

AFRICA ENERGY ROUND TABLE



Power struggles

With Africa's energy market becoming increasingly developed, *Legal Business* hosted a round table with Miranda on the challenges facing the fast-changing power sector, the pitfalls of operating in new jurisdictions and the role of arbitration

MICHAEL WEST

Developing energy projects in Africa often means embarking into new legal territory, requiring energy companies to rely on law firms and their local counsel to navigate often untested, ill-suited or non-existent regulations and ensure that, if things go wrong, reparations will be available.

Legal Business and Miranda Correia Amendoeira & Associados hosted a debate for energy lawyers who shared their experience of working on the continent, and how they saw Africa's energy market evolving.

Talk turned quickly to one of the often-cited problems for operating in African countries: uncertainty and how uneven enforcement of local regulations is introducing extraneous risks. But the room was divided over how much of a role this plays in the oil and gas sector, with some wary of governments' ability to introduce new rules at the critical juncture, while others found that stabilisation clauses combined with arbitration provisions worked effectively.

More consensus was found over the substantial impact US shale gas is having, with at least one major project already rerouted to service other markets, while there was also unanimity on the importance of local counsel in getting transactions over the finishing line and the increasingly important role local companies are playing on the continent.

Mark McAteer, Legal Business: Catarina, would you mind giving a flavour of how the market is operating and the health of the upstream market in Africa?

Catarina Távora, Miranda: From the standpoint of the oil industry, we are witnessing something we have not seen for a while. There is too much on offer for the

available investment. We will probably see this more clearly in 2015 when there will be more opportunities appearing in the market than demand. This may change the way companies negotiate contracts, the terms they are willing to accept and, in time, it may lead African countries to think a bit more about what they are demanding if they want to stay competitive.

Greg Hammond, Eversheds: It is definitely the case that the industry in 2014 is in a slightly worse place than it was [in 2013]. You only have to see the number of potential M&A opportunities that are out there. A lot of companies are looking to raise money to fund development projects and they all seem to be doing that at roughly the same time, which in turn depresses prices. With a decline in the oil price, it is further bad news.

David Moss, Hogan Lovells: Then there is very much a focus on capital expenditure. There is much more focus on how companies are spending their money.

Catarina Távora: There will also be a task where there are several licensing rounds going on at the same time. A licensing round is open in Mozambique; there is a licensing round going on at the same time in Equatorial Guinea; the Ivory Coast is putting blocks up for sale; the Congo is putting blocks up for sale, etc. It seems too much. We may see fewer companies picking up blocks and, in negotiation, they will be more careful in commitment to expenditures. They will have to be.

Martin Stewart-Smith, Bracewell & Giuliani: Another factor that plays hand in hand with this is the way that a number of African countries



Greg Hammond, Eversheds: Africa's energy market less buoyant in 2014 as oil prices fell

► are putting into effect local content requirements [a minimum rate of involvement by domestic companies or workers in a project]. Even if these requirements are already on the statute books, governments and regulators are now starting to get more serious about enforcement and we certainly have some indigenous companies utilising that quite effectively.

Catarina Távora: IOCs [international oil companies] will prefer countries with less local content and some countries have started to realise that they will need to be less demanding to get investment.

David Moss: It also places a much-increased demand on the part of the foreign oil company, with respect to the due diligence that it does, from the standpoint of ABC compliance when it has to check out a prospective local partner.

Martin Stewart-Smith: It is noticeable to see the way that the Chinese have been largely on standstill for a while and that is because of investigations going on in China. There is a bit of paralysis at the moment, but that goes hand in hand with some blowback in certain African countries, because the

expectation was that signing up to the Chinese economic model for investment would mean that deals would not only close more quickly, but also that they would create a lot of local employment. In many cases that has not materialised, so you are starting to see local content driven out of a response to the way some of the Chinese companies have mobilised in practice.

Patrick Wallace, Simmons & Simmons: If you are doing a deal that is quite complicated where you have prolonged negotiations with a government, you do not even know if the position is going to be stable while you are going through this project development process. Simmons is involved in one project in Africa where you look at the current legal requirements and they are not actually that difficult, but you know you have a long project development process coming and it is a moving picture that you are operating against.

Clients are going to Africa and negotiating the terms of huge investments against a background of legislative change and the problem is not just things changing in future, but that the baseline is evolving as you negotiate: you are waiting for regulations that will emerge and affect issues that will be really important to the project.



Catarina Távora, Miranda: Some African countries now need to be less demanding to stay competitive

Michael Burns, Ashurst: That comes down to the investor's appetite for risk at the end of the day.

Patrick Wallace: The problem is that it is a type of risk that is extraneous. That kind of legislative change risk is not something these projects can accommodate well and these uncertainties are getting in the way of development, but it is understandable.

Michael Wachtel, Clyde & Co: Actually, if you want certainty, Africa is probably one of the best places. We have dealt with local content issues. They are an issue, but probably less, we find, for cost reasons because most of the contracts these days tend to be economically stabilised because of the 'R factor' [ratio of cumulative receipts from sales to cumulative expenditures]. Most of our clients are comfortable to spend more on local content because they are getting cost recovery and their production share remains high while the R factor is below a certain level. As regards legislative change, I have not seen a contract for a long time that has not been stabilised. Purists might get upset about the drafting of stabilisation provisions, but they have always been honoured. I have been advising in Africa for a long time now and it is probably one of

the most stable places you can do business, because of the stabilisation, because of the fact there is relative political instability. People that are going into Africa and are worried about stability should be far more worried about the North Sea, which is probably the most unstable fiscal regime in the entire world.

Greg Hammond: Yes, because of changes in tax regime. There is a theory that because, in Africa, everything is generally encapsulated and stabilised within your PSC [production-sharing contract] and there is very little dealt with outside of that, by comparison, the North Sea is fiscally more risky.

Nuno Antunes, Miranda: That depends on the jurisdiction. In Africa, you have the picture that Michael has just described, and you have the opposite where the country has developed beyond the PSC-only regime and has a continental law system, where the contract is an administrative law contract with all the implications that come out of it.

Michael Wachtel: I agree that you do get legal changes to the contracts, but very often those contracts contain an economic stabilisation clause, so even if the legal regime changes and you get some kind of creeping expropriation through increased tax rates, or varying tariffs or whatever happens, there will be an adjustment made to the economic terms to compensate you for that. The economic return of the investor is always stabilised.

Patrick Wallace: If you look at a comparison between eastern Europe and Africa in terms of the degree of recognition, legally, of the possibility of having stabilisation, it is better. That is partly because of the legal systems. The period of risk is, if you are doing a complicated development, until you have the agreements signed. I can certainly see, once you have signed the agreements, you can have the stabilisation built in.

Michael Wachtel: The stabilisation is usually in the exploration contract from the beginning.

Patrick Wallace: I am thinking more of pipeline infrastructure, where you have a longer build up.



Hamish Lal, Jones Day: Energy firms manage political risk by finding the right local partner

Catarina Távora: One thing that we have witnessed very often is that, when companies want to evaluate what their costs will be – one of the main difficulties is understanding what is in place and what will be in place, because they do not really know what the law is and how it will be enforced, from customs to foreign exchange restrictions.

that as long as they can get economic stabilisation. The other thing is impartial dispute resolution. If they can get arbitration in a neutral venue with sensible arbitration rules, they are relatively relaxed about the fact that there may be some legal uncertainty or less developed legal systems, because they get a fair crack of the whip if the wheels fall off a deal.

'People that are going into Africa and are worried about stability should be far more worried about the North Sea, which is probably the most unstable fiscal regime in the entire world.' Michael Wachtel, Clyde & Co

Michael Wachtel: The IOCs, big and small, are very used to investing in strange environments. There are certain things that they will always insist on and the ones that do not insist on them are not around for very long. One of those is economic stabilisation. Sometimes they would like legal stabilisation, if they can get it, but they are not too worried about

David Moss: I am interested in your experience, Michael, because I spent eight months helping one upstream client negotiate a stabilisation clause. The amount of wriggle room that the state wanted was pretty substantial and there was a pretty flaky dispute resolution procedure, which did not give a great deal of comfort.



Nuno Antunes, Miranda: Shale oil will become an issue and is becoming more and more so



Michael Burns, Ashurst: Relationships with local advisers are of the utmost importance

► **Martin Stewart-Smith:** Is that not really just confined to the upstream? At the end of the day, you have made this wonderful discovery; you have got your stabilisation around your upstream PSC, but you need to get the product to market and you need the infrastructure to get it there. Otherwise, until there is a clear route to market, it is not really worth anything.

Michael Wachtel: That is usually developed under the terms of the PSC. You will still get your stabilisation.

Patrick Wallace: Simmons has had this in several African countries – in the middle of negotiating the biggest deal in that country, when government decides it is time they had a proper regulatory structure and so you suddenly find that a law is being considered or has been passed.

Michael Burns: Or, conversely where an investor is looking for certainty through a new structure and a law fails to be passed.

to sign on the dotted line, after about three or four years of work. It is one of the hazards that you encounter but you have to be able to deal with it.

Patrick Wallace: It is not like anybody is trying to upset the process; it is just that you have to find your way through it.

Michael Burns: Sometimes they are.

Patrick Wallace: Yes, and then you have to have your strategy: is the host country just going through the legitimate process of working out what the sector legislation and contracts should say, or are they renegotiating the deal or potentially destabilising existing investments and assets?

Michael Burns: Meanwhile, the exploitation of the upstream resources is pushed back, destroying potential value.

Mark McAteer: *Given the impact of localised regulatory and political issues, how important is it to have local law firms involved in the process?*

Patrick Wallace: Hugely. It is an enormous mistake for anybody to come

'Very often, you are operating at a level that the local constitutional law has not yet reached.' Greg Hammond, Eversheds

Martin Stewart-Smith: In many cases, it is not. Often the PSC is limited to the pure upstream. In many cases, you have to go back and negotiate, having made the discovery. This is certainly true in Mozambique. Having made the discoveries, you have to go back and make modifications to the PSC and then build out the midstream infrastructure to get your route to market.

Patrick Wallace: Or is about to be passed, and you are sitting there and trying to work out how it will impact your particular project.

Martin, you may remember this from one of the deals we had when we were at the same firm. We were about to sign everything, including our wonderful stabilisation clause, and the country changed the sector legislative regime in the same week. We had all the banks lined up, ready

in and think that you can just, from an international law firm perspective, work out what local legislation means. It needs very close co-operation with very good local lawyers.

Michael Wachtel: It would be impossible to do it, because you need a local title opinion. You never raise any money without that.

Catarina Távora: It is crucial to be updated because you can have the exact same law in place, and the way it is construed and enforced can change in a matter of days. If you do not have anyone that knows that, you are lost.

Patrick Wallace: You have to have somebody who is open-minded enough to consider all the different possible outcomes and then give constructive advice about how the law would be applied, but not unduly imaginative advice. Local counsel in Africa have a more difficult job than we have in home jurisdictions where these things are typically more clear cut.

Martin Stewart-Smith: We were recently involved in reserve-based lending for the first time in a particular African jurisdiction that had never done one before. The only law that the local lawyers could look to was a law governing the taking of security that was designed for mortgages over residential property. The mortgage registration fee was on the basis of the number of square metres of the property. Of course, when you look at the offshore block, the security registration cost of applying that principle was going to be larger than the amount of the entire loan facility. It was a question of getting that conversation going with the local lawyer, who then has the relationship with the tax authorities, to be able to find a sensible solution.

Michael Burns: Just focusing the point on the relationship with local law firms, you cannot underestimate that importance. International firms' credibility is on the line by reference to who they recommend and also the client themselves is at risk based on who is ultimately selected as the local adviser. Also, one thing never to be undervalued is having multiple relationships in countries, because you never know when conflicts may arise.



'After three years' work, we were about to sign everything and the country changed the regime the same week. You have to deal with it.'

**Patrick Wallace,
Simmons & Simmons**

Greg Hammond: The local lawyer relationship has to be totally co-operative, because, in a young jurisdiction, inevitably there are going to be gaps.

Very often, if the law does fall short, really the only way to fix it is to go back to the government and request a state guarantee – a letter of assurances or whatever it might be – to get confirmation that things you would normally take for granted are going to happen over the course of maybe a 15 or 20-year financing or project. It is a very collaborative experience and, all the time, you are taking what is very often the best local firm on the ground, whose reputation may have been established in a totally different field, and in a period of six to 12 months, educating them up a massive learning curve so that the end product you come up with is going to pass scrutiny by banks who are lending potentially billions of dollars.

Patrick Wallace: To get these deals done, often the trick is just finding the practical additions to the normal model of transaction that get you through whatever unexpected problem is thrown up in a legal system that has not yet accustomed itself to the particular type of transaction.

Martin Stewart-Smith: I came across a situation about a year ago where there was a particular assurance letter that was given by the government and there was a question of whether it was actually binding in any way. The argument made was that, if you want to have a binding commitment, it must be with the republic, not the government, because the government is just the government of the day.

You have to deep-dive on some quite important issues of *vires* and whether the commitment you are getting in your contracts from the government is actually going to be enforceable.

Patrick Wallace: One of the things you are wary of is the risk that a change in government can have on deals that have been negotiated and approved by the existing regime. I remember feeling very sorry for a recently appointed energy regulator because the government's term of office was coming to an end in a foreseeable time and he did not know how the elections would work out. He was recently appointed and was being asked to approve a bunch of documents that had taken two and a half years to negotiate, and he must have been sitting there thinking: 'What ►



Martin Stewart-Smith, Bracewell & Giuliani: There is a risk that contracts made with governments won't be enforceable

► if the regime changes and I was the regulator who finally blessed this? How does that leave me? We absolutely had to have that regulatory sign off in a way that would withstand future examination - you can't just rely on the current government continuing. It is a problem and you have to be really careful with it.

Martin Stewart-Smith: That kind of issue came up on a recent transaction: can the regulator actually fetter their discretion? If they are a creature of statute, can they enter into a binding commitment, thereby fettering the later regulator's discretion? You get into these quite knotty issues.

Greg Hammond: Very often, you are operating at a level that the local constitutional law has not yet reached. As a result, you end up requesting a

state letter of assurances. Typically, it will be blessed with some kind of decree so that you can be comfortable that you are contracting with the right entity and waiving sovereign immunity. As it's being finalised, the banks are sitting in the background thinking: 'We want this and we want that', and you end up with this absolute filing cabinet of tick boxes.

Nuno Antunes: There are two levels to what you are talking about. There is the legal level, where you have local counsel to, hopefully, guide you through and tell you: 'This is not the entity that can give you this commitment,' or: 'It is not the only entity. You need a joint decision by A and B.' But then you have the other, which is, if it comes to that, how will this work in practice? That is a much bigger issue that can have an impact on arbitration.

'Suing governments is something that you do not want to do, because it really is the mutually assured destruction button.'

Michael Wachtel, Clyde & Co

Greg Hammond: Some would argue that there is limited use in most African countries in a right to sue a government, because they sit on the asset. The sponsor can bring an arbitration claim, but it is then almost immediately in an exit strategy.

Catarina Távora: In oil and gas upstream projects, it has to be limited. Arbitration is limited.

Michael Wachtel: They follow the currency payments and seize their product. It is very effective. Look at what happened to Exxon in Venezuela.

Catarina Távora: It was an exceptional situation. You try everything before you -

Michael Wachtel: Absolutely, but the reason that you have the arbitration provisions is because they are effective and suing governments is something that you do not want to do, because it really is the mutually assured destruction button. You are exiting the country. You do not sue the government and stay. If you have to, you will and it does work.

Hamish Lal, Jones Day: The IOCs that we work with have sought to mitigate political risk or local-content risk by having a good local partner. The way that they do it is by purchasing influence, which one can construe in different ways. The second difficulty that people discussed earlier was the local-content legislation. Where I see it of most relevance is not at the project agreement level, but how it is implemented and, normally, that's at the EPC [engineering, procurement and construction] level, at the supply-chain level. That is where we have real difficulties, because a claim comes up to the IOC or the consortium, but there is little expertise, precedent or case law in how the local-content legislation has been applied or what it really means in hard-edged contractual terms.

What we tend to have, then is local counsel who advise on the transaction, but then a series of local QCs who advise on what the clause or local-content legislation is likely to mean if it goes into the local courts or to arbitration.

Mark McAteer: *How big is the impact of the US shale gas boom in Africa?*

Greg Hammond: It is already affecting gas flows globally. I would say Africa may be less



David Moss, Hogan Lovells: Collaboration with local counsel is necessary to work through the intricacies of the legislation

affected, arguably, than Australia, for example, which for a long time has had plans to build these liquefied natural gas (LNG) projects that would supply the Asian market. Their pricing is now really under pressure because the US is producing its own shale gas at reasonable prices and east Africa is now approaching with a much more cost-effective product. A lot of those projects in Australia are now under scrutiny. They clearly will not be supplying the US market. They cannot compete on price with the upcoming east African suppliers.

Nuno Antunes: Even if they do not export, and depending on how shale oil goes – we are talking about shale gas, but shale oil will become an issue and is becoming more and more so. Nigeria, for example, had the US as its main export market for light sweet crude and they now have a problem because their market has gone. They are not finding a replacement easily, so it is creating issues for Africa and especially on the west coast. I am not entirely sure how the east coast will work, because the markets are entirely different, certainly for gas.

Martin Stewart-Smith: It is interesting to watch the rise and rise of the indigenous Nigerian companies. They live with country

risk and know how to manage that. We will start to see them make a more regional play within Africa, which is part of a growing level of intra-Africa investment.

Michael Wachtel: We see a lot of Nigerian companies investing outside Nigeria.

Greg Hammond: That is part of the natural cycle. You are a nation with big oil reserves; you invite the IOCs with their technology and, over time, there will be an evolution into an indigenous market and then an EOR [enhanced oil recovery]-type market, then the territory declines and you move on.

Michael West, Legal Business: Presumably, you will have to develop your contacts with those national entities.

Martin Stewart-Smith: It means that the relationships between international firms and local counsel become more important.

Hamish Lal: There are two things from our own experience. Michael just made the point about Nigeria and the indigenous entities having a positive attitude towards their neighbours. Our head of projects, Arman [Galedari] is seeing more gas to power

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projects in west Africa and it is probably no secret to people around the table that this is a particular focus for Jones Day. The US does not need [gas].

Nuno Antunes: We are seeing in Mozambique that the massive quantities of gas are leading the government to look into whatever use of gas they can make of it.

Martin Stewart-Smith: If you look at the quantities in the Rovuma Basin, I don't believe Asia can take all that LNG without a significant fall in prices. I know it is still some way away – 2023/24 or something like that – before it comes on. But, it is such a large quantity that it will definitely move the market and has the potential to almost crash the LNG market, so they have to diversify into other products, and certainly clean diesel or [gas to liquid] make sense.

Mark McAteer: Thank you all for participating. **LB**
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