THE
NATIONAL LAW REVIEW

International Pipeline Projects – Key Considerations for East Africa

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Article By
Martin Stewart-Smith
Paul Jones
Bracewell LLP
Energy Legal Blog

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Saturday, November 1, 2014

The majority of landlocked ***Uganda's estimated 6.5 billion barrels of crude oil r***eserves are destined to be pumped to the East African coast for export (potentially linking up with supplies from Kenya, South Sudan and Ethiopia along the way). While preferred export routes continue to be debated, it is likely that multiple pipelines stretching across the East Africa region will be developed in the near future. The development of such infrastructure will be heavily dependent on project finance. In this article, we consider some key issues affecting international pipeline projects that sponsors and host governments in the East Africa region will encounter.

Contractual framework

The traditional contractual framework for an international pipeline project involves a common pipeline SPV that owns and operates the pipeline facilities, markets the pipeline's capacity, transports hydrocarbons in return for a commercial tariff and acts as borrower of limited recourse debt. To the extent national laws dictate that a portion of the pipeline must be owned by a domestic company, sponsors typically establish a special purpose company to own such pipeline facilities but transfer the marketing capacity to the SPV project borrower.

The national and international legal and regulatory framework is a critical piece of the pipeline bankability analysis and both ***Intergovernmental Agreements (IGAs)*** and ***Host Government Agreements (HGAs)*** will play a key role.

Sponsors need to pay careful attention from a bankability perspective to the proposed content of any IGA or HGA. For example, any constraint imposed on a state's right to change laws relating to environmental, labour, health and/or safety standards during the life of the project will conflict with the policies of the IFC and other ***development finance institutions (DFIs).*** There may also be obligations imposed on states which affect the human rights and social welfare of citizens, such as land acquisition to secure the pipeline corridor. Any such act would need to be done in accordance with World Bank standards, with issues around population re-settlement being a particularly sensitive issue.

Early-stage understanding of environmental and social compliance threshholds

As the participation of DFIs and e***xport credit agencies (ECAs)*** in international pipeline projects grows, so too does the level of analysis and consultation regarding environmental, economic and social issues. Any project financing facility involving the above contains strict covenants regarding environmental and social compliance. In the context of pipeline projects, one of the most difficult issues relates to the process of population re-settlement along the pipeline corridor. It is vital that at the outset, any population re-settlement is done in strict compliance with World Bank requirements so that down the line, when the project is being subject to due diligence by DFIs and lenders, no major issues arise as regards environmental and social compliance. Any failure to conduct the early-stage development in full compliance with World Bank Guidelines could set the development phase of the project back by well over a year.

Using pipeline revenues to support local economic and social development

It is well documented that the World Bank's direct loan to the government of Chad to fund its equity stake in the Chad-Cameroon pipeline has been repaid. One of the key conditions of that loan, which subsequently became the bone of contention, was Chad's commitment that revenues from the pipeline would go towards redeveloping the social infrastructure for the poorest members of society. This linked into the Chad government's revenue law. The IFC had safeguards written into the project financing documents ensuring that 80% of the total revenues were to be spent on the above – mentioned developments, with 10% held in trust offshore by an escrow bank and 5% spent directly on local communities in Chad. As well as the World Bank loan to the Government of Chad for its equity investment in the pipeline, debt and political risk cover was provided by IFC (using an A/B loan structure), US Exim and Coface. The B loan portion was massively over-subscribed. The Government of Chad subsequently reneged on its obligations by changing its law and diverting oil revenues away from its people and into other programmes, particularly defence expenditure. This Chad-Cameroon

pipeline represents the more extreme end of DFI intervention which was partially due to the economic state of Chad and partly a function of this project being the first major project financing in Africa. Nonetheless, it does show that there is precedent for DFI intervention at this level and it will be important to understand early on in discussions with DFIs the extent of any requirement for a participating government to support economic and social development within its territory.

Commercial and political risk mitigation

(i) International Development Association (IDA)

Very few IDA guarantees have been issued globally to date, but there is an increasing trend towards this particular instrument. The IDA political risk guarantee would potentially cover commercial banks lending to the pipeline project company for up to 100% of debt service defaults caused by: government non-performance, political risk, foreign currency convertibility and transferability risk, asset expropriation and changes in law.

(ii) MIGA

MIGA is the political risk insurance arm of the World Bank Group. One of the key aspects of World Bank Group operations generally, and which equally applies for MIGA, is that there must be some tangible positive development outcomes from the investment projects in which they lend to, guarantee or insure. Accordingly, all investment guarantees initiated after 1st October 2013 are to comply with a broad and comprehensive set of environmental and social performance standards.[1] These standards are over and above the basic requirement of compliance with all applicable laws and regulations. Another related set of guidelines which will need to be met are those of the World Bank Group regarding Environmental, Health and Safety (EHS)[2].

Once the due diligence process is completed, MIGA will then classify an investment project based on the level of likely social or environmental impact. The categorization given will affect directly the length of time required for public disclosure. What is disclosed is a summary of the proposed guarantees which will describe the project, its location and purposes as well as information about the investors. Sponsors should expect NGO comment and feedback at this stage which can trigger delays.

(a) Breach of Contract coverage

Breach of Contract (BOC) coverage is a relatively new element and is intended to cover both breach and repudiation of contract by the government or its state owned entity (SOE). This invariably involves triggering the dispute resolution provisions in the relevant contract (such as ICSID arbitration) and MIGA will pay out once there is a final award under those provisions. Although reference is made by MIGA to discretionary payment in advance of award, since this product is an insurance arrangement (unlike the IDA partial risk or partial credit guarantee), sponsors should work on the assumption that MIGA would not pay out a claim until final award since it will wish to exercise its rights of subrogation against the Government or

SOE after award.

(b) Expropriation coverage

MIGA coverage here is triggered on assignment or transfer to MIGA of the investor's interests in the expropriated investment to MIGA (again, so as to allow MIGA to exercise its rights of subrogation against the Government or SOE counterparty). The payout is on the net book value of the insured investment – and this is in practice an area of controversy, particularly where there is partial or creeping expropriation and there is a wide difference in view between the Government or its SOE and the investors as to the impact on the net book value of the investment as a whole.

Lessons from Nord Stream and BTC

The Nord Stream and Baku-Tbilisi-Ceyhan (BTC) pipeline projects demonstrate that for an international pipeline project to be bankable it requires:

- sound project fundamentals, including viable upstream and downstream markets;
- a structurally secure framework of interlocking commercial contracts that allocate project risks in a commercially acceptable manner;
- a stable legal regime which enforces contracts;
- transportation contracts with ship-or-pay obligations that produce a balanced revenue stream for the borrower and insulate lenders from market or volume risk;
- shippers or suppliers with verified proven reserves that are either in production or supported by a robust capital development plan to deliver first oil to creditworthy downstream buyers consistent with the pipeline's construction schedule; and
- uniform treatment of issues such as force majeure across the entire value chain in all long term contracts so as not to unduly burden the pipeline project borrower.

East Africa-specific issues

Legal risks particularly relevant in the East Africa region include the following:

1. National legal and regulatory issues and changes

Legal uncertainties resulting from changing frameworks and the development of new legislation and institutions to manage recent discoveries will need to be clarified. In particular, any new regulations relating to the following in each of the relevant states will be pertinent to the project:

- the transportation, storage and distribution of petroleum;
- petroleum refining and interaction with associated infrastructure;
- third party access to infrastructure;
- fiscal regimes and tariffs;
- domestic supply obligations and restrictions on export;
- state participation in key petroleum infrastructure including its role in owning and operating such infrastructure;
- access to and use of land and marine areas (including the use of ports and jetties);
- licensing processes affecting relevant activities; and
- local content requirements;

In Uganda, the National Oil and Gas Policy, 2008 and Petroleum (Refining, Conversion, Transmission and Midstream Storage) Act, 2013 are relevant instruments while the formation of a new National Oil Company which will have a role in upstream, midstream and downstream ventures will also affect the dynamics of any project.

2. Regional regulatory issues and changes

In addition to the development of domestic laws and policy considered above, the East African Community is also looking to increase its role in the sector and implement regional policies and master plans for energy use and supply which could have long term effects. Regional politics and the interaction of a proposed project with other sources of petroleum and existing and proposed transportation and distribution networks will need to be considered carefully.

3. Management of environmental and social issues

Projects in the region have frequently been delayed or disrupted following issues relating to the management of land rights; resettlement issues and the environmental and social impact of the project.

4. Tax risks

Recent cases across East Africa (including in Uganda itself) have demonstrated the tax risks and uncertain tax treatment that needs to be assessed in respect of major projects.

5. Political considerations

Major projects in the region are regularly subject to delay often as a result of the slow movement of state processes including in the management of negotiations and in the making of decisions or implementation of regulations required to give effect to projects.

[1] link to http://www.miga.org/documents/Policy_Environmental_Social_Sustainability.pdf

[2] link to www.ifc.org/ehsguidelines