Eric Rasmussen

THE EBRD AS A PROBLEM-SOLVING PARTNERSHIP FOR RESPONSIBLE NATURAL RESOURCE INVESTORS

Through its practical involvement in the natural resources sector, the EBRD implements its institutional mandate of promoting sustainable investments and dispersing best practices of resource development.

The long-term rationale for investing in oil, gas and mining remains strong. Natural resources will remain at the core of the world's industrial production and supply chains feeding demand buoyed by growth in populations, incomes and urbanisation. Natural resources also significantly contribute to economic growth and social development in a number of the EBRD's countries of operations, with local communities often benefiting significantly from oil, gas and mining activities. The potential benefits of resource dependence are however contingent on whether the natural resources and associated revenues are developed and managed responsibly over time. Past experience shows that the extraction of mineral resources may have negative economic, environmental and social consequences, and can result in increased macroeconomic volatility, reduced incentives to invest in physical and human capital, and weaken institutions and governance. The resource-rich countries are often plagued by inequality, corruption and strong vested interests.

Environmental, health, safety and social standards are currently being applied to varying degrees in the EBRD region. Through its practical involvement in the natural resources sector, the EBRD implements its institutional mandate of promoting sustainable investments and dispersing best practices of resource development. The Bank is also involved at the macro level and pursues a policy dialogue in the countries that either lack sufficient legislation or do not have proper procedures to enforce it. The institutional policy dialogue focuses on improving environmental and social standards, governance and transparency principles, stakeholder engagement, as well as enhancing energy security and reducing the carbon footprint by pursuing energy efficiency (for example, by reducing gas-flaring) and switching to cleaner fuels.

Natural resources are commonly associated with anything that is extracted or collected in raw form. Natural resources in the context of this article mean oil, gas and metals mining. The EBRD has invested about €7 billion (90 per cent disbursed) in 165 oil, gas and metals mining operations to date. The current operating portfolio assets stand at about €2 billion, of which about 10 per cent is invested in equities.

AUTHOR

ERIC RASMUSSEN
DIRECTOR,
NATURAL RESOURCES
EBRD
Email: RasmussE@ebrd.com

The EBRD also works alongside responsible investors, who apply good corporate governance and best practices to their operations which are summarised in environmental, social, health and safety action plans (ESAPs) and are disclosed to affected stakeholders. The Bank also supports constructive institutional relations and good economic management. In particular, the EBRD assisted several countries in creating frameworks for the implementation of the Extractive Industries Transparency Initiative (EITI) that has become the global standard for transparency and reporting in the extractive industries. The Bank also insists on high levels of public disclosure of fiscal payments from the projects it finances (the so-called "Publish-What-You-Pay" principle).

The EBRD is mindful that investors in the natural resources sector face significant challenges. Already the capital intensity, cyclicality and climate change pressures in the industry demand strong balance sheets and organisational capacity for long-term survival. Moreover, natural resources investors have a substantial share of their portfolio of extractive and supply chain assets in remote places and emerging markets. Emerging markets, of which many are located in the EBRD region, however also increase the risk exposure to, among many other factors, weak legal and institutional frameworks.

Discussion on how investors handle the risks of weak legal and institutional frameworks is the focus in this brief article. The question is at the core of the ongoing tension between investors' needs for objective, neutral and fair rule-based institutions on the one hand, and vested interests of the host countries on the other. Even where the rule of law has triumphed after centuries of familial favoritism by clan leaders, some degree of threat often lingers that elected leaders may seize an

EXAMPLE OF EBRD LEGAL TRANSITION WORK WITH AN EITI FOCUS

The revised EITI standards were launched in May 2013 and Mongolia, together with Kazakhstan and Albania, were among the first countries to produce an annual report on the basis of the new EITI standards. The new standards require, among other things, regional- and project-level separation of revenues, which require considerable administrative implementation capacity at regional administrations. EITI representatives plan to validate Mongolia's compliance with the EITI standards in 2016. In response the EBRD is offering technical assistance to the Mongolian mining sector with the aim of publicising the EITI to local communities. Technical cooperation will specifically support mining- and transparency-focused civil society organisations (CSOs). Such CSOs play a critical role in spreading awareness among local communities of EITI and mining activities. The need to assist CSOs is recognised in the 2014 EITI Annual Report for Mongolia, which recommends more effort and funds for organising trainings for civil society organisations, for training of companies' accountants and to generally promote EITI within local communities in a more understandable way.

opportunity to reverse the democratic transition. Furthermore, the economic and financial downturn with its pressure on budget revenues often triggers debates about re-nationalising key natural resources or increasing tax collection. The question for the natural resource investor in places with weak institutional and legal frameworks is therefore to which degree the host country (or region) is "ruled by law" where the legal system creates a level playing field for everyone except the host country's leadership – and what can be done to ensure that the rules for an investment will be guided by the "rule of law" so the host leadership will have a strong incentive not to exempt themselves from the rules governing everyone else – including the natural resources investors.

In jurisdictions with weak legal and institutional frameworks the natural resources investor can face a variety of interference disrupting the rights and ability to control and operate assets in the supply chain. The key threat is actions of state institutions (for example, regional administrations, federal ministries, agencies and state-owned enterprises). Interference often concerns the access to public infrastructure and services. The severity can range from a local official's inability to handle a required technical certification to unlawfully revoked permits and attempted extortion. The list of incidents "goes on and on" as risk insurers say.

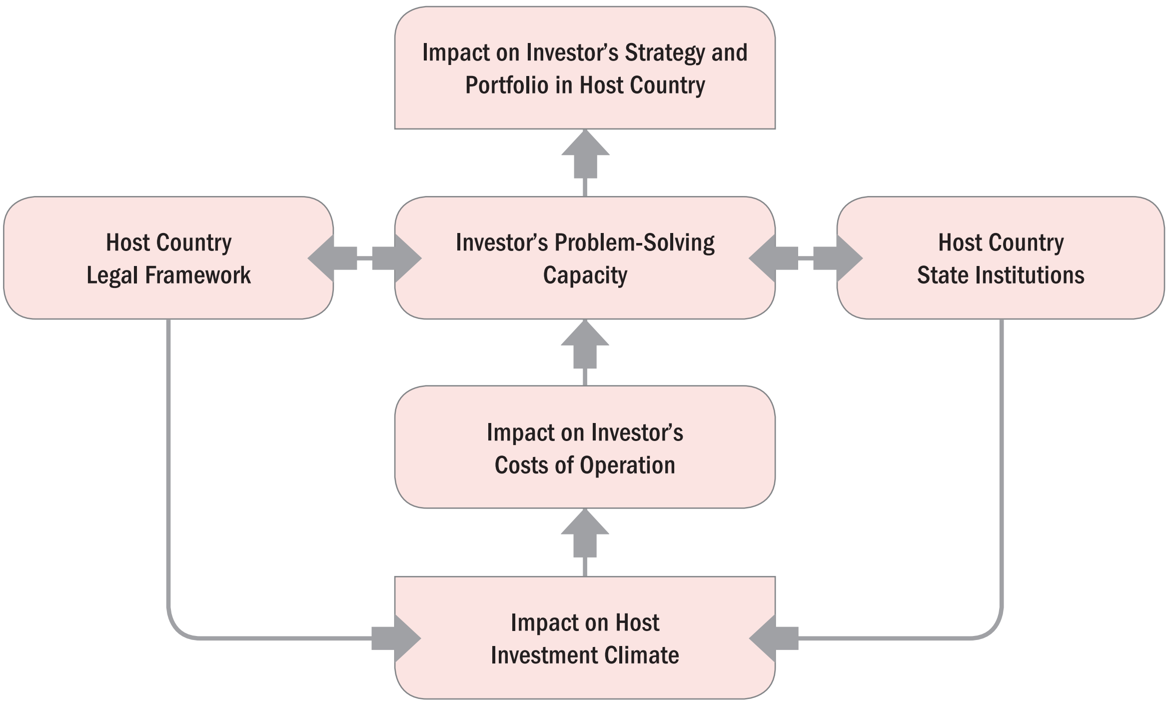
In order to mitigate interference investors seek to protect themselves through extensive project documentation and increased capacity and efforts to solve problems. The *responsible and law-abiding* natural resources investor's problem-solving capacity is mainly a function of available resources and leverage.

(i) *The resources* will include skilled manpower, management information systems, contingency budget, external supportive stakeholders and nurturing local relationships.

(ii) *The negotiation leverage*, which mainly stems from the value of the host government take (for example, economic benefit) from the asset and to what degree the investor is a fair, transparent and resilient counterparty, who ultimately has the strength to suspend local operations. An investor's negotiation leverage can be very high, when the investment asset is critical for the host country's reputation, budget income or energy security.

The investor's problem-solving capacity is a critical success factor for operations in places with difficult investment climates. Complex project documentation requires continued monitoring and maintenance, which in itself demands a minimum level of problem-solving capacity from financial controllers, lawyers and compliance officers. However many more resources must be mobilised, when a legal and institutional framework deteriorates and becomes a deterrent to the investment process. As state interference increases, the investor's required problem-solving capacity will need more resources until the costs undermine the return on investment and trigger the investor to reassess the strategy in the host country. The issue may be exacerbated if the investor relies on capital markets to provide a substantial part of the funding. The deterioration in the host country business climate or allegations of wrongdoing may weigh heavily on the investor's share price and hence reduce the ability to attract funding. The outcome could be suspended operations or selling all or part of the investment to adjust the asset portfolio, as illustrated in Chart 1.

CHART 1 INVESTOR'S PROBLEM-SOLVING CAPACITY



Problem-solving capacity is a critical success factor for a responsible investor, who bets on a long-term investment of strategic importance in investment climates rooted in an autocracy. The investor would typically face high political risk and ambiguity relative to the pace and direction of the leadership, legal and institutional transition. The investor would therefore need to design an investment structure, which would have very strong and lawful incentives for the local leadership to remain a supportive counterparty and continue to embrace an agreed government take as well as the standards and processes encompassed in the ESAP and EITI. As political risks are high, the investor would typically aim to share risks on the investment and insure risks to the extent feasible. This is where the EBRD may assist the investor's project company by diversifying its funding sources, providing financing for the tenor that matches asset life and therefore supports building a stronger balance sheet with a leverage fit for purpose. Having a Resident Office and investment portfolio in the host country (or region), the EBRD is well positioned to assist the investor in dialogue with the local government and, if needed, provide technical assistance to help the country adopt the EITI and best-practice standards for environmental, health, safety, social and stakeholder engagement. Autocracy-rooted government institutions usually have limited capacity in implementing clear, objective and predictable regulation as the basis for attracting investors, who are committed to good corporate governance, EITI, best-practice ESAP and reliable enforcement.

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TABLE 1 SIMPLIFIED ILLUSTRATIVE EXAMPLES OF INVESTMENT SITUATIONS AND SOME POSSIBLE EBRD SUPPORT

Host leadership's general attitude to regulation	**Rule of law**	AUTOCRACY	SEMI-DEMOCRACY
		• A significant part of the natural resources business is serving patriarchy clans, who often inherit seats in government and institutions. • Elections are weak and at times only ceremonial. State institutions are entangled with the business interests of clans. Institutions interfere and tend to subvert NGOs. • A reactive dialogue with investors is anchored by inexperienced and uninterested officials. • A ***key deterrent*** in the investment climate is the high political and counterparty integrity risks. Leadership succession may cause a flare-up in clan feuds, violence and asset seizure.	• The natural resources business is micromanaged by an elected government from a dominant political party. Local and international NGOs are tolerated if they project political neutrality. • The government effectively reaches out to investors on behalf of its remote natural resources regions, which lack significant investment. • Infrastructure and service markets exist but suffer limited capacity due to the lack of investment. • A ***key deterrent*** in the investment climate is the risk of state institutions interfering to force fatal renegotiation of deals seen to be too attractive.
		The EBRD may share risks, help design an ESAP, support policy dialogue and be part of an early warning network on integrity and state actions.	*The EBRD* may share risks, mobilise capital, support SMEs, help design the ESAP and act as a "burglar alarm" and broker in case of state interference.
	Rule by law	ADHOCRACY	DEMOCRACY
		• The government, freely elected, pursues bold industrial reform to develop a significant potential in natural resources. • Resource licence tenders and investment incentives are transparent. • The government's dialogue with investors is often "tit for tat" deal-making. Investors face pressure to develop local content and make non-core business promises, which can enhance the government's image. • A ***key deterrent*** in the investment climate is the risk of a xenophobic backlash, if the economic transformation fails to meet expectations. Investors could face instructions to maintain high employment and pay more taxes in a downturn.	• The government is a coalition of moderate politicians aiming to improve citizens' living standards in regions with natural resources and to boost the tax revenues from natural resources. • The policy dialogue with investors is well advised and systemic in adopting best practice. • Entrepreneurship in the service markets and public-private partnerships (PPPs) are encouraged to enhance capacity and efficiency. • Resource licence tenders and investment incentives are transparent. Arbitration and enforcement is proven and respected. • A ***key deterrent*** in the investment climate is the intensifying competition and increasing asset acquisition prices and the government take. Very high fixed costs will impair assets in a downturn.
		The EBRD may share risks, mobilise capital, help design the ESAP, support policy dialogue, invest in SMEs and help assess political changes.	*The EBRD* may mobilise equity capital, help design the ESAP, support local partners and infrastructure.
		Lower	**Higher**
		Host government institutions' capacity to Implement (that is, design, supervise and enforce) **legislation**, which support best practice ESAP and EITI standards	

In investment climates rooted in democracy the investors will often operate several parallel and complex joint venture structures with the aim to leverage partnership alliances to expand and diversify their global asset portfolios. The EBRD would often be one of the few financiers available to provide long-term limited-recourse project finance with equity, mezzanine finance and/or syndicated debt. At the same time the EBRD may complement the investor's problem-solving capacity by its country presence, expertise and outreach to local companies. A local presence enables the EBRD to support the development of transport, energy, water infrastructure and waste management and other value-added facilities and services, which are key to the development of projects. Moreover, in those countries which are significant energy producers, the EBRD will also help diversify the local economies by attracting investors to other sectors.

For the sake of illustration only Table 1 shows various simplified highlights of investment situations and the possible EBRD support to responsible investors' problem-solving capacities.

In conclusion, the EBRD has gained the trust of its partners and is recognised for its experience and pragmatic attitude in helping natural resources investors to coordinate and resolve a variety of issues associated with a project's diverse and multiple stakeholders (that is, equity partners, banks, suppliers, competitors, unions, NGOs, courts, media, and so on) as well as devise the means to shape the behaviour of host countries' leadership and government institutions. The EBRD is therefore well positioned to offer a problem-solving partnership for responsible investors operating in the EBRD region.