Investing in African Infrastructure projects: Risk and Risk Mitigation

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Introduction – Key topics and themes

• What can be achieved in this session – the danger of over generalisation
• Managing project risk – an investor’s key objective
• Looking to the discipline of Project Finance
• A key concern: political risk
• Mitigating political risk through traditional and integrated measures
• The importance of Development Finance Institutions
• The ongoing concern of corruption
• General summary of fiscal issues
• Case study – Rabai IPP
Risk management (1): Risk? What risk?

- How is risk approached in your company?
- Typically, informally; some visits, meetings, ask the lawyers … decision
- Very little disciplined risk analysis at an early stage of investment – project gathers a momentum of its own
- Often too late to unwind – tax and corporate structures are a particular problem
Risk management (2): And it’s a real risk

• The spectrum of risk is wide; depends from who’s perspective
• And it’s a real risk in development, financing and operations particularly on the regulatory side:
  o Corruption – the Opacity Index
  o Administrative barriers to investment
  o General approvals
  o Sectoral licensing
  o Site development
  o Operational requirements
• And of course, “ultimate” political/regulatory risk
  o First Quantum (DRC)
  o Rio Tinto: Guinea
  o ACR: Marange
  o Creeping Expropriation
Risk: The discipline of project finance

- Benefits of looking at risk through the eyes of project finance lenders
- Project finance teaches us that:
  "... risk should be allocated to the party best able to manage that risk..."
- Risk allocation is important but in Africa it is essential (delays and shareholder dissent magnified)
- Inadequate passing of risk means the project is unbankable or will require sponsor support … or worse.
- Importance of early analysis and understanding of risk.
- It’s also a good discipline in risk mitigation
The discipline of project finance

• Project-specific risk
  o Completion risk: EPC
  o Operating risk
  o Market
  o Participant risk
  o Supply or resource risk
  o Infrastructure risk
  o Environmental risk

  o Currency risk
  o Engineering risk
  o Syndication risk
  o Interest risk
  o Legal risk
  o Force Majeure

• Political/sovereign/regulatory risk
Project specific risk (1)

- Completion risk: EPC/construction
  - EPCM vs EPC
  - Design risk
  - Interface
  - Mechanics for passing risk (time specific; LDs; termination for delay)
- Operating/maintenance risk
  - Cost, management and technical components
  - Obligation to provide specific level of service
  - Payment mechanics – risks/reward
  - Termination
Project specific risk (2)

- Market risk: who’s going to buy the product? What’s the commodity price going to do?
- Supply risks
- Participant risk: who is the sponsor?
- Environment
- Foreign exchange
- Engineering/design risk
- Infrastructure risk
- Syndication: will the banks be there?
- Interest risk: possibility of interest rate escalation
- Legal risk
- Force majeure
Political/regulatory risk: General

- What is political risk? Widely misunderstood term
- List items of political risk that can affect your project
Political and regulatory risk

- Historically:
  - Expropriation (communists)
  - Political violence (revolutionaries)
  - Currency transfer/inconvertability (WWII)

- But more extensive now:
  - “creeping expropriation”
  - disruption of access to infrastructure
  - failure to provide security
  - targeted fiscal measures
  - spurious allegations of fraud/breach of agreement
  - unusual compliance activity
  - revocation/denial of operational/environmental permits
  - changes in law affecting rights or imposing burdens
Mitigating political/regulatory risk

- **Traditional sovereign risk mitigation**
  - Political risk insurance – a tool of last resort?
  - Host government contracts
  - Bilateral investment treaties

- **Integrated approach to risk mitigation**
  - Invest in transparent relationships with host government
  - Align interests with host government
  - Align with multi-lateral agencies – victim status
  - Encourage direct government participation
  - Open, competitive bidding, avoiding ‘fast track’ arrangements
  - Examine the political connections of your local partners carefully
  - Compliance
  - Don’t limit channels to national or local government
Political risk: PRI

- PRI coverage
  - Expropriation
  - Breach of contract
  - Political violence
  - Currency risks (transfer and convertability)

- Partial risk guarantees
- Credit guarantees
- Export credit agencies
Political risk: PRI

- Key players
  - MIGA (multi-lateral) – political risk insurer within the World Bank
  - EFIC, CDA, OPIC (bilateral)
  - Private insurers
Political risk: PRI

- Advantages
  - Claims made against insurer not government
  - Good coverage for political violence
  - Arbitration may not be required
  - Certainty

- Disadvantages
  - Expensive
  - Are you fully covered in quantum?
  - Are all political risks covered? What about discrimination, protectionism, breach of contract?
PR: Host Government Contracts

- What are they? Concessions, licences, implementation agreements, PSCs, development agreements, land use agreements.
- Can include stabilisation clauses and freeze regulatory or tax regimes.
- Where is the arbitration?
- Is the government party to a relevant convention?
- Advantages
  - Contractual claims can be made in arbitration
  - Can specify exactly what political events apply
- Disadvantages
  - Long process for negotiation
  - Can ministries bind all levels of government – change of Government
  - Are all political risks covered?
Political/regulatory risk: BITs

- What are bilateral investment treaties?
- Wide protection for foreign investors and granted direct rights of international arbitration
  - “Fair and equitable treatment”
  - National treatment standard
  - Most favoured nation standard
  - Free transfer of funds
  - Protection against expropriation
Political risk/regulatory: BITs

• Advantages
  o Immediate
  o All existing and future investments covered
  o Binding on all levels of government
  o Governed by international law
  o No privity of contract required

• Disadvantages
  o Do you satisfy nationality requirements
  o Differences in scope of coverage, reservations, coverage
  o Australia has how many BITs with African countries?

• The importance of investment planning. Where should you incorporate your group companies?

• But be careful when you’re BIT shopping – are you adequately covered?
Mitigating with DFIs

- Benefits of DFI support and involvement
  - Long term debt
  - No need for political risk insurance?
  - Higher level of risk
    - Resources (i.e. projects outside of gold, nickel and copper)
    - Countries with higher risk profile
    - Infrastructure
  - Sovereign risk
  - Regulation/legislation reform
  - Contact in government
  - Infrastructure development
DFI requirements

- Minimum investment conditions
  - size of project/investment
  - the “black art” of bankability (see later): who is the sponsor; sovereign risk; infrastructure; technology; market
  - reserve threshold: some banks require 50% reserve tail
  - security over assets

- Economic contribution
  - must make contribution to poverty reduction
  - employment and fiscal revenues
  - see Mineral Deposits Ltd (Senegal) (45% of employees were Senagalese)
  - tax revenue (DFI’s will consider “tax optimisation” but will be viewed cautiously)
  - overall risk mitigation: low revenues may lead to renegotiation by governments
DFI requirements

- Financial subsidiarity
  - Must be a lack of investors or private lenders
  - High commodity prices over last few years

- Social and environmental benefits/obligations
  - Compliance with environmental and social legislation
  - IFC Performance Standards
  - Employment and fiscal revenue
Political risk conclusions

• Consider whether you can structure to ensure BIT protection ... do it early
• Negotiate, where possible, arbitration and stabilisation in HGCs ... devil in the detail
• PRI ... tool of last resort?
• Integrated risk mitigation measures – have you met your friendly DFI neighbours?
Transparency/Bribery

- Themes of corruption in Africa
- Criminal Code Act 1995 (Australia)
  - Offence to influence a foreign public official in the exercise of the official's duties by offering, providing, promising a benefit to another person which is not legitimately due to that person
  - Facilitation payments
- Bribery Act 2010 (UK): does it apply to your company?
- FCPA 1977 (US)
- Managing the risk of corruption
Taxation issues

• Tax is a wide area: broad overview of recurring tax issues in an African context

• Structuring
  o Initial steps – looking at presence on the ground (company/branch)
  o Capitalisation
  o Double taxation treaties
  o Capital/profit repatriation
Taxation issues

• General tax issues
  o Withholding tax
  o VAT/GST
  o Customs
  o Stamp duty
  o Transfer pricing

• Offshore structures – Focus on Mauritius
Case study: Kenyan IPP

- **Project**: Power station
- **Sponsors**: Power developers in Africa
- **How did it come to life**: A difficult path: litigation
- **Financing**: Immediate candidates are development banks – shapes process
- **Logistics** – Establish office; local ex-pat manager based in Nairobi (meetings, travel).
- **Feasibility** – financial, legal, commercial due diligence carried out at early stage. Sponsor risk.
- **Local support** – shareholders
- **Advisers** - tax advisors, legal and international counsel, insurance, financial advisers.
Case study: Kenyan IPP

- **Government**: Government support; state utilities
- **Tax structuring**: development costs, development fee, onshore/offshore EPC.
- **Early-stage documents**: Term sheets, JDAs.
- **Specific issues**:
  - Types of corporate vehicles – minimum shareholders
  - Thin capitalisation
  - Financing matters (capital restrictions, interest payments …)
  - Registering and enforcing of security
  - Land issues
Notice

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