WHITE & CASE

Structuring Energy and Natural Resource Investments into Sub Saharan Africa

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"It is no secret that seven of the ten fastest growing economies by GDP in the world are predicted to be in Africa and we are seeing significant flows of investment into Africa from many different parts of the world."

Chris Utting

Johannesburg Partner, White & Case

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An improving investment climate

Perceptions of Africa as an investment destination are changing rapidly and parts of Africa are increasingly considered very attractive for foreign direct investment. Compare this to similar findings as recently as three or four years ago, and it becomes clear that there has been a remarkable change in Africa's image in a short period of time.

The statistics suggest that these changing perceptions are justified. Africa's share of global foreign direct investment stands at 5.7% – an all-time high, of which, notably, 80% is directed towards sub-Saharan Africa[1]. In addition, there has been a marked increase in intra-African investment. While the majority of this inward investment has been focused on the traditional extractive industries, it is worth noting that there is also a long-term trend towards increasing investments in consumer-facing industries, such as financial services. Kenya, for example, is harnessing such investment to establish itself as a regional commercial financial hub.

Drivers for increased investment

The reasons for the increased interest in sub-Saharan Africa are as varied as the countries that are investing. For investors from many developed Western countries, difficult investment environments and a shortage of interesting opportunities at home and in the investment destinations that they were used to have contributed to the increase. In the case of Japan, supply diversification – in respect of scarce commodities, as well as hydrocarbons – has been a key driver. This policy objective helps to explain why Japanese investment into Africa has increased 76.5% over the last two years[2], including investments into sub-Saharan countries such as Mozambique and South Africa. In spite of this recent growth, African imports still constitute only 2.5% of all imports into Japan, with South Africa accounting for almost one-third of this amount[3]. It is clear that there is still scope for the economic ties between Japan and Africa to strengthen significantly in the coming years.

This article follows a White & Case seminar held in September 2014 in Tokyo and includes quotes from panelists on the day:

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1 EY. *Africa Attractiveness Survey,* June 2014.

2 Ibid.

3 Japan External Trade Organisation (JETRO). *Global Trade and Investment Report,* August 2013.

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"The standing of countries can change relatively rapidly, so one has to follow developments closely."

Chris Utting
Johannesburg Partner, White & Case

Africa is made up of 54 countries and, while the overall picture is of a global improvement in perceptions of Africa as an investment environment, there remain significant differences between these diverse economies. Certain countries stand out as being relatively favorable locations across a range of sectors, such as Botswana, Ghana, Namibia and South Africa. However, investors continue to be more cautious about certain other countries, such as the Democratic Republic of Congo and Zimbabwe, despite the undeniable potential that there is in these countries. While certain countries in other continents may also be more or less attractive than their neighbours, what sets Africa apart is the speed with which the relative standing of its countries can change. Countries such as Angola, Sierra Leone, Rwanda and Liberia have shown significant governance gains over the last decade, whereas certain other countries have shown significant governance losses over the last decade which would make foreign investment challenging[4].

Although it is clearly in any country's interest to improve its reputation overseas, the nature of most foreign direct investment into Africa means that even countries which score lower as favourable investment destinations are seeing increased investment due to the opportunities that exist there. Investors must therefore be well informed as to the risks inherent in their ventures and well advised as to how to structure their investments in order to mitigate these risks. On the other hand, some countries (such as Botswana and Namibia) score relatively high as favourable investment destinations, but have not succeeded in attracting high levels of investment. Some commentators suggest that this is on account of the smallness of the local market and limited number of potential projects.

Old risks, new risks

"The classic understanding of political risk, which used to mean expropriation and war, is now no longer as high up on investors' lists as are more practical business issues around the failure to pay bills, increasing Government "take" and the ability to take currency out of the country."

Mukund Dhar
Johannesburg Partner, White & Case

Despite the promise that Africa holds, potential investors remain concerned about certain key risks. Expropriation, corruption and war remain on the agenda, but as Africa has developed into a more sophisticated marketplace, these classic risks have been overtaken in the minds of investors by more commercial concerns such as macro-economic instability, access to qualified staff, the suitability of existing infrastructure, breach of contract by a government or government-owned entity, transfer and convertibility restrictions and changes in law. Such changes in law are not always the result of new regulations or legislation. In Nigeria, until recently, investors in oil and gas assets assumed that they could freely transfer shares in companies holding interests in such assets without government consent. Following a court decision in 2011, ministry consent is now required for such transfers where they result in a change of control. Such changes can have a real impact on the smooth management of an investment or project, as the process for obtaining consents can be complicated and time-consuming, and may often require the payment of a consent fee.

Concerns around resource nationalism remain central to decision-making in respect of investments in Africa. Modern resource nationalism tends to manifest itself in three main forms: increased taxes and royalties, requirements for government ownership, and requirements for local content in projects, often backed by export restrictions.

4 2014 Ibrahim. *Index of African Governance* (2014).

It is becoming clear that such matters need to be looked at holistically by investors and their lenders, taking into account local as well as regional considerations, in order for them to put in place the most suitable protections available. Such protections may include government agreements, political risk insurance, domestic legislation or bilateral investment treaties ("BITs"), although it is worth noting that Japan currently has only one such BIT with a sub-Saharan African country: Mozambique. For the African countries in respect of which Japan does not have a BIT, Japanese investors may consider investing through a country that does have such a treaty, or alternatively may seek agreements with host governments to protect themselves against changes in law or tax rules. However, this needs to be considered on a case-by-case basis.

Investors should be aware that the landscape in terms of local content and national interest laws in Africa is constantly changing and evolving. Investors will need to consider not only recent changes, but also proposed developments that could have an impact on their investments. Tanzania, for example, is currently in the process of considering constitutional reforms, leading some potential investors to evaluate the timing of their investments into Tanzania.

Defining expectations and mitigating risk

A thorough understanding and a sophisticated analysis of all of the available options to protect against these risks is required to enable an investor to confidently assess how effectively it will be able to protect itself from the kinds of risks referred to above.

In some African countries, the legal and business regime may not provide clarity as to how a particular project within a particular sector will proceed and how the benefits and costs of developing it will be shared between the government and the investors. Often, new legislation is required (see, for instance, the new Petroleum Law in Mozambique). Government agreements therefore provide a unique opportunity for the relevant parties to formalize in detail their expectations and responsibilities in respect of a project. Such agreements may take the form of, for example, implementation or concession agreements. An ongoing issue is that many countries and sectors lack a standard form of government agreement, meaning a significant amount of time and effort is likely to be required in negotiating and finalizing them. Given this lack of recognized forms, investors need to take great care to ensure their contractual arrangements with host governments address all of their concerns and cover every conceivable issue that may affect the project or investment. Such concerns will include the nature of the concession itself, the tax benefits and exchange control protection to be granted to the investor, the limits on government participation in the investment, stabilization and the investor's ability to bring other participants into the project. The parties' common understanding on such matters should be set out clearly in the government agreement, as they will often impact on the protection available under BITs or political risk insurance. For example, if there is a lack of clarity in the government agreement as to whether a certain set of circumstances constitutes a breach, this may undermine an investor's ability to claim under its political risk insurance or initiate arbitration proceedings under a BIT in respect of issues faced by the investor.

> "We have seen many examples of political risks affecting projects, and working through these issues to find a solution that works for all parties can be a long and difficult process."

> "There is a variation between countries and between industries and sectors, which investors must keep in mind when seeking to understand what comfort they can get from governments."

Mukund Dhar
Johannesburg Partner, White & Case

"Risk mitigation requires a nuanced, sophisticated analysis of all the options available to investors. Some of these may be obvious, but what is not obvious is the way in which these options interact with each other."

Mukund Dhar
Johannesburg Partner, White & Case

From the host government's perspective, the Government Agreement is an opportunity to put in place arrangements that will allow it to make the most of the investment into its country and the development of its resources. It will therefore seek to maximize its right to participate in projects, while minimizing the cost to it of doing so. Many such agreements will therefore provide for the government to have (or to be entitled to take at a later date) a "carried interest", which will afford it a share of the benefits, while minimizing its obligation to contribute to the costs of a project. It is not unusual to encounter a government that expects to be carried completely freely; there is a great deal of variation internationally in this respect, and Africa is no exception. The existence of such carry rights or the possibility that they may arise in the future may give rise to complications when arranging financing for a project. For example, can such stakes be made available for security or collateral? Some governments may agree to this, whereas others will prohibit it. It is important that such matters are addressed at an early stage, so that the deal can be structured accordingly.

Development Finance Institutions ("DFIs") may provide an answer to some of the challenges of getting African projects off the ground – most notably, funding difficulties – and some projects have actually proceeded with 100% DFI financing. DFI involvement provides a number of unique advantages to investors, including the ability to offer long tenor loans in local currency, which may prove challenging for other lenders. As governmental institutions, DFIs are also well placed to establish and maintain policy dialogues with host governments and may be prepared to take risks that international banks simply could not accept.

"A Development Finance Institution can be a powerful friend, in particular when host governments take actions that may be adverse to a project."

Chris Utting
Johannesburg Partner, White & Case

Political risk insurance ("PRI") may also be employed as a tool to mitigate and manage the risks inherent in investing in Africa and may be available to cover matters such as currency inconvertibility, transfer restrictions, expropriation, terrorism or the failure by a counterparty to honor its financial obligations. Such insurance is often provided by national export credit agencies, multilateral organisations or global institutions such as the World Bank. PRI can, however, be complex and expensive to arrange.

Many project sponsors consider entering into local joint ventures or alliances with local companies as a key tool for mitigating political risk. In weighing up whether to (and how to) enter into such arrangements, investors need to take a number of considerations into account. A bespoke joint venture agreement will likely be required, and the negotiations for such documents can be complicated, especially when a government or government-owned company is involved. Investors need to consider the ability of a government or government-owned partner to fund the project and provide support on an ongoing basis. A consortium of investors will also be keen to structure deals so that they can present a united front to the host government, and this may require the creation of a two-tier joint-venture structure.

The South African experience

South Africa is widely seen as the most favourable destination for foreign direct investment across the continent. As mentioned above, the country accounts for almost one-third of all of Japan's imports from Africa. Its success in attracting overseas investors can be attributed to a beneficial legal system and institutional framework that provide a relatively high level of clarity on the issues that will be of concern to potential investors. For example:

- Property rights are generally well protected: expropriation is not permitted unless authorised by statute and there are currently no statutes that would permit the expropriation of petroleum interests.
- The government generally reserves for itself a 10% participation right in any petroleum project.
- The level of royalties to be imposed on a range of minerals and resources is established by statute.
- The country benefits from sophisticated labour laws and a developed tax system.

On the other hand, South Africa is not immune to many of the risks that are more generally associated with investments in sub-Saharan Africa. For example, there is a growing requirement for local content in projects, and infrastructure is still poor in some parts of the country, meaning additional investment may be required in this area to make a project viable.

The Mineral and Petroleum Resources Development Act ("MPRDA") is one of the most important pieces of legislation promulgated over the last 10 years and governs minerals, oil and gas. Amendments to the MPRDA are currently being considered, creating some uncertainty for investors. Some of the proposed amendments are controversial, in particular as they will require some form of local beneficiation in regard to specific minerals. In addition, it is expected that the MPRDA will provide for a free carry right in favour of the government, although it is not clear at what level.

As a result of the generally positive perception of South Africa as an investment destination, FDI has increased rapidly in the last few years and has been predicted to continue to increase.

"South Africa has a strong and stable legal system, which constantly takes cognizance of changes and amendments that occur in legislation in the rest of the world and adapts its own legislation to be in line with current best practice"

Joz Coetzer

Johannesburg Partner, White & Case

"The sharp rise in investor-state arbitrations can be explained by reference to the increased number of BITs, but also by a growing trend towards resource nationalism."

Hiroshi Oda

Tokyo/London Counsel, White & Case and Japanese representative to the ICC Court of Arbitration

Arbitrating investment disputes in sub-Saharan Africa

There has been a sharp increase in the number of BITs globally since the beginning of the 1990s, and the current number of BITs in existence is approaching 3,000. African countries are party to 769 of these, 80% of which are between African and non-African countries. Countries such as the Netherlands have established relationships with a large number of African countries in this way. Japan, however, currently only has one existing BIT in Africa (Mozambique), although negotiations are ongoing with Ghana. The existence of a BIT will have a significant impact on the way an investment is structured. For example, if no BIT is in place between the investor's country and the host country, the investor may choose to funnel its investment through a country that does have such arrangements in place, such as the Netherlands.

A typical BIT will, among other things, specify the rules to be applied in the case of arbitration arising out of an investment in one of the contracting states. Japan's BIT with Mozambique, for example, provides that disputes may be resolved by reference to the International Centre for the Settlement of Investment Disputes ("ICSID") or the United Nations Commission on International Trade Law ("UNCITRAL"). These are the most common forums for settling such disputes, accounting for some 90% of all arbitral claims.

The United Nations Conference on Trade and Development has reported an increase in the number of disputes between states and investors since 2000, and this has been reflected in a rise in the number of cases brought before ICSID. Having been established in 1965, ICSID has a membership of 140 countries, although there are notable absences including Russia, Brazil, Mexico and South Africa. Largely dormant until the 1990s, ICSID heard almost 400 cases in 2012.

ICSID offers a number of advantages as a venue for settling disputes between investors and states. In particular, it is generally considered to be neutral, regardless of the seat of the arbitration.

ICSID also plays a leading role in Africa, with 44 of 54 countries being signatories. The majority of African cases brought before ICSID relate to disputes with European investors (61%) and arise from the manufacturing, oil and gas, construction and mineral sectors, among others. Where a deal is structured in a way that means the investor will not be able to benefit from a BIT, then the investor will instead need to rely on the national laws of the host state or alternatively, seek to put in place a government agreement that identifies ICSID as the agreed forum for resolving disputes. It is worth remembering, however, that even where ICSID is not an option, the parties may agree to ad hoc arbitration or seek resolution through an alternative body.

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