Sovereign Risk: Commentary

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Mr Turner is to be commended for the very extensive research supporting his most interesting paper. As he says, the term "sovereign risk" now is heard very frequently, particularly in the context of resources operations or projected resources operations. However, a search of dictionaries and other references is generally fruitless, with the notable exception of the Industry Commission Report referred to by Mr Turner.[1]

In the *1991 AMPLA Yearbook* there is a substantial paper, entitled "Coping with Political Risk" by David Frecker (and a commentary by John Williamson), wherein the terms "political risk", "sovereign risk" and "country risk" were used somewhat interchangeably. Indeed, the page heading for the papers is "Sovereign/Political Risk". However, the thrust of those articles follows the introduction by Mr Frecker:

> "Although political risk is a factor in Australia, and can have its own particular twists in the context of Aboriginal land rights issues, this paper will concentrate on the risks for an Australian or other foreign investor in a developing country which is a host state for foreign investment."[2]

He went on to say that expropriation "is what is most appropriately called 'sovereign risk' ".[3]

The other risks, he defined as:

- currency exchange restrictions;
- war and civil disturbance;
- repudiation or breach of contract by the host government;
- refusal of the government to grant or renew titles;
- interference with the foreign investor's ability to export production;
- other government action which frustrates performance, such as refusal to grant or renew ancillary permits, consents and licences;
- non-expropriatory adverse changes in the host country's fiscal or regulatory regime; and

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1. Industry Commission, *Mining and Minerals Processing in Australia* (1991) (hereafter "Industry Commission Report").
2. [1991] *AMPLA Yearbook* 507.
3. Ibid.

- unfair, arbitrary or wrongful administrative action.[4]

Mr Williamson's commentary begins:

> "Political risk remains a significant factor in the investment decision-making process where an investment in a developing country is being considered . . . In most cases it will not be possible completely to avoid or eliminate these risks; but action can be taken in a number of ways to reduce them. I wish to address some of the issues from the point of view of an Australian investor investing overseas. Obviously political risk exists domestically."[5]

He then offered a definition of "political risk" (or "sovereign risk" or "country risk") as taking four principal forms: expropriation, exchange control restrictions, war or civil unrest and contract repudiation. He added other risks, including the non-recognition of the host government as the legitimate government, risk of sovereign insolvency, risk of liquidation or reorganisation and risk of sovereign immunity.

He stated that a further risk could arise where a host government took equity in a project, whether directly or indirectly, exposing the investor on two fronts: the host government as regulator and the host government as co-owner.[6]

Mr Turner, by contrast, focuses on forms of sovereign risk which can strike an Australian investor in an Australian project. His suggested definition is most helpful—although, perhaps, it does not necessarily have to be restricted (as he does) to resource or infrastructure projects. In addition, sovereign risk also will be a risk for a lender, although possibly the expression "participant" may encompass that category of potentially affected persons.

Another question in relation to the definition is whether para (d) is quite wide enough to encompass some of the Commonwealth/State clashes which have arisen in Australia and no doubt will continue to do so.

Australia's constitutional and political system and the allocation of powers between Commonwealth and State governments (and conflicts about that allocation) is an especially fertile field in which all manner of difficulties can flourish. These tensions can become particularly acute in times where the governments of the Commonwealth and of a particular State are of a different political or ideological persuasion. However, of course, a federal structure is not unique to Australia.

In considering some of the specific examples in Australia where projects have been impeded, or totally stopped, by sovereign risk, the conflict between State and Commonwealth laws is usually found.

The concept of sovereign risk or political risk had come into consideration originally in the context of some third world countries, such as those prone to sudden changes of government—normally without the necessity of the intervention of the ballot box. Resource

4. Ibid at 508-509.
5. Ibid at 536.
6. Ibid at 536-537.

companies operating in those environments tried to plan appropriately and assessed the commencement or continuation of a project accordingly.

It, therefore, became something of a novelty for this factor to be included when assessing projects in Australia.

In common parlance, sovereign risk can be seen as the umpire changing the rules after the game has commenced or the moving of the goal posts after the start of the game—indeed, sometimes, after the full forward has let fly with what would otherwise have been the winning kick.

The real vice is the lack of certainty engendered by an element of sovereign risk. Uncertainty will make an investment far less attractive and almost certainly more costly.[7]

A simplified definition of "sovereign risk" is set out in the glossary in Vol 1 of the Industry Commission Report:

> "The risk undertaken by developers that governments will subsequently change 'policy' from that which applied when investment decisions were first made."[8]

The Report also stated:

> "Sovereign risk (the term used to refer to governments changing the rules mid-project, thus eroding the value of private property rights) is a grave problem facing the mining industry in Australia. Sovereign risk represents a serious impediment to the efficient development of mining and mineral processing industries in this country, and one which diminishes the value of the mineral estate owned collectively by all Australians."[9]

Several Australian examples of projects affected by sovereign risk are mentioned by Mr Turner and comments follow on two particularly clear instances. It is also interesting that almost all of the Australian situations appear to involve the fiery cocktail of Commonwealth/State powers with the added flavour of the various forms of the conservation movement.

The first of these, in time, involved sand mining on Fraser Island. The intervention by the Commonwealth government into that matter, as Mr Turner points out, was dealt with by the High Court in the case of *Murphyores Inc Pty Ltd & Dillingham Constructions Pty Ltd v Commonwealth of Australia*.[10] The joint venturers held valid mining leases under the State legislation, the *Mining Act* 1968 (Qld), for the extraction of mineral sands on Fraser Island. The mineral sands were processed to produce zircon and rutile and the vast majority of that production was exported from Australia. In other words, the business essentially depended upon its ability to export. Export of rutile and zircon, without the permission of the (Commonwealth) Minister for

7. It can be observed, also, that lenders are looking with an increasingly jaundiced eye at proposals, whether large or small, where it is considered there may be increased risk due to the potential of sovereign risk.
8. Industry Commission Report, Vol 1, p 194.
9. Ibid, p xxiv.
10. (1976) 136 CLR 1; 50 ALJR 570.

Minerals and Energy, was prohibited by reg 9 of the *Customs (Prohibited Exports) Regulations* made pursuant to the *Customs Act* 1901. In December 1974, the Minister had indicated that export approval would be forthcoming, subject to compliance with certain conditions.

A few days later, a new Commonwealth law, the *Environment Protection (Impact of Proposals) Act* 1974 came into force. In July 1975, the Minister administering that Act directed that an enquiry be conducted into:

> "all of the environmental aspects of the making of decisions by or on behalf of the Australia government in relation to the exportation from Australia of minerals (including minerals that have been subjected to processing or treatment) extracted or which may hereafter be extracted from Fraser Island."[11]

The Minister for Minerals and Energy then said that no export approvals would be granted until after completion of the environmental public enquiry and consideration of the report.

The joint venturers instituted proceedings for relief in the High Court, claiming, inter alia, that the Minister for Minerals and Energy was not entitled to take account of any environmental report in determining an application under reg 9, and failed.

Stephen J (as he was then), with his usual clarity, summed up the situation of the conflict between the application of State and Commonwealth laws:

> "The plaintiffs extract zircon and rutile-bearing mineral sands on Fraser Island, Central Queensland, pursuant to mining leases granted by the State of Queensland. Because the principal markets for zircon and rutile concentrates lie overseas the continued extraction of mineral sands on Fraser Island, and with it any threat which this may involve to the ecological environment of Fraser Island, is largely dependent upon the plaintiffs' continued ability to export these concentrates. Thus, although the control of the plaintiffs' mining operations and of their effect upon the local environment is, no doubt, essentially a matter for the State, the power to prohibit exports, which lies within the legislative competence of the Commonwealth, is inherently capable of having an impact upon the plaintiffs' mining activities and, in consequence, upon the environment of Fraser Island. Hence the present proceedings."[12]

It is interesting to note that Fraser Island later was the scene of a further illustration of sovereign risk, involving the clash of State and Commonwealth laws. Logging of timber was proposed and approved by the State authorities, subject to strict controls. The Commonwealth government initially found itself unable to act, as in the case of the mineral sands, because the timber (saw-logs) was intended for domestic consumption. Accordingly, the Commonwealth Minister arranged for the area to be included in a World Heritage area, thus closing down the logging operations.

11. 50 ALJR at 572.
12. Ibid at 573.

Another, and perhaps one of the clearest illustrations of sovereign risk in Australia involves the proposal by joint venturers for a $500 million gold/palladium/platinum mine at Coronation Hill in the Northern Territory.

The joint venturers had spent in excess of $15 million, from 1985, exploring, proving up resource, planning development with a high regard for environmental and Aboriginal sensitivities (including a $2 million environmental impact study) and surviving the closest government and bureaucratic examination of a mine project.

In June 1991, the Commonwealth government blocked the project by purporting to extend Stage III of Kakadu National Park to include the joint venture's mining and exploration leases. As the matter is presently before the courts, it is not tactful to say much, other than to observe that the joint venturers have publicly acknowledged that governments have the right to act in what they see as the national interest. However, if those actions have an impact on private property rights, as with the expropriation of land, then the owners should be compensated.

The venturers claimed that, not only was no compensation forthcoming, but the expropriation was unconstitutional. Accordingly, proceedings have been issued and a decision is awaited. It would also appear from the recent television series *Labor in Power*, that even the Commonwealth government's Cabinet had suffered as a result of sovereign risk, to the extent that the Prime Minister of the day had his way, despite the views of the rest of the Cabinet.

A great deal of the background to the Coronation Hill proposal can be found in the Industry Commission Report.[13] Rather presciently (the Report was published in February 1991), the Commission observed:

> "The mining industry is already wary of what it sees as arbitrary and ad hoc changes in government policy which adversely affect mining projects. This 'sovereign risk' problem acts as a disincentive to undertaking exploration, without which there would no longer be an industry once existing projects reach the end of their economic lives. If the government does not, finally, allow Coronation Hill to proceed after repeatedly assuring the [joint venturers] that it would, that outcome would be seen as the latest—and in many ways the most spectacular (given the publicity the project has attracted)—evidence of the reality of sovereign risk problems in Australia."[14]

Mr Turner offers most useful details of some of the techniques for removal, or, perhaps reduction, of those doubts and uncertainties, including contracting with the Crown or seeking parliamentary approval of Agreements. As he points out, there are many difficulties and potential pitfalls. Once again, the difficulties are compounded by Australia's federal system and, possibly, the uninhibited desire of the Commonwealth to extend its reach—exacerbated when the Commonwealth government is of a different political hue from the relevant State government. Especially when an election is looming is a

13. Industry Commission Report, Vol 3, pp 503 ff.
14. Ibid, p 521.

Commonwealth Minister likely to find illumination in a burning bush on the road to what he or she perceives as the road to the voters' hearts.[15]

However, as Mr Turner notes, none of the techniques is entirely free from risk. The High Court has confirmed, in its recent *Mabo* decision[16] that perceptions of what is the "present" legal situation can vary. There may be also practical difficulty in the legislative route—even assuming a State will enact specific "project" legislation, the Commonwealth may not follow suit.

I conclude by echoing Mr Turner's conclusion and adding some words from the Industry Commission:

> "Governments must realise and accept that if their actions heighten perceptions of sovereign risk, everyone will lose, including governments, the community and explorers/miners (who may well respond by taking their knowledge and expertise to other parts of the world where the rules are known in advance and adhered to—or at least where they judge sovereign risk to be not as great)."[17]

15. Certainly, the Tasmanian enabling legislation, referred to by Mr Turner, which supported the Wesley Vale project (the *Northern Pulp Mill Agreement Act* 1988) was not sufficient to ensure the establishment of the pulp mill. Again, this situation combined a mixture of State and Commonwealth laws with "green" pressure. On this occasion, as one of the venturers was foreign, the Commonwealth's Foreign Investment Review Board "bought in", by attaching special conditions to the foreign participant's approval under the *Foreign Acquisitions and Takeovers Act* 1975.

    It is also interesting to note the further reach of the State legislation in binding the Tasmanian government. Sections 7 and 8 provide as follows:

    > "**7.** Subject to section 9(1), the laws of the State are modified so far as may be necessary to give full effect to the Agreements and shall, except where the contrary intention appears in the Agreements, be construed subject to any such modification.
    >
    > **8.** Subject to section 9(1), where any inconsistency arises between any provision of the Agreements and any provisions of the laws of the State (other than this Act), the first-mentioned provision prevails."

16. *Mabo v Queensland* (1992) 75 CLR 1; 66 ALJR 408.
17. Industry Commission Report, Vol 1, p 40.