYDNEY | MELBOURNE | PERTH

RULES AND EXPECTATIONS: SHARING IN AFRICA'S OPPORTUNITY

Phil Edmands[1]

INTRODUCTION

This paper is not intended as a legal treatise on investment in Africa. Rather it makes some practical (and hopefully thoughtful) observations about making a success of that investment, and about Australia's role in facilitating it.

In a nutshell its central propositions are these.

Like most things in life, success is in large measure about relationships. Yes you need a stabilised investment framework, but unless you have strong relationships that support it no project will be fully secure, realise its true potential, or perform in the most cost effective manner.

And building those strong relationships is in large part a function of attitude. Having a healthy respect for African governments as sovereigns, for communities as vital, and for Africa as the giant of tomorrow rather than the supplicant of yesterday, is a good starting point. Africa as a continent is not poor – it has abundant resources. Its people are poor. But that does not make them any different to anyone else, or any less than anyone else. They want the things those in the developed world have, and as they gain them so Africa's power will grow.

Good relationships also rely on good communication, and in the age of social media you need to publicly prosecute your case and get your story out or others may well fill the void with mistruths. Mistruths destroy trust – which is at the core of good relationships.

Finally Australian and Western Australian Government initiatives to improve the competitiveness, administration and governance of mining in Africa are not only laudable, but economically rational - both for Africa and for Australia. The pie will grow for both of them.

But there is a catch. As Africa develops so its sovereign and operating risk will diminish, and its infrastructure will improve. Compared with Africa Australia attracted a disproportionate share of international resources investment relative to its resources endowment during the last boom, partly as a result of its greater stability and development. But the playing field will be much more level going forward.

Australia's luck will ultimately run out unless it stays match fit. Long term, corporate tax rates need to come down to be competitive with comparator countries, and the mining industry in Australia cannot bear any additional imposts or royalties. The proposal to increase rent on iron ore from 25c to $5 a tonne for two mining companies is particularly egregious. It is the very definition of sovereign risk and fiscal irresponsibility, and would be highly destructive (not just for those mining companies).

STATE INVESTOR AGREEMENTS GOVERN RELATIONSHIPS

Investors in Africa often seek upfront agreement on the taxes and imposts that will apply to a project. That is often part of a wider tendency to focus on technical issues upfront - with a view to dealing with matters such as community relations later.

Achieving an enduring stabilised investment framework takes much more than getting the technical aspects right, however, and once you have one you are not done, you have just started.

[1] B. Juris LLB MBA (University of Western Australia), Partner Gilbert + Tobin. Opinions expressed in this paper are those of the author, and do not necessarily represent the opinions of Gilbert + Tobin.

The stabilised investment framework needs to be supportive of relationships - in addition to assuring fiscal stability. To draft and negotiate such a framework requires mutual respect, cultural sensitivity, balance and transparency.

Often material community issues seem to spring up more frequently during steady state operations[2]. They often have their genesis much earlier, however. The die is cast early, and giving attention to these softer skill areas from the outset ("front-end loading" them) is vital[3]

Of course another reason why softer skill areas are sometimes left until later is an erroneous view that they are not about costs. Yet a common result of community conflict is delay or temporary shutdowns. It has been estimated that a major project with a capital cost of US$3.5 to 5 billion will suffer costs of US$20m per week in net present value (NPV) terms due to temporary shutdown[4]. Difficulties caused through supply chain disruption as a result of community conflict likewise can potentially cause significant cost through delay.

And a stabilised investment framework cannot fix *everything* in stone. Even in developed economies the rules change, and investors need to constantly engage with governments to support their investment.

Often investors expect something different in developing countries. Arguably they assume greater negotiating power in relation to developing countries than they would seek to exercise in developed economies. In effect they have less respect for emerging economy governments, including the sovereignty of those governments, meaning the relationship lacks mutuality.

This approach can be a mistake – particularly during a low point in the resources cycle. Contracts made during that low point with inexperienced governments – or governments under pressure – and which reflect unequal bargaining positions frequently come under renegotiation pressure when the cycle turns.[5] As we know, what seems too good to be true usually is.

Really what should be sought is a fair and balanced investment framework, and that the fundamental aspects of that framework – those that supported the investment decision – do not change. It is naïve it is submitted to expect that *nothing* will change. Circumstances evolve, and States work within a fluid political environment to which they must respond.[6]

A stability agreement is best viewed then as ground rules for a living and dynamic relationship between the developer and the State.

Of course it contains elements of deterrence. States do not like to be the subject of proceedings under a stability agreement. But if it has reached that stage things are already bad and, as with all relationships, provisions that keep the parties talking are generally helpful. Examples are mediation

[2] Deloitte : "State of Mining in the Spotlight" (Second Edition, 2015) at p13 (http://www2.deloitte.com/za/en/pages/energy-and-resources/articles/state-of-mining-in-africa-2015.html)

[3] See eg Davis, Rachel and Daniel M. Franks. 2014. "Costs of Company-Community Conflict in the Extractive Sector." Corporate Social Responsibility Initiative Report No. 66. Cambridge, MA: Harvard Kennedy School

[4] Ibid at p 19.

[5] This point is made by 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.

[6] 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.theaustralian.com.au/business/the-new-australian-resource-rent-tax/story-e6frg8zx-1225869337321) (at p 12), whilst investors may seek stabilisation 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 stabilisation unsatisfactory arrangements of any kind, once established, would continue forever.

as a preparatory step to arbitration, or a structured process for appointing independent moderators as a required first step in trying to resolve disputes.

And sometimes the deterrence is most effective against third parties. If an investor has an enforceable stability agreement it may be difficult for a third party competitor to undermine that and acquire an interest without exposing itself to action by the investor. Also, the interest the interloper gets may be tainted - in which case it will be difficult to sell it down to blue chip companies or sovereigns.

Two other points are worth making in relation to stability agreements. The first relates to transparency. A fundamental aspect of respect is transparency. Yes an open exchange between investor and State about an appropriate division of resource rent and an adequate return for the investor might lead to arguments about the appropriate risk premium to use when calculating the return. Information disclosed to the State may also not be secure. But it is better it is submitted to start as you mean to finish, and it is heroic to expect that a negotiation with the State owner of the resource, which treats the State as a junior partner by withholding information, will be durable.

The second point is to ensure that any investment framework smooths returns and does not *only* deliver long dated returns to the State (eg by providing tax deferrals or holidays without earlier royalty payments). Also, if the State needs to contribute as participant the investment needs to be structured so that the State has the cash flow to do so. As we all know a State short of cash is a risk.

GOOD RELATIONSHIPS, AND GETTING YOUR STORY OUT

Turning to individual relationships themselves - it is worth reiterating that it is not just necessary to build one on one relationships or a relationship with the State – and that building and maintaining relationships with local communities and each of the other stakeholders needs to be constant. Both the investor and the State will need to manage and balance the demands of competing constituencies - shareholders, suppliers, local communities, the broader community, and relevant political and geopolitical constituencies.

Furthermore, managing these competing demands sometimes means mediating and moderating them - which you cannot easily do if mistruths take hold - so it is really important that you publically prosecute your case and get your story out.

And as we know, Africans are increasingly linked into all forms of social media.

There are a few points to make in relation to projects in Africa in particular. First the projects are often of much greater size relative to the economy than an individual project would be in Australia. So they are of enormous significance to the host country's future. Unsurprisingly then they both capture the public's attention, and how they are handled can significantly affect the fortunes of the relevant country's government. In that heightened context an investor simply cannot afford to let mistruths about the project take hold, or lose its engagement with relevant communities.

Notwithstanding all we have heard about the resources curse, resource abundance is not necessarily linked empirically to investment instability or to poorer economic performance, and certainly does not need to be[7] . Indeed Africa seems to get a bad rap in relation to conflict around mining. A study suggested that Africa had 18% of mineral-related conflicts versus 28% for Oceania, 26% for South America and 20% for Asia[8]. Whatever the case part of preventing project instability is carrying not

[7] See generally Ascher, W. "The 'Resource Curse" in Bastida, Wälde and Warden-Fernández (eds.), International Comparative Mineral Law and Policy (Kluwer Law International, 2005), 569-588

[8] Davis, Rachel and Daniel M. Franks. op.cit., annex C at p46

just the Government with you as the project develops, but also the communities to which the Government must respond.

WIN-WIN GROWTH FOR AUSTRALIA AND AFRICA

The Western Australian Government has long had a policy of supporting both Australian mining companies and the success of mining in Africa[9]. It signed a Memorandum of Understanding with the Common Market for Eastern and Southern Africa (COMESA) in 2014, and has since been working with African Governments in relation to mining legislation, governance, environmental and safety regulation, mineral titles and the like[10].

Similarly the Federal Australian Government has increasingly moved to economic diplomacy, and is implementing this in its developing country aid program. The intention is to assist developing countries to maximise the sustainable benefits from their natural resources whilst helping them overcome the challenges. In the African context the Australian Government has supported African led initiatives like the African Minerals Development Centre as well as skills development, community partnerships and governance[11].

Africa has been strongly impacted by the end of the commodities "super-cycle". Whilst foreign direct investment (FDI) inflows to the continent increased 22% between 2010 and 2014 they plunged 31% in 2015[12]. More broadly though Africa has attracted increased interest as an investment destination in recent times because of, amongst other things, a perception that it has become more politically mature and easier to access with improved judiciary systems, because of its significant mineral and other resources, and because of its increasing population and rise in consumption[13].

It is submitted that Africa, longer term, is much more a huge future market than a competitor for Australia. Resource sector growth will help propel development of that market – but ultimately it will be a huge consumer market. Already two thirds of Africa's growth over the last decade has come from increased domestic demand[14]. Africa also has an enormous infrastructure deficit, generally estimated to require annual expenditure of greater than US$90 billion per annum to address[15]. By facilitating African resource growth Australia facilitates the success of Australian companies investing in it, facilitates growth of this new broader market for Australian goods and services, and ultimately grows demand for its own resources.

But to be part of this win-win Australia needs to remain competitive.

As stability and certainty increase in Africa, so risk premiums will reduce. Africa has abundant resources. The Africa Development Bank suggests that Africa has about 30%of the world's known

---

[9] See for example The Hon Colin Barnett MLA, Premier of Western Australia in a paper entitled "Australian Mining in Africa" delivered on 5 February 2014 at the *Investing in African Mining Indaba* in Cape Town South Africa (https://www.premier.wa.gov.au/Ministers/Colin-Barnett/documents/speeches/speechCBarnett_20140205_Investing-in-African-Mining-Indaba.pdf) where he says at page 14 "From a government perspective, I support Australian mining companies and offer our assistance to African nations as their mining industry develops. It is as simple as that."

[10] See eg the press release issued 18 February 2016 by the Hon Bill Marmion MLA Minister for State Development; Finance; Innovation (https://www.mediastatements.wa.gov.au/Pages/Barnett/2016/02/WA-mining-expertise-to-help-African-nations.aspx).

[11] See "Extractives sector development assistance" Australian Government Department of Foreign Affairs and Trade (http://dfat.gov.au/aid/topics/investment-priorities/infrastructure-trade-facilitation-international-competitiveness/extractives-sector-development-assistance/Pages/extractives-sector-development-assistance.aspx)

[12] KPMG "What influences foreign direct investment into Africa: Insights into African Capital Markets" at p4 (https://home.kpmg.com/za/en/home/insights/2016/02/what-influences-foreign-direct-investment-into-africa-.html)

[13] Ibid at p 10

[14] See "Africa: Too big to fail", an address delivered by Kofi Annan at the One Young World opening ceremony on 18 November 2015 (http://www.kofiannanfoundation.org/speeches/africa-too-big-to-fail-2855/)

[15] See for instance World Bank figures quoted in "Spanning Africa's Infrastructure Gap" The Economist Corporate Network, 2015 (http://ftp01.economist.com.hk/ECN_papers/Infrastructure-Africa)

reserves of minerals, that there is upside because there has been a comparably low level of exploration, and that in 2012 mining, oil and gas accounted for 28% of the continent's GDP[16].

Australia received a disproportionate share of resources investment relative to its resources endowment during this last boom. The Grattan Institute estimates that in the 8 years to 2013 $480 billion was invested in Australia in mining projects – more than any other country in the world[17]. But Africa is going to increasingly attract its share of international investment. According to the Export-Import Bank of China cumulative Chinese investment alone in Africa will amount to at least US$1 trillion over the next decade[18]. Australia needs to maintain the competitiveness of its fiscal settings in light of the changing competitive landscape going forward.

While other jurisdictions remained unstable and carried greater sovereign risk Australia enjoyed a competitive buffer. It has been a very stable commodity producer, and benefits from strong rule of law. It has been able to price those benefits through a relatively high fiscal take. But that shield will dissipate as Africa's stability and governance improve.

At the moment suggestions are that Australia's competitiveness will go backwards. There is great opposition to allowing corporate tax rates to move down and so be less out of step with international comparators, and there is a suggested increase (for two companies) in per tonne rent for iron ore from 25 cents to $5 – the very definition of sovereign risk.

Yes at the moment there are significant funds in the world system looking for a home with any sort of reasonable return, and this fact, the stickiness of incumbent investment, and the sheer cost of bringing on supply in emerging markets when commodity prices are low, mean that changes may not have an immediate effect on investment in Australia. But, longer term, moves that damage Australia's sovereign risk profile – one of its great competitive advantages – and put it out of step with the tax settings of other countries, will degrade Australia's performance and reduce its living standards. And the irony of this is that it need not be so. Australia can both improve its competitiveness and so be stronger as it benefits from the strengthening of the economies of commodity producers in Africa.

And one final practical suggestion where gaps in the fiscal regimes of African countries are identified - exercise care in exploiting them. One example is where share dealings in ultimate holding companies of participants in African projects do not technically require Ministerial consent in the project jurisdiction, and the undeveloped laws of that jurisdiction mean that no tax or other duty is payable. Where the relevant country has granted the original title for little or no consideration, a relatively small amount has been spent on it, and it is then sold for a significant amount consider the position of that country's Finance Minister if the offshore transaction takes him or her by surprise.

Transparency is always preferable it is submitted. If it is likely to lead to a demand for some return to the State better to deal with this in a friendly atmosphere before the transaction concludes than to try to manage it in the hostility that may follow completion where there has been no upfront transparency with the State.

[16] See for instance the information quoted by the African Natural Resources Centre (a division of the African Development Bank) at http://www.afdb.org/en/topics-and-sectors/initiatives-partnerships/african-natural-resources-center-anrc/

[17] See eg the transcript of a discussion entitled "Mineral Resources Rent Tax – will it work?" held in Melbourne on 13 May 2013 (http://grattan.edu.au/wp-content/uploads/2014/05/518_transcript_cities_melb_MRRT.pdf

[18] The Economist Corporate Network op. cit. at p16

CONCLUSION

This paper has focussed on practical and relationship factors that support security of investment in Africa. In conclusion it is useful to quote some comments by the former Secretary General of the UN, Kofi Annan, in the context specifically of Australian mining company investment in Africa.[19] These related in particular to tax issues, but their sentiments are more generally applicable:

> "*Australian investments in Africa must be seen to be transparent to create long-term partnerships needed for generating the best returns … Managed correctly, foreign expertise and investment … represents enormous opportunity to improve the lives of millions in Africa. Long-term partnership will be key to generating the best returns. Australian investments in Africa must be seen to be fair … meanwhile, increasing internet access and the return of many well-educated Africans from overseas are helping to boost awareness of tax avoidance issues. And Africa's tolerance is declining. For companies, this will likely emerge as a hot reputational issue that may ultimately impact access to mining resources ... Some companies, such as Rio Tinto, have shown impressive effort to become more transparent with their tax payments. Other Australian companies, including the small and medium-sized, may wish to enhance their reputations and long-term relationships in Africa, their "social licence to operate", by taking the initiative on tax and transparency issues … Africa and Australia have common interest in creating a predictable and fair global business environment. This is particularly important to the people of Africa, who expect their fair share of the wealth beneath their soils and waters. What Australian companies may lose by accepting to pay fair taxes and investing in their host countries' economies, they will regain many times over through the benefits of a predictable, rule-based and transparent business environment and positive long-term partnerships*."

[19] "Rewards for mining companies that play fair on tax in Africa", Kofi Annan, Australian Financial Review, 30 August 2013 (http://www.afr.com) .