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Briefing note

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Resource nationalism

Resource nationalism represents a major challenge to investors in resource-rich economies and one that appears to be growing. With some commodity prices at or near record levels, the stakes are higher than ever for both investors and host Governments. With particular reference to the mining sector, this briefing looks at how resource nationalism manifests itself and outlines some potential investor strategies for managing this key risk.

Key issues

- Resource nationalism is a growing business risk in the natural resources sector and is manifesting itself in increasingly diverse and subtle ways.
- Investor returns are drastically impacted by occurrences of resource nationalism so care needs to be taken on how deals are put together and documented. Some contractual protections are available such as stabilisation clauses, BITs and via political risk cover (which needs to be bespoke to be of genuine worth).
- When resource nationalism is threatened or occurs, contractual solutions are only part of any investor strategy for minimising the potential loss – commercial negotiations are key. To preserve and pursue contractual rights, an investor will need to take specific steps under its investment agreement or insurance policy and failure to do so may impact on the protection provided.

What is resource nationalism?

The term "resource nationalism" typically refers to the assertion of control by people and governments, for strategic and economic reasons, over natural resources located on their territory[1].

Typically, where investors are seen by host Governments to be getting too good a deal and especially when prices rise beyond the levels originally anticipated (even if they have had to manage price slumps in-between), there is a risk that governments will seek to impose a new settlement to improve the position of the state.

It is by no means a new phenomenon, as the long history of oil company nationalisation and contract renegotiation in the oil-rich Middle East and North Africa stretching back for well over half a century illustrates.

In the 21st century, it increasingly has wider political and social drivers in addition to traditional economic ones.

Long term concessions with flat royalty and tax rates – which are characteristic of investments in the mining sector – are not very well designed to smoothly accommodate significant changes, such as record commodity price levels that nobody accurately predicted. Consequently, such arrangements can find themselves subject to challenge during the life of a long term investment.

Resource nationalism is sometimes mistakenly seen as a purely developing world phenomenon. We too readily fail to register under the same heading changes to the taxation regime in developed economies – e.g. the UK government's North Sea windfall tax or the revised minerals resource royalty and taxation regime introduced in Australia.

Having said that, the phenomenon is often more acute where one or more of the following factors is present:

- over-dependence on natural resources
- fast growing population
- evolving politics – democratisation

[1] This formulation of the term is used, for example, in "The mining sector's two biggest risks: country risk and resource nationalism" written by Richard Mills on 26 August 2011 (mining.com)

- need for jobs, infrastructure and social services
- outdated or inappropriate laws (mining and petroleum codes)
- non-transparent licence award processes.

All of the above can create pressure on a government to increase its 'take' from its natural resources. But in all countries the host government faces a difficult dilemma – how to maximise their benefit from a finite resource while at the same time not scaring off investors.

In some cases, it may be acceptable for investors to agree revised terms if this will help sustain relationships that may support democratic governments and/or the institution of the rule of law and transparency (which hopefully should protect their investments).

How is resource nationalism manifesting itself in the mining sector?

Some manifestations of resource nationalism are more obvious than others. Hugo Chavez simply nationalised the gold industry outright in Venezuela, but there are many other ways in which host governments have sought to obtain a 'new deal' in this sector. Some examples just from the last few months are listed in the box below.

Concentrating on the mining sector, in the past two years more than 20 countries have announced plans to increase the government take from mining projects through increased taxes or royalties.

In addition, just as was seen in the oil and gas sectors with the growth of the national oil companies, we are seeing increasing demands from governments for local participation. For example, the Republic of Guinea's new Mining Code grants the State a free carried interest of 15% in iron ore and bauxite projects with a right to acquire a further 20% on a fully paid basis. In Zimbabwe, foreign owned companies are required to transfer at least 51% ownership to locals; in South Africa, the black economic empowerment drive already requires 26% to be transferred to black owners by 2014. Such changes can have significantly greater impact on investment returns than increased royalty and tax rates and also raise questions of compensation, control and management.

Some recent examples:

- **Angola**: new Mining Code introduced (Sept 2011)
- **Argentina**: government orders repatriation of export revenue of energy and mining companies (Oct 2011)
- **Botswana**: relocation of London-based De Beers staff to Gaborone (Sept 2011)
- **Brazil**: proposed new mining code (expected end 2011)
- **Chile**: potential state purchase of Anglo American Sur copper assets (current)
- **Mongolia**: dispute over government share in Oyu Tolgoi copper mine (Oct 2011)
- **Peru**: mining sector profit tax introduced (Sept 2011)
- **Republic of Guinea**: new Mining Code introduced with increased state participation (Sept 2011)
- **Zambia**: plans to increase state stake in mining projects to 35% (Oct 2011)

What does this mean for investors?

Greater clarity and transparency are generally welcomed by investors and a higher government economic take can be factored into investment decisions if it is clearly spelled out prior to investments being made. But the real challenge and threat to investors is where changes are made after significant investments have already been made – often notwithstanding earlier express promises of economic and fiscal stabilisation. The risk of future changes in a climate of resource nationalism is one that can act as a significant deterrent to investment.

To the extent that new mining codes seek to mandate greater local content – for healthcare, education, employment and management – this is something that the mining community has often been willing to embrace in line with its wider corporate social responsibility initiatives; although aggressive targets may not be easy to attain and junior miners may have little experience and even less capacity to implement such programmes.

Certainly among the larger mining companies there appears to be a clear awareness that actively promoting local skills, healthcare and employment is not just good for the host country, but also creates a virtuous circle of cost-effective local resource and local stakeholders supportive of foreign investment. This

may, in practice, also mitigate the risk of fiscal changes as the benefits of the investments are felt by the local community who will be loath to see them threatened.

Anticipating resource nationalism: strategies for investors

Contractual remedies

Implementing a mining project frequently requires massive up-front capital expenditure. The dilemma faced by investors entering into mining concessions is how to bind a sovereign entity (or its representative, such as a state mining company) to an agreed commercial bargain given that this contravenes the basic principle of public international law that States may not renounce their sovereign prerogatives, which include changing the law to meet the country's objectives and needs.

In essence, two approaches have been taken, sometimes separately, sometimes in combination – the stabilisation clause and the contract adaptation clause.

Stabilisation clause

The contract stabilisation approach seeks to preserve the sanctity of contract against the sovereign right to change the law by binding the sovereign entity to the existing terms of, for example, fiscal, employment, social or environmental law, thus preserving for the investor a 'frozen' set of rights and obligations vis-a-vis the State from the date of the concession for an agreed period of time.

Typically, the less investment a country has been able to attract, the longer the period of freezing and the more generous the terms, such as tax holidays, on offer. However, over time circumstances and the investment risk profile can change significantly. This might be the result of successful transition to democracy (e.g. Mongolia, Liberia) or might be due to significant new investment flows due to new investment "plays" being identified – such as deep water oil and gas off the west coast of Africa. In a climate of resource nationalism – often promoted as a populist policy in the context of "democratic" elections – and high commodity prices, the ability of mining companies to enforce stabilisation provisions has been limited.

Adaptation clause

The contract adaptation clause seeks to preserve some degree of balance between the parties in the light of changing circumstances, giving one or both parties a right to seek a contractual adjustment to accommodate changing circumstances. These circumstances may be limited to certain criteria (for example, commodity prices or specific mining costs) or may be completely undefined.

In some jurisdictions, economic equilibrium provisions may be implied into a contract (and this is a matter to be checked with local counsel when entering into a concession). However, an express adaptation clause seeks to create a contractual obligation on the State (e.g. to negotiate in good faith) to conduct negotiations over changes to a concession rather than seeking to unilaterally impose them. Because such a clause does not require a freezing of the surrounding legal framework, an adaptation clause is more in the nature of a private law arrangement between the parties.

Other contractual provisions

Aside from the specific provisions above, perhaps the key consideration when negotiating a mining concession is agreeing the governing law and jurisdiction clause. It is imperative for investors to analyse and understand the local law issues impacting a mining concession – for instance, does the host State law recognise the sanctity of contract, does it have investment laws offering protections of the kind that may be found in Bilateral Investment Treaties (see

below) and what are the procedures for enforcement?

Where compensation for expropriation is available in the host State as a matter of law, investors should understand as far as possible the circumstances in which compensation would be payable and how it is defined (e.g. whether it includes compensation for loss of profits).

It is advisable, where possible, for investors to include compensation provisions or other protections directly in the contract with the host State regardless of whether such protections are available as a matter of law.

Bilateral Investment Treaties (BITs)

The provisions mentioned above may be of assistance in the actual mining contract or concession with the host country. However, investors sometimes forget that they may also be able to protect their investment without requiring any new agreement from the host country by structuring their investment to take advantage of existing Bilateral Investment Treaties (BITs).

BITs are short agreements, often of no more than ten or so pages, entered into between two States. They provide for the mutual promotion and protection of investments made by investors of the two States. In order to achieve this, BITs prescribe certain minimum standards. The formulation of these standards varies from BIT to BIT, although there are some typical standards that tend to be included (see box below), and their meaning is undergoing a process of development in international case law.

Most importantly for investors, BITs allow an investor to bring international arbitration against the host State, which frees the investor from having to bring proceedings in the local courts. No separate arbitration agreement is required to be negotiated between the investor and the State, because the BIT is sufficient.

Where possible, investors should attempt to structure their investments through a company in a jurisdiction that has a BIT with the State where the investment is being made (being careful in each case to check that the relevant BIT has been ratified or enacted). This simple step can provide significant extra protection and comfort to investors, as they will have an independent procedure for seeking compensation from the host State in addition to any contractual protections they may have.

Typical BIT provisions:

- No unlawful expropriation - the host State must not expropriate investments of investors from the other contracting State unless it is done for a public purpose, is non-discriminatory, is in accordance with the due process of law, and prompt, adequate and effective compensation is paid.
- Fair and equitable treatment - the host State must not harm the investment by unreasonable or arbitrary conduct, or act in a way which is not transparent or contrary to the reasonable expectations of the investor.
- Full protection and security - the host State must physically protect the investment.
- Non-discrimination - the host State must not act in a way that discriminates against investments of investors of the other contracting State.
- National treatment - the host State must grant investors the same treatment that is given to its nationals.
- Most-favoured-nation treatment - the investor is entitled to treatment as favourable as that given to nationals of any third countries.
- Comply with obligations - some BITs require the host State to comply with all its obligations entered into in relation to the investment, which may include all its contractual obligations.

Political risk insurance (PRI)

Political risk insurance, which is written by a market comprising private insurers – including Lloyds of London as well as a number of major insurance companies – alongside export credit agencies and the World Bank's insurer MIGA, provides insurance against what has become a well defined set of specific political risks, including:

- expropriation – acts of a host Government which deprive the insured of ownership or control of property
- currency restrictions – the prevention of converting or transferring funds out of the relevant host State
- political violence, war and civil war
- contract frustration – or breach of contract (such as non-payment) by, or caused by, the host Government.

The cover provided by a political risk policy might be narrower than that provided by a BIT. However, as political risk insurance is a bilateral contract between insurer and insured, it provides more flexibility, giving the opportunity – obviously not present with a BIT – to negotiate and tailor the precise scope and terms of cover. Although, also unlike a BIT, insurance obviously comes at a price, in the form of a premium.

Indeed, the first issues to address when contemplating taking out political risk insurance will be availability and pricing. This will vary from country to country and project to project. It will depend on the market's perception of the risks involved – so, for example, rates for expropriation cover in Egypt have increased over recent months – as well its existing aggregate exposure to the region in question.

The market's capacity for cover in particular regions is finite and where there is capacity, the cover available for any particular project will be limited, to such a level as provides only partial cover for larger projects.

The next key issue to address will be making sure the policy covers the risks to which the insured is actually exposed.

As noted above, depending upon the nature and location of the investment in question, these may be more subtle and complicated than the out-and-out expropriation of property. There is clearly little point paying substantial premiums on a policy which protects against the confiscation of assets, if the risks to which the insured is really exposed are the risk of being penalised through discriminatory taxation or having a mining licence revoked.

The starting point will usually be a form of standard policy wording. That will need to be reviewed carefully – and tailored – so that it covers the risks to which the insured is realistically exposed.

The effect of a political risk policy is to transfer political risk from the insured to the insurer. Accordingly, it is not surprising that the insurer will include in its policy a range of terms directed at protecting its interests, by ensuring that it is:

- able to monitor the risk in question
- kept informed of all relevant developments
- given the opportunity to become involved in and direct any efforts to avoid or minimise a loss or effect recoveries.

The terms requiring the above will very often be expressed as exclusions, conditions precedent to cover or as warranties – such that any failure to comply will entitle the insurer to avoid the particular claim in question or to avoid any liability under the policy. It is therefore essential for an insured to familiarise itself with the policy terms, understand the obligations imposed upon the insured, and put appropriate procedures in place to ensure compliance with these terms.

Insurance can certainly play a valuable role in mitigating political risk but it is only going to do so if handled with care and treated as a bespoke product, rather than off-the-peg.

Export Credit and Multilateral Agencies

Political risk cover may also be available from export credit agencies or through the participation of multilateral agencies. This type of political risk cover includes both 'hard cover', to enable recovery of investment or the repayment of bank debt, and 'soft cover', through the participation of institutions that countries will be reluctant to offend.

What can be done when resource nationalism actually occurs or is threatened?

Commercial solutions

Investors in the natural resource sector are more aware than ever of the importance of local engagement. Where good relations have been fostered with host States, this can give investors – among other things – greater scope for negotiation of the terms of any new requirements affecting the investment. Investors may be able to pre-empt or contribute to changes. One recent example is the Oyu Tolgoi copper project in Mongolia, where investors successfully negotiated with the host government for it not to accelerate the timescale for increasing the State's stake in the mine.

In recent times, investors have had to become much more mindful of the

importance of good PR, and in the current climate it is more important than ever for investors to be able to communicate effectively to the local community about the contributions they are making and the benefits the investment is bringing to the host State.

Contractual or BIT claims

The first place to look when assessing the rights of an investor is, naturally, the relevant contract, and the importance of taking the best advice and ensuring that contracts are well drafted and negotiated cannot be underestimated.

Some contractual protections have been highlighted in this briefing and it should be emphasised again that, as well as including commercial protections to the extent possible, the choice of governing law and jurisdiction should be carefully considered.

The first step to take when considering a claim will be whether there has been a breach of contract (or of the BIT). Investors should also be aware of the procedural steps that need to be taken. With BIT claims, for instance, the claimant is required to submit a notice of arbitration and then there is a cooling off period – this means the process can be slow. There may then be a question as to whether more urgent action can be taken (e.g. obtaining an injunction or emergency powers).

Generally, an investor will ultimately want to retain its investment and thus have a continuing relationship with the relevant host State or counterparties, so the pursuit of any legal claim may need to be considered as part of a broader strategy.

Political risk insurance

If an investor has taken out political risk insurance, the one thing that they must do if there is any actual or threatened act of resource nationalism is talk to the insurer.

Any policy will impose an obligation on the insured to:

- notify the insurer
- exercise due diligence to minimise loss
- obtain the insurer's consent before agreeing on any loss.

Not keeping the insurer informed of what is happening is the most common source of disputes between insured and insurer, and can easily invalidate a claim.

Investors must also understand what the policy provides in terms of the procedure for a claim. A policy may provide that the insured is obliged to exhaust all its legal claims before it can seek an insurance pay-out. The insured may be obliged to prove expropriation (i.e. obtain judgement) before it can claim on the insurance. There may be a waiting period – typically around 180 days – before the policy will pay out. The precise terms will of course vary from policy to policy and may be negotiated up-front, so it is imperative for investors to understand the process before agreeing to the policy, not least so that they will be able to follow the correct procedure in the event of having a claim.

Investors should also be aware of the insurer's rights of subrogation. In the event that an insurer does pay out under a policy, the insurer will be entitled to step into the shoes of the insured and use its name to pursue compensation from the host Government, and the insured will have continuing obligations to assist with that process. So it is not necessarily a simple matter of making the claim, receiving payment and then forgetting about it.

Conclusion

No one approach to protecting one's investment against the potential effects of resource nationalism provides a perfect solution in all circumstances. As is to be expected, a combination of contractual provisions, informed deal structuring and active management of political risk will provide the best chance of minimising the risks of future resource nationalism, and should it arise, its impact.

Engaging early and regularly with the host countries and being able to demonstrate tangible benefits – such as healthcare and employment – to local communities is something that investors must increasingly focus on.

Ultimately, pre-empting resource nationalism through detailed discussion with relevant stakeholders, a willingness to make acceptable adjustments where the balance of benefits shifts unsustainably out of equilibrium and ensuring any changes of law are appropriate and certain may be the best course available. There are ways of protecting against resource nationalism but in the end prevention may be better than the available cures.

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