Managing sovereign risk in long-term capital intensive projects

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What is sovereign risk?

"The risk that a country might …expropriate and nationalise privately-held assets,…..or that the business environment might change as a consequence of government intervention, as in change to taxes, regulations, etc."

Source: Macquarie Dictionary

Infrastructure Partnerships Australia and Perpetual 2017 study - more than 35% of responding major investors identified either sovereign risk or taxation as a significant challenge.

The risk premium arising from possible future regulatory and tax changes is one contributor to the decision on whether a proposed project is economically viable

Australia cannot assume that having a lower sovereign risk premium than other resource-rich countries is enough – projects in countries with higher premiums may have much better economics in other respects

Examples of recent tax / regulation issues

Examples:	
1 July 2014	• reduction in thin capitalisation safe harbour • change in allowable debt:equity ratio to 3:2
30 November 2016	• announcement of review of PRRT • final report released in April 2017 • recommendations relating to future and existing projects • Treasury was due to report back to Government on 30 September
19 April 2017	• announcement of future changes to senior executive visas • 2 years for CEOs, increased English language skills for all • subsequently revised to maintain status quo
September 2017	• Government considering gas export restrictions • challenges producers and distributors to “fix the problem”
17 October 2017	• announcement of National Energy Guarantee • minimum requirements for dispatch and emissions

What are the possible solutions?

Six principles to underpin an enhanced tax certainty (ETC) model:

A stable system promotes growth

Extractive industries are different from the rest – subject to both general and specific taxes, huge upfront sunk costs, prices for their output are set globally

Governments can, and do make long-term commitments, but no government can legally bind a future one

Adverse changes of law reduce the return on current investment, and change the prospects of future investment

A risk premium caused by a change of tax law impacts each individual project's comparative economics. It is not an abstract number to be compared with that of other countries

Federal and state/territory cooperation as joint holders of an interest in Australia's future would be optimal. But ETC at any level is worth pursuing in its own right

A suggested ETC framework

ETC to:

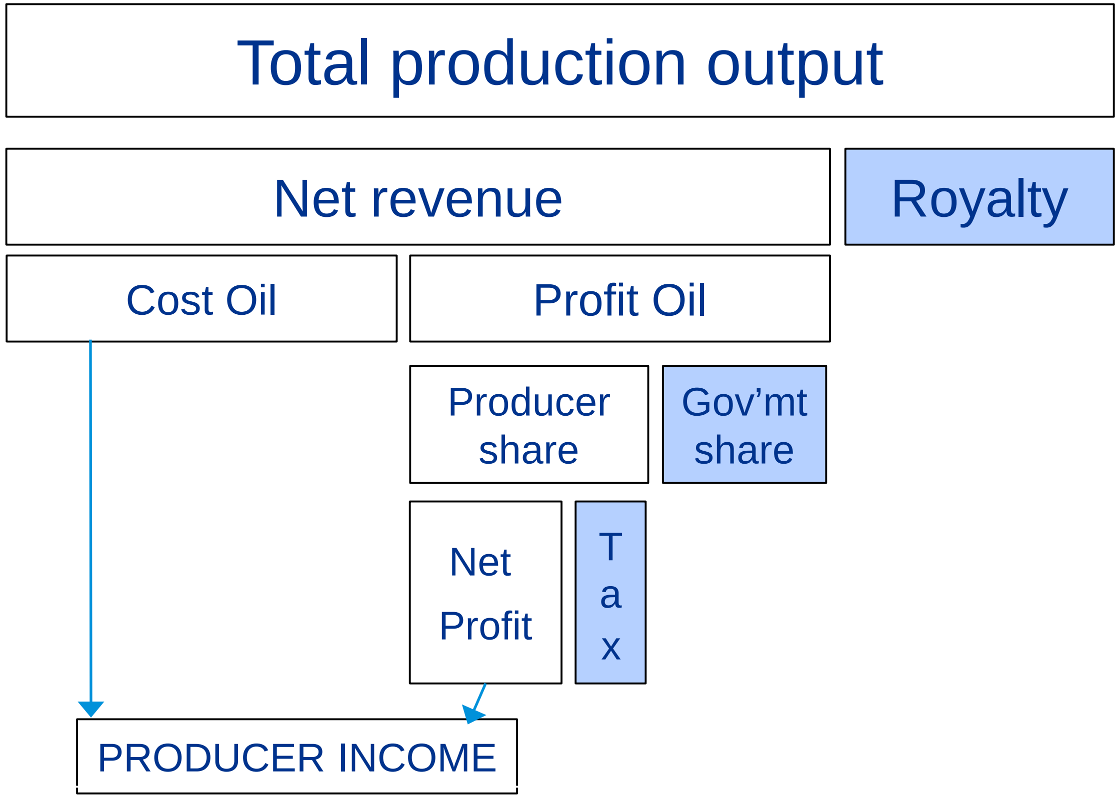
- **apply on a “total cost” basis to Federal and State/territory taxes:**
  - restricted to features that materially impact return on sunk costs
  - including thin capitalisation, capital allowances and royalties
  - excluding, for example, payroll taxes on operating labour
- **cover only the first 20 years from project commencement:**
  - compliance cost for “whole of project life” too great
  - cash flows after year 20 heavily discounted in investment models
- **benefit projects that have a minimum sunk cost investment of $400m**
  - restrictions to certain project types could also be considered
- **cease to apply where taxpayer triggers an anti-avoidance provision**

Alternative approaches we have seen

Production sharing agreements

- government takes a share of the production output in return for granting a project-specific tax regime

Example structure:



Variations used in Africa, Indonesia, Russia, Timor Leste

Managing "sovereign risk"

Actions:
Review investment models and ensure that they incorporate reasonable contingencies for future tax changes
Carry out sensitivity analysis to identify the impact of a particular tax change going beyond the contingency
Ensure that executive and media relations teams are aware of those tax issues which are of greatest importance to the economics of current and future projects
Seek private binding rulings on significant items for which the tax treatment is not clear-cut. Get involved in the consultation process when major tax reform is being considered.

Thank you

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