IF PRIVATE EQUITY GOES ABROAD

Overcoming inhibitors to U.S. private-equity investment in emerging and mature markets is possible.

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Private-equity funds have faced tough market conditions in recent months, but PE funds with a focus on oil and gas have enjoyed greater fund-raising success than most—and existing PE funds have made many high-value investments in upstream and oilfield services targets. Much of the recent deal activity has originated in, and has focused primarily on, the Americas.

Outside the Americas, however, PE investment has been less significant than anticipated, despite the potential benefits of portfolio diversification, the general acceptance of the growth in potential of emerging markets, and the emergence of credible technological improvements which promise to make mature markets attractive again.

This article will consider some of the key legal inhibitors to U.S. private-equity investment in the oil and gas sector in emerging markets (with a focus on Africa), and in mature markets (with a focus on the United Kingdom Continental Shelf or UKCS). Certain positive developments and steps can be taken that may lower the risk profile of such investments and overcome inhibitors to a deal.

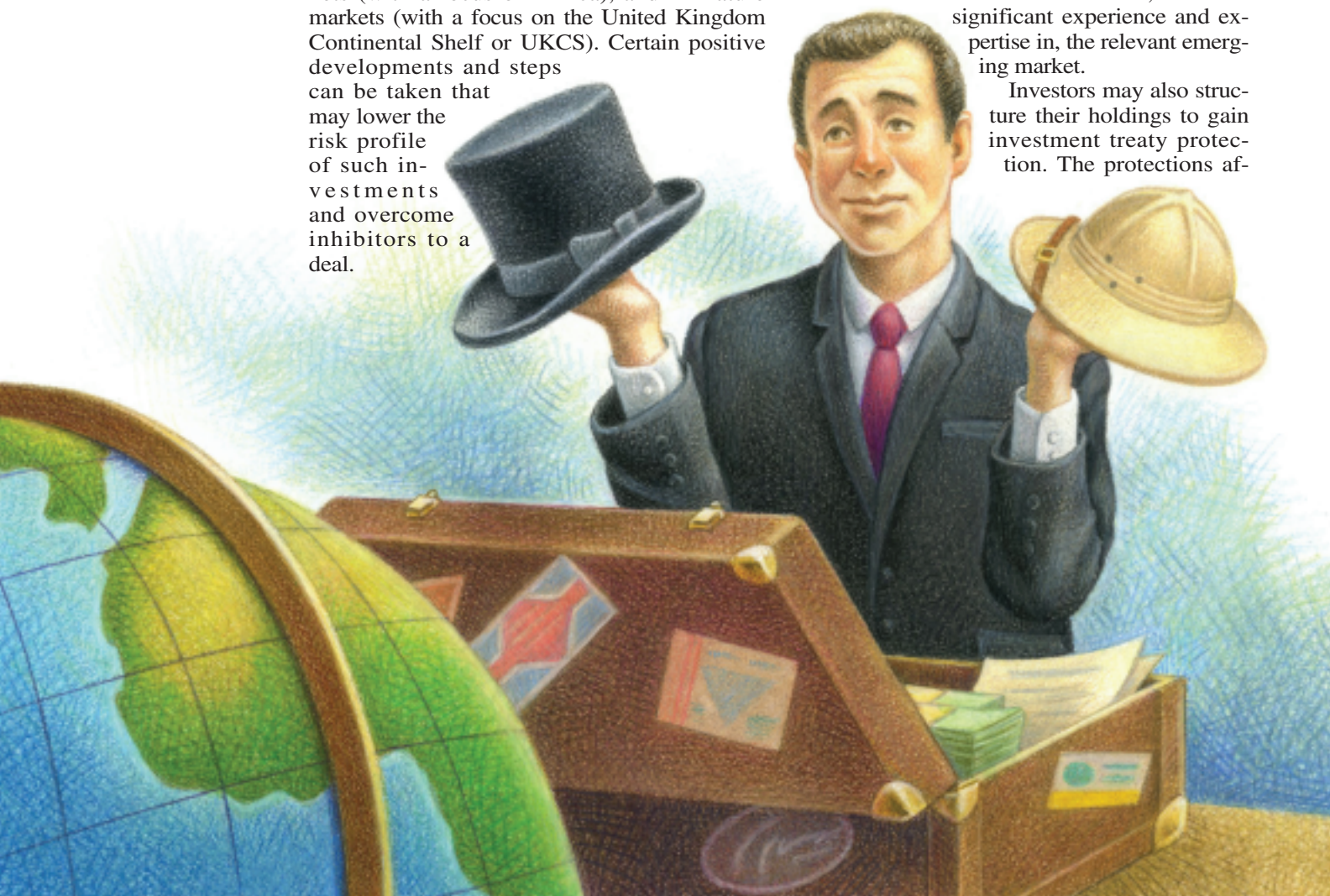
Inhibitors in emerging markets

There are several key examples of the legal risks that are more acute in emerging markets and that may inhibit potential investment, as well as certain positive developments and means of mitigation.

Governmental interference. This may involve a host state exercising pre-emption or back-in rights, revoking interests, refusing to grant consents, or imposing exit charges. Host states may exercise such rights without the same commercial considerations and motivations as commercial parties.

The risk of interference may be mitigated by restructuring the transaction (for example, as a share sale), and using contractual protections, including changes in political conditions triggering (or being excluded from) material adverse change provisions and related termination rights. New entrants may also wish to co-invest with other funds that are focused on, and have significant experience and expertise in, the relevant emerging market.

Investors may also structure their holdings to gain investment treaty protection. The protections af-



Many of the inhibitors identified here result from actual or perceived political risk in emerging markets. Mature markets are not, however, devoid of political risk.

forded by bilateral investment treaties (or BITs) vary, but they are generally designed to provide foreign investors, where the acts of host governments are damaging to their investments, with direct remedies through arbitration proceedings against the host government.

Typical protections include fair and equitable treatment, full protection and security, and expropriation only for a public purpose. Investment-treaty planning is best accomplished prior to making the investment, and should be made in conjunction with tax-treaty planning.

Change of law or regulatory practice. Obtaining and acting upon clear and timely advice from local counsel on regulations and contractual enforceability in the host country is a key mitigation step, as well as ensuring that the investor, and underlying asset, benefits from a robust stabilization provision. Agreeing on the correct strategy and tactics when approaching regulators, and the consequences of consents being withheld or withdrawn, is of key importance.

Compliance. Complying with the U.S. Foreign Corrupt Practices Act (and, if relevant, the UK Bribery Act) is a key concern for private-equity investors. Investors now frequently perform detailed due diligence on prospective partners, agents and counter-parties, insist on appropriate warranties, and obtain audit rights. Investors also adopt and implement anti-corruption policies and training.

Local participation. Certain host states impose local content requirements so that upstream investors must use local suppliers or have significant local ownership. This needs to be factored into procurement timetables and the structure of the acquisition vehicles. Some nations also impose requirements on the supply of oil or gas production to their domestic market, and the price at which such domestic supply must occur. This is frequently a discount to the global market price and should be factored into the financial structuring of the transaction.

Access to infrastructure. A lack of existing infrastructure may cause significant production delays and cause the PE investor and its client company to incur significant capital and operating expenditures. Where host states require that title to such infrastructure is transferred to the host government when a project is completed, the impact on project viability, timing and costs needs to be considered. In the case of landlocked countries, the infrastructure and political stability of neighboring countries must also be examined, where monetization strategies may involve access to such countries.

Cash injection and extraction. Although all African host states impose a percentage cap on the total production that may be applied towards cost recovery, the entitlement for operators to recover costs differs between states.

Separately, certain host states impose exchange control restrictions and offshore dividend taxes that make injecting and extracting cash problematic. The applicable laws and regulatory practice therefore need to be factored into the transaction's financial structuring.

Confidentiality and transparency. Certain host states have prohibited the distribution of existing production-sharing contracts to potential purchasers for due diligence—and, at times, they have asked for payment for access to contracts and technical data. To mitigate this, sellers should ascertain which prohibitions apply and structure the proposed transaction in a manner that permits disclosure.

There are also concerns around resource governance transparency, which acts as a barrier to new entrants and may leave potential investors fearful of exit prospects.

Leverage and project financing. Reserves-based lending in markets is not always readily available, particularly where projects are not politically underwritten with support from the IMF (International Monetary Fund), African Development Bank or World Bank. Syndication may not be forthcoming when dealing with exploration assets in emerging markets. Any lack of available debt funding may require more equity investment during the exploration and appraisal phase of a project.

Exit strategies. Investors naturally fear making an illiquid investment. Trends are encouraging, however: in 2012 there was a 40% increase in exit volume from African private-equity investments. Potential exits or partial exits include initial public offerings (IPOs), although liquidity is currently severely limited; secondary transactions (which may increase in Africa, given the number of funds approaching the agreed term of their investments); secondary buyouts (which may also increase given the rise in Africa-focused funds and teams); share redemptions (assuming the target is cash generative and solvent); flip-up rights (into diversified holding companies with greater liquidity); and sale-and-lease-backs (where the target has significant real property).

On entry, investors should carefully consider an exit strategy and appropriate contractual protections, including: IPO timing, structure and terms; limits on the scope of exit warranties; transfer restrictions; leaver provisions; drag and tag rights; and preferences on liquidation or return of value to shareholders on sale.

Inhibitors in the UKCS

Many of the inhibitors identified here result from actual or perceived political risk in emerging markets. Mature markets are not, however, devoid of political risk. The frequent changes to the UKCS tax regime prompted one senior lender to remark that political risk was greater in the UKCS than in Egypt. This instability had a negative effect on activity: reduced field development in 2008 and 2009, and subsequent reductions in production in 2011, were blamed largely on fiscal instability and high tax rates.

Nevertheless, capital expenditure in the UKCS from 2010 to 2012 has been at its highest level since the 1970s. Further fresh investment and boosted production is anticipated over the next few years, partly as a result of recent positive changes in the fiscal regime. Mature markets represent an opportunity for smaller players with lower overheads to move in.

Examples of actual and perceived legal risks of investing in mature markets—and positive developments and means of mitigation—are summarized here.

Decommissioning: Attributing liability. The overall decommissioning costs in the UKCS are projected to be between $22.5 billion and $45 billion, a figure that continues to rise as new facilities are built. These liabilities are of critical importance to existing and potential licensees, particularly where the investment target is approaching the end of its life.

Liability for decommissioning extends, broadly, to all current and past license holders, operators and associated parties (on a joint and several basis).

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The test of association (for corporate bodies) is satisfied by either: 1) the possession (or entitlement to acquire) 50% of the issued share capital or voting rights; or 2) the ability to ensure that the corporate body's affairs are conducted in accordance with its wishes. This right to 'pierce the corporate veil,' and the continuation of liability even after disposal of the underlying asset, often causes investors concern.

Although it has not been the practice of the UK Department of Energy & Climate Change (DECC) to serve notices on associated parties, the DECC has indicated that such service will only occur where it is judged that satisfactory arrangements, including financial arrangements, have not or will not be made to ensure a satisfactory decommissioning program is carried out.

This is in line with its general approach to "speak softly and carry a big stick." Nonetheless, private-equity investors have typically taken a cautious approach and designed their investment so that they take less than a 50% interest, with special limited veto rights ensuring that they do not have "control" of the license-holding company, and requiring that no single shareholder holds more than 45% of the shares.

This is in contrast with some E&P companies, which hold more than 45% and manage the risk by ensuring partner creditworthiness; disposing to a creditworthy buyer and obtaining appropriate contractual protections; including more partners in a project than they otherwise might; and putting in place a decommissioning security agreement, backed by cash or letters of credit or similar instruments.

Decommissioning: Calculating liability. The need to account for decommissioning arises when the UKCS platform and related infrastructure is first installed, but tax relief is only available when decommissioning takes place. Ambiguity over the applicable rate of tax relief has resulted in uncertainty when accounting, or providing security, for future decommissioning costs.

In turn, this has tied up significant resources and diverted funds away from re-investment, made asset transfers and change-of-use projects harder to realize, and required a level of security to cover part-owner liability. This has deterred smaller companies from investing in late-life field developments. To deal with this problem, the UK government has undertaken to underwrite the level of future tax relief available for decommissioning costs through entering into contracts (decommissioning relief deeds) with oil companies.

Some political uncertainty remains. Investors in the UKCS have been keen to understand the potential implications of a "yes" vote in the referendum on Scottish independence in September 2014.

Access to infrastructure. Third-party access to infrastructure on the UKCS is regulated by a voluntary code designed to ensure an open and transparent process. Many newer and smaller fields are not economic unless access is granted to existing facilities. Investors should investigate whether the licensee has (or may in the future require) access through any third-party facilities, whether any facilities to be acquired are subject to third-party access arrangements, and whether the development of small fields nearby may require third-party access through the facilities in the future.

Environmental liability for a major incident. Liability for breaches of environmental legislation by an investee company typically only extends to an investor where it is operating the applicable asset, controlling the actions of the investee or otherwise issues some form of credit support or contractual protection (for example, indemnification).

Lack of materiality in mature areas. The extension of allowances targeting marginal or challenging oil fields, improved terms for heavy oil, different types of licenses (either carrying fewer up-front drilling obligations or with a longer period to perform mandatory drilling obligations), and the introduction of a brownfield allowance, have made the UKCS more attractive to investors. This is encouraging smaller companies to buy less productive and older assets. □

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