



# Managing Country Risk in an era of Resource Nationalism

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**“We will no longer waste time negotiating with people who refuse to see the transformation of our country . . . from now on we will only negotiate for six months and, if all fails, expropriation will take place.”**

The heightened risk of contract repudiation and expropriation of assets in emerging markets was brought into stark relief in August 2006 when Lulu Xingwana, the South African Minister for Agriculture and Land Affairs, made this declaration of policy. While specifically referring to the transfer of white-owned farms to black claimants under the Black Economic Empowerment programme, her statement embodies the increasing challenges confronting investors in emerging markets. That is to say a willingness to ignore both recently signed and historic agreements and rights thereon in favour of a drive to gain political and economic capital, often justified by casting blame for current woes on a foreign or domestic investor of particular colour or creed.

An increasing number of governments across Central Asia, South America, West, and East Africa and indeed in Russia have explicitly or implicitly adopted policies of Resource Nationalism that in many cases appear to specifically target the interests of western businesses operating in these regions.

## Contagion

In a process that exhibits signs of a contagious disease, the populist rhetoric of nationalism that contributed to the December 2006 re-election of President Hugo Chavez in Venezuela, has brought similar leaning governments to power in Bolivia and Ecuador. Soaring commodity prices have fuelled aggressive Resource Nationalism policies in a range of African and Central Asian states as energy-producing nations move to secure a greater share of the money and power from their resources, irrespective of the costs and risks of exploration carried by others typically in well documented and carefully negotiated agreements. Meanwhile in Russia, President Vladimir Putin is using the state controlled gas monopoly, Gazprom, as a device for restoring the country's declining glory and as a form of international leverage to moderate the policies of neighbouring Ukraine and Georgia and as an implicit threat against the west. The latest news concerning Shell and Sakhalin also exhibits a willingness of a foreign government to leverage their position irrespective of contractual agreements in the knowledge that there is a sense today that they can get away with it.



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The drivers for these actions are various and there does appear to be a genuine desire to right perceived past wrongs including unfair / unreasonable contracts formed by naive governments with exploitative foreign companies. However, whilst these and other social and environmental issues are often presented as reasons to justify contract repudiation, forced renegotiations and expropriation, the majority drivers today increasingly appear to be far more cynical - political capital and short term economic gain being high on the list.

Harsh government measures across emerging markets should not be considered without a critical eye being cast over government action in the western world. In December 2005, when confronted with a budget deficit, British Chancellor Gordon Brown effectively retrospectively increased the rate of tax for oil and gas producing companies in the North Sea to 50%. The new legislation was not portrayed as nationalisation or expropriation, but depending on how you look at it, at best it was a cash grab to compensate for failed revenue forecasting (and therefore reduced tax receipts) and at worst it was equivalent to expropriation of funds. The apparent impunity with which Brown made the announcement of his planned action, in the same speech to parliament in which he surreptitiously slipped in without explanation his new and reduced growth forecasts, and the muted response it received in the open and transparent Houses of Parliament is remarkable, particularly when contrasted to the sense of outrage associated with what have been essentially similar, if more brazen acts by Chavez and his peers. It also raises questions about where the nationalist 'contagion' began - did Brown replicate the policies of populist leaders or did Correa learn from him? The sentiment appears to be that prevailing economic conditions give governments the right to intervene and change the terms of existing contracts with investors.

Notwithstanding Brown's arbitrary tax increase, the rule of law clearly constrains the actions of governments in western democracies, and provides a means to pursue rights of recourse, thereby delivering a certain level of protection. Furthermore, OECD governments are typically signatories to multilateral trade and investment

agreements giving businesses confidence that they have recourse through the somewhat nebulous body of "International Law" and more specifically through Bilateral Investment Treaties, and forums such as ISCID. In contrast, judges generally do not dictate to developing world politicians, and while emerging world governments may be signatories to some trade and investment agreements, it is interesting to note how often these agreements fail to be ratified. The overall consequence of these issues is that whilst we should correctly be aware of the failures of developed nations (typically western) governments, investor recourse for government failures in emerging markets typically presents a far more fragile position.

The inherent risk in resources projects in emerging countries is personal, physical and financial. Often the first company into a particular sector in an emerging country is forced to operate in an environment with no legislative infrastructure and very limited legal protection. Having worked with the challenges of national and regional officials, and assuming exploration activity has revealed the presence of the expected resources, the prospector may be forced to renegotiate, sometimes through a new tender process, to secure the right to exploit them. Having won the right to exploit resources the prospecting company may yet find themselves involved in bearing the cost of drafting both the documents and the legislation to safeguard the project and develop the infrastructure that makes the project viable. During this process a project in an emerging market may be confronted with one or two changes of government, through peaceful or violent means, and the on going challenges of conducting business in a system where bribery and barter are part of the process. In addition, the project company will be subjected to the scrutiny of NGOs and vested interests in the host country. This may result in the investor being cast as the oppressive foreigner, and as such they may receive less support from their own home governments than they are reasonably entitled to, should they run in to local difficulties. The obstacles are daunting - however with effectively managed risk come tremendous rewards.



## Are there 'good' and 'bad' countries?

In contrast to popular perceptions of risk, the belief in 'good' versus 'bad' countries is something of an illusion. Trade flows to 'high risk' countries like Angola, Sudan and Yemen remain significant despite perceptions that they are 'dangerous' places to do business.

Development of natural resources in emerging markets provides substantial opportunities and through an effective analysis of risk at the onset, the number of threats can be significantly reduced. In this respect one of the most important lessons of recent years is that Investors need to be cognisant that they are in fact the creators of some of the risks that assail them and take steps to ameliorate these risks at the onset. For example, a project can create enmity between different ethnic groups in a given region depending upon where it sources its human and other resources from. This may result in, on the one hand, the positive impact of wealth generation and on the other, the unfair distribution of that wealth which in turn becomes a major source of discontent. This can be a difficult concept to accept - there is a prevailing victim mentality, which in significant part exists because of the kind of hardships a resources company may face over many years in developing a project. Astute investors appreciate that they are a participant in risk and can act from the beginning to address this issue, rather than crying foul as an innocent "victim" later.

Contrary to historic perceptions and homogenous concepts of country risk and indeed regional risks, political risk is not generic across a region or even within a country. Before investing in a country foreign investors must analyse the specific environment in the specific region of the country for their specific project and conduct relevant due diligence. This includes security on the ground, legacy issues, reputation risk, social impact, environmental impact and relations with the current and potentially future political decision-makers in the host country. Different projects in the same country will have differing risk exposures and proximity to risk. The adoption of a coherent risk strategy can neutralise potential sources of risk and reduce or at least identify more clearly those risks that cannot be eradicated.

The first step in effectively minimising country risk for a project is clearly to identify the different stakeholders and their respective interests. This somewhat obvious and apparently simple first step is often the point at which the analysis falls down; - the issue being that "stakeholders" are not limited to contractual counter party's and investors, but will probably extend to include the host government, local government, community groups or tribes, project sponsors, lenders, offtakers and NGOs etc. The reality is that in order to ensure that a project is developed and operated as smoothly as possible, project managers need to actively engage at the outset all stakeholders to maximise their knowledge and respective contributions and to reinforce their commitment to their stake in the success of the project. The point being that even if some of these "stakeholders" are opportunistic groups looking for some form of economic gain they can and do cause very significant problems if not engaged and effectively managed at an early stage.

## Redressing imbalances

Ensuring equitable reward sharing between project sponsors and the host government and other participants is vital. A major driver for Resource Nationalism, has been perceived inequality in the face of commodity price rises. One way to address this possibility is to link Government royalties to project profitability and commodity prices. Direct government equity participation in projects can also be a clear risk management tool and may be an alternative to the royalty structure . For example, it was recently reported that the Laos government had reached agreement with a foreign mining group to take a 10% equity stake in their gold and copper mine in exchange for the cancellation of all future royalty payments from the mine. An advantage of this approach is that the government revenue is now directly linked to the success of the project and the equity interest should ideally should encourage the government to maintain the relevant security, transportation and legal infrastructure necessary for the smooth operation of the concession.

Whilst the participation of the host government in the economic success of an emerging market project is critical, other stakeholders, particularly local communities and NGO's with interests in social and environmental impact, remain equally important. The good news is that an increasing number of NGOs are beginning to realise that espousing well meaning liberal policies is of no value to the local communities they are trying to defend, if they are unable to deliver tangible economic benefits. There has been a gradual transformation among NGOs and local authorities as they grasp the fundamentals of commerce and develop an appreciation of the benefits of working with the right foreign investor. When properly engaged, the local knowledge and expertise of NGOs may provide the tools to minimise future problems such as strikes, riots and civil commotion. For example, in developing the local infrastructure NGOs can advise on balancing the interests of competing tribes, employing equally from different ethnic groups, the building of schools and hospitals and local sensitivities to things such as historical and religious sites. A financial cost is associated with this approach but it is far less than the cost of remedial action later.

The participation of the World Bank and other applicable Multilaterals, for example the Asian Development Bank, as guarantor, lender or investor, can provide a very effective means to manage and minimise risk, although the benefits must be weighed against the cost of the time and process that can be involved. As a preferred sovereign creditor, the World Bank wields considerable influence in the event of contractual disputes and defaults with emerging governments. This influence also exists because of the World Bank's role as a key source of liquidity when a country is in turmoil.

Other public sector entities, notably ECAs, may serve as excellent and meaningful sources of political risk management (and mitigation) through their G to G relationships and typically strong adherence to social and environmental issues. Once again there are other considerations similar to those referred to for the World Bank, but this time associated with national political interests of ECAs, that need to be understood in the context of a given project in a specific territory.

## Political realities

Resource Nationalism is changing the traditional power structures between states and perceptions of states national interest. The desire to control natural resources is not just a function of revenue and populist politics - it is also a product of national and strategic interest. The imperative of influencing government's of energy rich countries has informed Washington's support for high-risk "colour revolutions" in Georgia, Ukraine, Uzbekistan, Belarus and Kyrgyzstan.

However, US influence is increasingly resented throughout Central Asia and is, paradoxically, encouraging these states to bury traditional animosities and to cooperate with Russia and China in developing their natural resources. While the world remains unipolar in the sense of the undisputed economic and military predominance of the US, other centres of economic power are emerging that challenge western pre-eminence in the field of resources investment. This is also rapidly changing the risk profile of many projects. Support from China, Russia and Iran are alternatives to US patronage and the terms of engagement are often less onerous than those insisted on by the west. Developing countries have choices that didn't exist before and these choices are affecting the balance of power in everything from politics to economic relations. This is the new reality that underpins the current trend towards Resource Nationalism.

In general it is reasonable to say that Chinese investors are comparatively easy for many autocratic emerging market governments to work with. Their concern for due diligence on sensitive issues such as the environment and land ownership rights appears to be less acute than that of western investors. Contractual agreements with Chinese investors are often perceived to be less onerous than those with western companies. In addition Chinese companies are also considered to be relatively immune from pressure to develop socially and environmentally friendly projects exerted by domestic activists and international NGO's, in light of the relatively low perception of reputation risk in China. There is also a view that Chinese companies can make themselves "easier" investors for emerging market governments because they know that if problems arise the Chinese authorities can and do exert more diplomatic clout to resolve issues than their western counterparts.



However, this does not imply that Chinese companies are always forces for good in developing countries, not least because the “positive” issues highlighted are associated only with government relationships and may ignore the all important other local stakeholders. So, whilst a Chinese investor may well have a lower risk profile associated with a project in an emerging market today than a western company would have, and indeed partnering with a Chinese investor could be a short term way for a western investor to help manage or reduce risk, this is unlikely to be the end of the story.

(It is worth noting that quite apart from the growth of Chinese investment, this summary does not capture the impact for western foreign investors of the generally increased levels of antagonism felt towards the western world across a wide range of both Islamic and non Islamic states following the impact of the “War on Terrorism”.)

China is gradually becoming more closely integrated into the world economy and will progressively become less pervious to the views of the UN and other international bodies and associated agreements (such as the equator principles). The relative ease for an emerging market government in dealing with a Chinese investor is producing short term gain, but in the longer term the very issues that make dealing with a Chinese investor easier today may result in increased problems in the future. Politics is cyclical. A failure to address the complex issues briefly outlined in this article, with all relevant stakeholders, is precisely the sort of failure that upon a change of government, or complaint from a local group, can result in forced renegotiations, threats of expropriation and the possibility of localised civil disorder, strikes and political violence. Western companies have been here before and a failure to learn their lessons is perilous indeed. It is worth noting that similar concerns also exist for those mining projects that are being funded with few strings attached by hedge funds. Due diligence requirements of hedge funds are typically far less onerous than those imposed by banks, which lessens the external imperative to manage projects 'by the book'.

## Every risk is an opportunity

The demand for national resources is increasing as the developed world consumes greater quantities of energy and industrialisation accelerates in the great population centres of China and India. If all nations consumed at the same level of the US estimates suggest that we would need seven planets to sustain us, and demand is unlikely to fall in the near term. To exacerbate the current demand, investors in the resources sector and particularly mining are still playing a game of catch up. Little investment was made in the sector during the 1990s, which has allowed demand to exceed supply to such a degree - especially in light of the time line from exploration to operation - that investment spend is still belatedly coming on line.

In this context the need to invest in remote locations in emerging markets is only going to grow, - especially as you consider the other investment (power, transport etc) that resources projects require, and the further investment that the wealth generated by natural resources produces. Whilst political / country risk losses are not frequent, when they do manifest they can be catastrophic. Thus emerging market resource investment necessarily present significant perils and the key question is how to manage such investment without creating localised instability, or falling victim to adverse government actions, in an era of Resource Nationalism and associated heightened threat. We have outlined here that there are indeed ways to manage elements of political or country risk, though “management” of such risks will never translate to elimination.

For those risks that cannot be eliminated Political Risk Insurance (PRI) may provide an effective safety net. However, in order to be effective, PRI should be structured with professional advice at an early stage and linked in to all aspects of the project development and project agreements. This is important for several reasons, not least because for many resources projects the “asset” being insured is tied up in the right to explore for, and receive a share of the revenue derived from, natural resources, and not an actual ownership interest in those resources. It is accordingly critical to understand that PRI will not compensate for deficient

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contracts, poor development processes or lack of political risk management. On the contrary, well structured project agreements and suitable engagement with local stakeholders will enhance country risk and help ensure that PRI is effective. Indeed there is an argument to say that investors and lenders should consider their political risk exposure per se as an "asset" to be enhanced by effective management, such that

maximum value can be extracted from it. This philosophical approach to selling risk, as opposed to buying insurance, can and does result in a better managed risk, which can be sold to a PRI underwriter more competitively. In turn this should improve yield on the investment (i.e. by reducing the "cost of risk") and provide the benefits of longer term security.

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