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SESSION ONE

**IMPACT OF THE GLOBAL ECONOMY ON THE
AUSTRALIAN RESOURCES INDUSTRY**

**STRUCTURAL CHANGES IN AUSTRALIA'S
RELATIONSHIPS WITH ITS FOREIGN
RESOURCES CUSTOMERS**

Paul A Davis
Baker & McKenzie
Tokyo

Structural Changes in Australia's Relationships with its Foreign Resource Customers

by Paul Davis*

SUMMARY

Australia's relationships with our resource customers have generally followed a model made up of two components: the foreign company enters into a long-term contract to purchase the resource commodity and it makes a "strategic" equity investment in the project. The equity investments have generally been at too low a level to give the buyer any meaningful control over the project, but have been viewed by buyers as providing valuable access to cost, reserves and marketing information.

The current rush for resources is now pushing our customers into a race to secure ownership of the upstream resource body. Governmental policies in Japan and China in particular have led to a number of measures to encourage such investments. From a legal viewpoint however there is a real issue as to whether ownership improves security of supply, particularly where the host country is Australia.

Further changes to the relationship are resulting from the changing business models of our traditional customers, and the advent of new kinds of customer, such as traders, and Chinese companies that have limited familiarity with the Australian way of exporting, access to vast financial resources and different motivations and approaches from those of our traditional customers.

The changes are resulting in an evolution of long-term contracts, commoditization of such contracts and increasing cross-fertilization between contracts used for different commodities.

The strategic equity component of the traditional model gives rise to minority interest holder issues and some unique issues raised by the new International Oil Company ("IOC") aspirants, by National Oil Companies ("NOCs") and sovereign funds.

The issues unique to the long-term sales contract/equity combination include: (i) whether the two components are interdependent, (ii) whether the equity investment results in the buyer bearing heavier duties than it would under a pure sales contract, (iii) the issue of how much access the buyer should have to joint venture information and how involved the buyer should be in decisions concerning marketing and sales.

* LL.M.(Hons), B(UC) Baker & McKenzie, Tokyo. Written with the assistance of Janet Cechanski.

“If [we] acquire fields abroad and they turn out to be small they achieve no strategic purpose. But if they turn out to be really large, they will probably be expropriated.”¹

THE TRADITIONAL MODEL OF OUR RELATIONSHIPS WITH OUR BUYERS

The development of Australia’s major resource projects was largely underwritten by the demand for those resources from Japan.²

Until the 1960s Japan’s resource requirements were largely satisfied through spot purchases. Increasing demand for resources prompted reconsideration of this strategy. Rather than following the model of resource buyers in the United States and Europe, of acquiring and developing such resources outright, a unique Japan-Australia model developed, comprising two main components: the first of which involved the Japanese buyer entering a long-term contract and the second of which involved the Japanese buyer taking a minority “strategic” equity stake in the project.³ The equity stake was often taken by a Japanese trading company, such companies at that time functioning primarily as an international window to the world for Japanese manufacturers. A third component of the early model was that the capital, technology and entrepreneurship were supplied by the American multinationals.

Reasons this model developed as it did included the limited availability our Japanese customers, the steel mills and power utilities had to capital, management and entrepreneurial expertise, and their belief that they should keep narrowly to their primary businesses.

The level of Japanese investment in Australia’s resources projects is low, which is unusual, given the importance of Japan as a market for Australian minerals⁴. An approximate analysis of the 2007/2008 Register of Australian Mining (the “Register”) lists 75 investments by Japanese companies in coal projects, the interest levels on the part of the coal users ranging from 2% to 32.5% and on the part of trading companies from 3% to 90%. In the case of iron ore, 11 Japanese investments are listed with an average holding below 10.5%, except for one trading company investment of 33%. Similarly the 2007 Register of Australian Petroleum lists 80 Japanese oil and gas investments (many in contiguous blocks) at interest levels generally around 5%-25%, with some wholly owned Japanese blocks at the prospective stage.

The “strategic” equity holdings have generally been too low to give any meaningful control over the project,⁵ raising the question of what benefits the buyer seeks to obtain from such a low level of investment. The principal advantages to the Japanese buyer have been, and still are, seen as being:

- Access to the seller’s cost information which is not only highly valuable in price negotiations but also gives utility buyers an invaluable pre-warning of likely price increases, enabling them to commence the internal and regulatory processes which are necessary to increase the price of the final commodity

¹ S Anklesaria and Aiyar, “Perils of buying foreign mineral rights”, Times of India, 17 July 2007.

² In 2004 Australia supplied 60% of Japan’s coal, 55% of its iron ore imports, 27% of its aluminium and 22% of its uranium. See Agency for Natural Resources and Energy; Ministry of Economy, Trade and Industry; “Energy in Japan 2005” cited in Minerals Council of Australia Submission to Department of Foreign Affairs and Trade, An Australia-Japan Free Trade Agreement: The Minerals Industry Case, October 2005 at pp. 12-13.

³ Hammersley and Mount Newman were early examples of this pattern. See K Kojima, “Japan’s Resource Security and Foreign Investment in the Pacific: A Case Study of Bilateral Devices between Advanced Countries” in Krause L B, Patrick H (eds), *Mineral Resources in the Pacific Area* (University Press of the Pacific, 2002 reprinted from the 1978 edition) at p 510.

⁴ Ibid at 510. See also P. Drysdale “Minerals and Metals in Japanese-Australian Trade”, *The Developing Economies*, Vol. 8, pp 198-218. Nippon Steel’s 2005 Basic Fact Report listed the company as having equity interests in iron ore projects of 10.5% in Robe River, 28.2% in Beasley River, 25.4% in Nibrasco, Brazil and 2.4% in MBR Brazil. With respect to coking coal, the company lists six investments in Australia of between 5% and 12.5%. J-Power, Japan’s biggest thermal coal importer owns only 7% of Blair Athol, and 10% of Ensham, from which projects it imports much of its coal.

⁵ For example, of the 75 Japanese investments in Australian coal projects listed in the Register, only two Idemitsu projects (Ensham and Muswelbrook) were more than 50% Japanese owned. Of course the joint venture agreement itself often gives greater levels of control than would be available at corporate law, including the right to veto major business decisions. The smaller the Australian partner the more possible it has generally been for the minority Japanese offtaker to negotiate a higher level of control.

(electricity or gas), thereby minimising the disastrous lag which many of them have experienced this year.

- Access to the sellers' marketing policies and plans, including information about the other customers that are being approached, the status of such negotiations and sales prices.
- Access to early information on issues likely to affect reserves, delivery and quality.
- Preferential entitlement, formalised or de facto, to purchase product, sometimes with rights to market the commodity in Japan or Asia.

It is to ensure that these advantages are realised to the fullest that the agreement provisions concerning representation on committees, reporting and access to information are so fiercely insisted upon by the buyer, and why they are often equally fiercely resisted by the seller.

Korea generally followed the Japanese model, investing at minimal "look-see" equity investment levels.

Whether this long-term sales/strategic equity model has been good for the buyers has been the subject of some debate. The long-term contract involves a divvying up of the risks and benefits by means of the price, or other mechanisms which are decided at the beginning of the contract. The obvious alternative is the European/American vertically integrated model under which the foreign buyer takes all risks and benefits in the product chain. Under Australia's foreign investment policies this alternative is, and has been at various times, available for projects at various stages of development.

In any event given the limited capital resources available to our Japanese customers, the traditional model allowed them to use their scarce resources to support the development of multiple mines in different countries and gave Japan a favourable position as "dominant buyer".⁶ As is discussed later, while our Chinese buyers have also favoured an equity/long-term contract combination, the size of their equity investments has not been constrained by the factors faced by Japan and Korea.

CHANGES TO THE TRADITIONAL MODEL

Recent global events are leading to a move away from the traditional model which has served the Australian export trade so well over the years.

These events can be broadly divided into those relating to the current rush for security of supply, those affecting the business models of our traditional customers and the advent of new kinds of customer.

Buyers Responses to the Current Rush for Security of Supply

Overshadowing all other changes in the resources market has been the current rush to secure supplies. Securing reliable resource supplies has been a high priority for Japan for over half a century. Korea's demand for resources grew steadily and was accommodated in the world markets without major disruption. However, China's recent emergence, virtually overnight, from a net exporter to a net importer of many resource commodities, and India's moves into the market, have introduced a fierce competition.⁷

The effects of this competition have been exacerbated by the geopolitical uncertainty in many resource rich nations and a resurgence in resource nationalism. This has resulted in moves among host countries to secure a greater share of the higher prices being realised for their "national resources."

⁶ Kojima op cit n 3 at pp 514 and 521.

⁷ Japan is the largest customer for Australia's steaming coal, coking coal, oil and gas and aluminium. China is the largest customer for our iron ore, 4th largest for steaming coal and 3rd for coking coal and oil and gas, while India is the 2nd largest customer for our coking coal and our largest customer for gold. See ABARE 2008, Australian Commodities June Quarter, 08.2 retrieved from www.abare.gov.au.

The importance to our customers of securing resources, particularly oil, is hard to overstate.⁸ Objectives are voiced in terms ranging from “security of supply” through “energy security”, to “national security” and methodologies in terms of “locking in” resources and “avoiding being locked out”.

Japan’s approach

Japan’s basic approach to the new competitive environment is encapsulated in a number of policy documents⁹ and the business objectives of Japan Bank for International Cooperation (“JBIC”), Japan Oil, Gas and Metals Corporation (“JOGMEC”) and INPEX. Key policies of relevance to this paper include:

- Moves to improve investment environments and establish mutually dependent relationships with host countries through diplomacy and multi-dimensional cooperation including education and cultural exchange;
- Dramatically increasing assistance by way of risk funding for exploration and development of oil and gas, with the specific target of increasing the ratio (*kaigai sekiyu jishu kaihatsu* - “owned oil” or “equity oil” ratio) of crude oil which Japanese companies own, to total imports of crude, from 15% to 40% by 2030;
- Assistance for exploration and development of coal, uranium, rare metals and other minerals resources and projects related to long term supply to Japan, provided through JBIC financing, New Energy and Industrial Technology Development Organisation (“NEDO”) research projects, financial assistance from JOGMEC¹⁰, a newly extended range of insurance coverage from Nippon Export and Investment Insurance (“NEXI”) and the allowance of deductions for reserve funds for losses on overseas investments and for exploration expenses;
- Diversification of supply sources;
- Nurturing core companies that are large enough to compete in the international marketplace.¹¹

Korea’s approach

Korea has eased its restrictions on overseas investment and introduced a number of measures to encourage investment in high risk projects overseas, including various forms of insurance for losses on overseas resource developments. Australia is a major supplier of Korea’s coal, uranium and LNG.¹²

China’s approach

China came to face the scramble for resources more abruptly than Japan. China’s oil consumption has more than doubled in the past decade and in 1993, it turned into a net importer. In 2006, the International Energy Agency (“IEA”) estimated that China will almost double its energy consumption by 2030.¹³ In formulating its strategy China has drawn on the experience of Japan and its attempts to develop its own oil. Its strategy is also being heavily influenced by its position as a “late comer.”¹⁴

⁸ Options studied by governments to secure vital resources include military options. See eg, G Woodard, “The State of Diplomatic History: Occasioned by the Thirtieth Anniversary of the Australia-Japan Basic Treaty of Friendship and Cooperation” (2007), Asia Pacific Economic Papers No. 362, 2007, at 3.

⁹ The new National Energy Strategy published in May 2006 by METI, Japan’s Basic Energy Plan which was approved by the Cabinet on March 9, 2007, METI’s Guidelines for Securing Natural Resources published in March 2008 and the FY 2007 Energy White Paper published by METI in May 2008.

¹⁰ JOGMEC’s investment guarantee for companies has been raised from 50% to 75%. See “Japanese Views on Energy, Minerals and Mining in an Age of Short Supply”, Interview with Keith W. Rabin, President, KWR International, Inc. on KWR site at <http://www.kwrintl.com/library/2007/japaneseviewsonenergy.htm>

¹¹ For example INPEX Corporation has as its main mission the securing of petroleum and natural gas supplies through exploration resulting in new discoveries.

¹² Government Policy Review Measures to Boost Corporate Expansion Overseas and Encourage Overseas Investment 14 Feb 2007.

¹³ T Aso, “Japan’s Foreign Policy and Global Energy Security” (2007), OECD Observer No. 261 May 2007 at 37.

¹⁴ T Kambara and C Howe, *China and the Global Energy Crisis: Development and Prospects for China’s Oil and Natural Gas* (Edward Elgar Publishing, 2007), p 120.

Essential elements of China's approach, based upon its 11th Five Year Plan which started from 2006, are:

- A belief that energy security is too important to be left to the markets;¹⁵
- A government supported "go out" strategy, which includes more active, energy-centric forms of commercial activity;
- "Goodwill gestures" extended by the government to host countries;¹⁶
- A high emphasis on "acquiring physical control of the reserve;"¹⁷
- The use of China's three major National Oil Companies ("NOC") (China National Petroleum Corporation "CNPC", Sinopec, and China National Offshore Oil Corporation "CNOOC") as the means of implementing the policies, with the aim that they would compete with the majors (the IOCs);¹⁸
- An appetite for investments which are viewed by incumbent industry participants as highly risky and not sustainable, including investment in "controversial" and "sanctioned" countries such as Sudan, Iran, and Syria;¹⁹
- The entering into of crude and LNG purchase contracts with a range of suppliers;
- The promotion of new oil and gas pipelines.

The literature reveals a high degree of apprehension as to China's economic power, the relationship between the government and the resource buyers, and the access they have to finance both from state-owned banks and their own reserves. This apprehension has given rise to allegations of unfair and potentially destabilising investment competition when the Chinese majors have ventured abroad and that China's approach is too aggressive.²⁰ In contrast, it has been said "Australia's experience with Japanese and Korean companies provides a good investment model".²¹ China's response is that it has little choice given the fact that there are few "less risky" areas in the world where rights are available and not already held by the majors.

¹⁵ K Lieberthal and M Herberg, "China's Search for Energy Security: Implications for U.S. Policy" (2006) NBR Analysis, Volume 17, April 2006 at 20.

¹⁶ Eg, China's Exim Bank loan to Angola of \$2 billion accompanied by the Angolan government's award of an oil concession to Sinopec. See D Rosen and T Houser, "China Energy: A Guide for The Perplexed" (2007) China Balance Sheet, A Joint Project by the Center for Strategic and International Studies and the Peterson Institute for International Economics, at 32.

¹⁷ An approximate analysis of the 2007/2008 Register of Australian Mining lists six Chinese investments in minerals projects at levels of 50% or more. Chinese companies made significant investments in the Channar, Eastern Range Mid West, Gindalbie, Balmoral South, Mt Gibson, Cape Lambert and Sino Iron ore projects. See eg, R W X Hu, "Promoting China-U.S. Cooperation in Energy Security: Rationale and Agenda" (2008) OGEL Vol. 6, Issue 1, March 2008 at 2. China is also reported to have declared that it wishes to own one-third of the world's iron ore resources. See M Condon, "Steelmakers Unite", Japan Inc, October 2008.

¹⁸ "CNPC is not satisfied with being merely a state-owned enterprise but seeks to be a successful multinational. Like Shell and Exxon Mobil". See E S Downs, *China's Quest for Energy Security*, (Rand, 2000), p 51.

¹⁹ "It is commonly argued that China's strategy is not sustainable because of the tendency to overbid for assets and the NOCs are increasingly exposing themselves to reputation and political risks they are not equipped to handle". See "Report Overseas Investment - The Myth and the Reality", *Petroleum Review*, September 2007 at 18. See also Kambara and Howe op cit n 14 at 121. The policy is to put the more controversial investments (Sudan, Iran) in the hands of CNPC, the more centrally directed NOC, rather than the market listed CNPC (PetroChina).

²⁰ Since China is not a member of the OECD, it is not subject to the Export Credit Arrangement which limits subsidisation of overseas credits to spur imports. See Ibid at 43. High profile investments include CNPC purchasing PetroKazakhstan, CNOOC acquiring 45% in an oil block offshore Nigeria for \$2.27 billion. "The Chinese companies use deep pockets combined with political opportunism. The US Congressional ban on business dealings with countries accused of supporting terrorism gave the CNPC the opportunity to replace Occidental Petroleum in Sudan". See Downs, op cit n 18 at p 17. The US Congress has made a number of inquiries into China's pursuit of energy supplies and its implications.

²¹ Resources Minister Martin Ferguson, quoted in R Callick, "The Chinalco Stake in Rio Tinto was Never going to get Knocked Back", *The Australian*, 25 August 2008. In contrast, Drysdale and Findlay suggest Chinese investments involve transparent shareholding in listed companies and arguably involve less potential covert control. See P Drysdale and C

Much of the apprehension seems to stem from difficulty in understanding the motivations behind some Chinese investments.²²

India's approach

While India is behind China in its quest for resources, the IEA indicates that India too will double its energy consumption by 2030. In the past many of its resources were secured by short term contract but there is now a trend towards longer-term contracts, and many of its major companies are acquiring overseas oil, gas and coal concessions.²³

Generally India's acquisitions in the upstream are viewed as more orderly than China's have been.²⁴

Is Ownership worth the effort?

“The strategy is very simple: get as many of them (ore bodies) as you can. Discover them or buy them.”²⁵

“The major geopolitical risks to stable oil flows... would disrupt equity and contract oil flows equally. There is no correlation between equity oil and energy security.”²⁶

The policy approaches of each of Japan (increasing the “equity oil ratio”), China (the “go-out” strategy) and India are all directed to improving security of supply through upstream ownership of the resource. Interestingly however there seems to have been little analysis of what is meant by security of supply, just how ownership achieves it, and how ownership achieves it better than a long-term sales contract, particularly where Australia is the host country.²⁷

From a commercial viewpoint, ownership enables the buyer to put the resource into its portfolio and decide when and how to develop and market it. This is premised on the resource being wholly owned, or jointly owned by venturers of like minds, which may or may not be the case. It is also premised on the ownership right not being subject to conditions which run contrary to the strategy.

In a legal context, however, the advantages of ownership, and whether it is worth striving for, are not as clear.

Against the state

What an investor can achieve in most countries is not a property right in the fullest sense of the word, but only some form of administrative or contractual right.²⁸ Different host countries give different forms and degrees of protection to such rights. Even in Australia, the rights an investor gains through holding a resources title depend very much upon the particular legislation.²⁹

Under the constitutions of most countries, even a property right is not inviolate - the state has right to expropriate property subject to payment of compensation. Foreign investors often attempt to bolster their rights by making the ownership or concession agreement subject to a foreign law, insisting that disputes be resolved outside the host country under international mechanisms, and bringing the arrangement under the protection of a

Findlay, “Chinese Foreign Direct Investment in Australia: Policy issues for the Resources Section” presentation to Crawford School Public Seminar, ANU, 4 September 2008.

²² See eg, Callick, op cit n 21.

²³ H. Ishida, “Energy Strategies in China and India and Major Countries’ Views”, (2007) IEEJ March 2007.

²⁴ Ibid.

²⁵ Tom Albanese of Rio Tinto, quoted by Andrew Davidson in *The Australian*, 25 August 2008.

²⁶ Lieberthal and Herberg, op cit n 15 at 20.

²⁷ “The Japanese government apparently is now subsidizing direct investment in minerals, probably for strategic reasons. The bureaucracy has thus have missed the point that direct investments are not particularly secure and that contracts involve much less political trouble. See op cit n 3 at p 532.

²⁸ Especially in oil but also in the case of other minerals. Eg, Financial or Technical Assistance Agreements (Philippines), Contracts of Work (Indonesia), and Producing Sharing Agreements (Myanmar).

²⁹ See eg, T Daintith, “Contractual Discretion and Administrative Discretion: A Unified Analysis” (2005) *The Modern Law Review*.

body such as the International Centre for Settlement of Investment Disputes (“ICSID”) or a Bilateral Investment Treaty (“BIT”) or Free Trade Agreement (“FTA”).³⁰

History seems to indicate, however, that such endeavours have had only limited success. There has been an alarming history of expropriation by various means, particularly where market prices for the product increase³¹ prompting a spurt of legal research on such subjects as discriminatory regulations, nationalisation, “creeping expropriation”, regulatory changes, currency inconvertibility and stabilization.

The general view seems to be that to date Japanese support for overseas resource ownership, particularly in the oil and gas area, has met with only limited success.³² Questions have also been raised as to whether China’s attempts to control offshore resources actually increases security of supply. The suggestion is that the main drivers behind the Chinese NOCs overseas investments may be their own commercial ambitions rather than achieving security of supply.³³ In any event, whatever dangers may exist in other countries, it is difficult to find cases where the Australian government has attempted to increase the national advantage through expropriation or similar action.³⁴

As against other parties

Ownership of a resource avoids the need to deal with a seller who, for example, may breach the sales agreement or become insolvent. It also avoids the transaction costs inherent in negotiating, administering and adjusting the contract and the many legal and commercial issues which arise from the tension between the quest for certainty on the one hand and the need for flexibility on the other. This tension leads to a difficulty in finding mechanisms that deal satisfactorily with adjustments that need to be made regarding price, quantities, force majeure, and hardship.

However these advantages of ownership assume the resource is wholly owned which, due to commercial considerations and foreign investment restrictions, is often not the case. Where the resource is owned by a joint venture the time, cost and other perils of negotiating and administering the joint venture relationship are merely added to the normal costs and perils associated with a long-term sales contract.

Further, holding a higher equity stake than the “strategic levels” traditionally held by Australia’s buyers does not enhance the benefits they have sought as against the sellers from such investments³⁵. These benefits can be achieved by the minimum level of equity holding that will entitle the buyer to a seat on the operating committee.

In the joint venture structure perhaps the greatest contribution to security of supply made by a minority interest held by the buyer is that it serves as a sort of second line of defence against a majority partner who may attempt to deal with the title in a way which is not authorised in the agreements, and against the partner’s insolvency. These are factors more relevant when the partner is a junior rather than a major.

Changing Business Models of our Customers

Globalisation is also changing our customers’ business models for reasons unrelated to security of supply. The traditional business model for our Japanese customers was that the steel company or utility focused on producing steel or electricity, leaving the production and shipping of iron, coal, gas to a party with expertise in that area.

³⁰ L Nottage and K Miles, ““Back to the Future for Investor-State Arbitrations: Revising Rules in Australia and Japan to Meet Public Interests” (June 25, 2008), Sydney Law School Research Paper No. 08/62 <http://ssrn.com/abstract=1151167>

³¹ Recent examples include Russia, Venezuela, Bolivia, and Kazakhstan.

³² E Chanlett-Avery, “Rising Energy Competition and Energy Security in Northeast Asia: Issues for US Policy”, (2005) CRS Report for Congress, February 9, 2005 Update at 3.

³³ Lieberthal and Herberg argue that while overseas equity investment may be conducive to oil companies’ gross strategy, holding equity oil assets abroad has little to do with securing the country’s oil supplies. Lieberthal and Herberg, op cit n 15 at 5.

³⁴ With the exception perhaps of such events as increasing environmental and native title requirements, the blocking of Shell’s attempt to take over Woodside, the Western Australian Governments gas reservation policy and increasing royalties to give the government a share of higher prices.

³⁵ See text at note 5 above.

Taking the example of the Japanese power utilities, their corporate charters limited the scope of their activities. Additionally, because Japanese power utilities were a regulated industry, their participation in upstream resource development would have exposed them to difficulties in increasing prices for electricity. It was much safer to buy “on the market” and pass the costs on to customers.

Now, due to the liberalisation of the Japanese power market, for the first time being faced with competition, political pressure to reduce prices, and with shareholders, including foreign investors, intent on improving historically low dividend rates, the utilities are having to increase their focus on ways to minimise fuel costs and improve profits. This has led to new imperatives both to better manage fuel supplies and to participate in other parts of the product chain from which value may be extracted, including the exploration, extraction, processing and shipping phases. It has also led to an increased imperative to ensure that purchase rights are legally enforceable. Similar but slightly different considerations apply to the gas utilities. Even the more traditionally conservative (albeit unregulated) steel mills have begun to take higher levels of upstream interest.³⁶ Korean industry is undergoing a similar liberalisation process.³⁷

Different Customers

Traditionally, Australia’s resource customers have been end-users (mainly Japanese or Korean), often using trading companies as agents to undertake the shipping and import procedures for which they were paid a commission based upon the value or tonnage sold. Although the relationships had rocky beginnings, over the years they have come to be accompanied by a certain degree of transparency and predictability on both sides. There has also been considerable give and take, depending upon the level of interdependency.³⁸

New kinds of buyer have now been entering the markets. Firstly, customers have been going directly to the resource suppliers with the result that the trading companies have lost an important part of their business. This has led them to venture into “principal-to-principal” trading and entrepreneurial investment. From the buyer’s viewpoint, the trading companies are “changing sides”.

Secondly, new “traders” have entered some of the commodity markets, with the consequences discussed later in this paper.

Thirdly, the recent customers from China and India have different levels of familiarity with the international (and Australian) export trade and act in ways different from those that Australia’s exporters have become accustomed to. As already mentioned, Australian exporters sometimes find the motivations of Chinese buyers difficult to understand. On the one hand they seem to be focussing on short term benefits rather than a long-term relationship while on the other hand some of their contracts appears to be only explicable on the ground that they must be strategic long-term. There was no doubt similar bewilderment when Japanese and Korean buyers first entered the market. Foreign buyers, too, no doubt initially find the sellers’ approaches and actions difficult to understand.

CURRENT LEGAL ISSUES

The above background illustrates how recent global events have led our buyers to move away from the traditional model, to take ownership or at least increased equity stakes in our projects and to have a higher level of concern with security of supply. New kinds of buyer have emerged, driven by different motivations and the business models of our traditional buyers are changing. The remainder of this paper considers some of the changes in their investment and purchasing relationships with Australia which are resulting from this new environment and the legal issues arising.

Long-term sales contracts: changes and current issues

Evolution of and increasing reliance on contracts

³⁶ Japan Steel for example, perhaps one of the most conservative of our major customers, has announced it may invest \$1.4 billion in a coal mine in Mozambique.

³⁷ See e.g. Energy Policies in Korea, 14 February 2007, accessed at <http://www.investkorea.org/> under the heading: Government Policy Review on 19 August 2008.

³⁸ For example, relationships between iron ore and coking coal producers and the steel mills have generally been “intimate” while those between producers and steaming coal customers have been less so.

Long-term sale contracts perform different functions for different commodities. In the past, for many commodities, there was a low expectation that the long-term contract would be performed, literally, in accordance with its terms. Rather, contracts were considered “relational contracts” which were viewed as “evidence” of the relationship. The continuation of the relationship relied upon factors such as the “intimacy” of the markets, the high degree of inter-dependency between the parties and longstanding personal relationships to ensure that there would be no “opportunistic behaviour.”³⁹ The persons involved in the negotiation and administration of such contracts, at both ends, were reluctant to change the established relationship pattern.⁴⁰

The rush to secure resources, the accumulation of hard nosed experience in the global markets, increasing scrutiny of directors by shareholders,⁴¹ the changing business models of our customers and the increasing intervention of “traders,” are leading to a shift to “operational contracts”. There is an increasing willingness to try and address issues such as the need for flexibility in the terms of the contract itself, rather than relying upon the “extra-contractual” relationship. Chinese buyers coming to the market generally do not have long lasting relationships with suppliers which might provide an extra-contractual context for dealing with uncertainty and ensuring flexibility where circumstances require it. There is now also greater willingness among all our buyers to test the contracts through formal dispute resolution.

In short, there is an increasing reliance on the contractual document itself and it, in turn, is evolving to more accurately reflect the real bargain between the parties.⁴² This trend is illustrated in the following diagram.

³⁹ Behavior which does not maximize the overall profit (i.e. is “inefficient”) or appropriates the wealth of the other party. See R Farrell, “Research Issues in Japanese Foreign Direct Investment” (2000), CIES Policy Discussion Paper 0024. There are various theories as to why long-term contracts work, and the role of the “contract” document itself in the relationship. See S MacAulay, “Non-contractual Relations in Business: A Preliminary Study” 1963 Reprinted from American Sociological Review, Vol. 28, No.1, February, 1963; D Campbell, “Ian Macneil and the Relational Theory of Contract” 2004 CDAMS Discussion Paper 04/1E March 2004; M Hviid, “Long-term Contracts and Relational Contracts” *The Encyclopedia of Law and Economics*, vol. III, B Bouckaert and G De Geest (eds), (Edward Elgar Publishing, 2000).

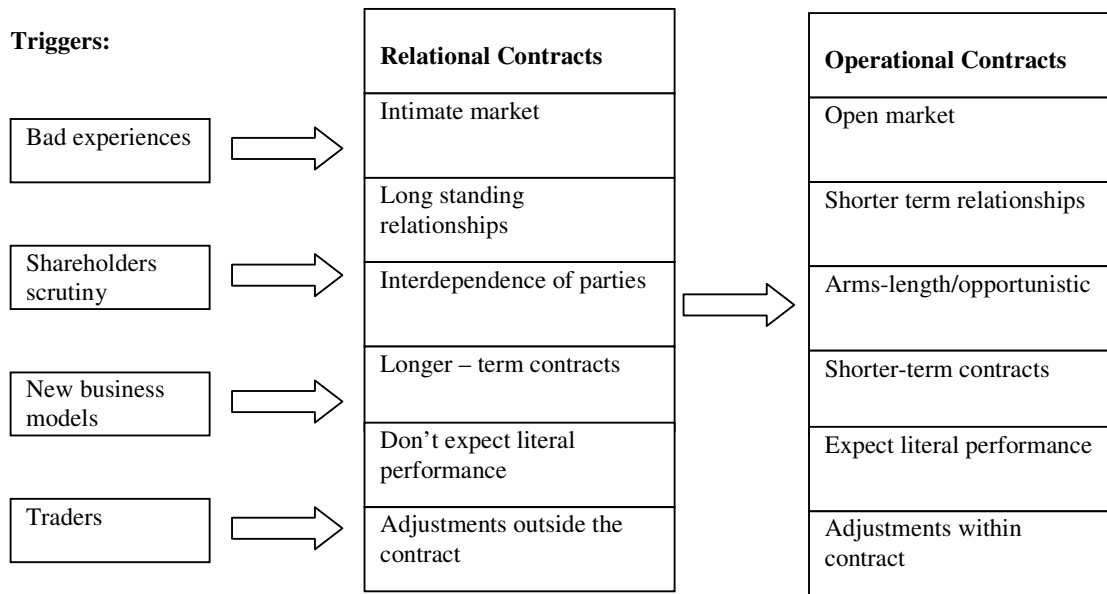
⁴⁰ In one project the author was involved in, a major 20 year sale contract was expiring as reserves in the mine depleted and the parties agreed to develop a new mine nearby and enter a new contract. Despite the numerous problems that had emerged with the contract over the years and general agreement that it was deficient, the parties decided to use it unchanged for the new project rather than “open up a can of worms and let the lawyers run all over it.”

⁴¹ In China, shareholder scrutiny is managed by putting the more controversial investments in the hands of CNPC itself rather than its market-listed global arm. See Lieberthal and Herberg, op cit n 15 at 18. This need partly arises from new internal requirements for “sign-off” by external legal counsel, that the transaction is in line with usual practice and contains no significant downsides for the buyer.

⁴² Regrettably perhaps, the evolution does not appear to be extending to the widespread adoption of the Vienna Convention on International Sales of Goods, although Japan has now acceded. See L Nottage, “Who’s Afraid of the Vienna Sales Convention (CISG)? A New Zealander’s View from Australia and Japan”, Sydney Law School Research Paper No. 06/21 Available at SSRN: <http://ssrn.com/abstract=880372>

Evolution of a Long Term Sales Contract

Triggers:

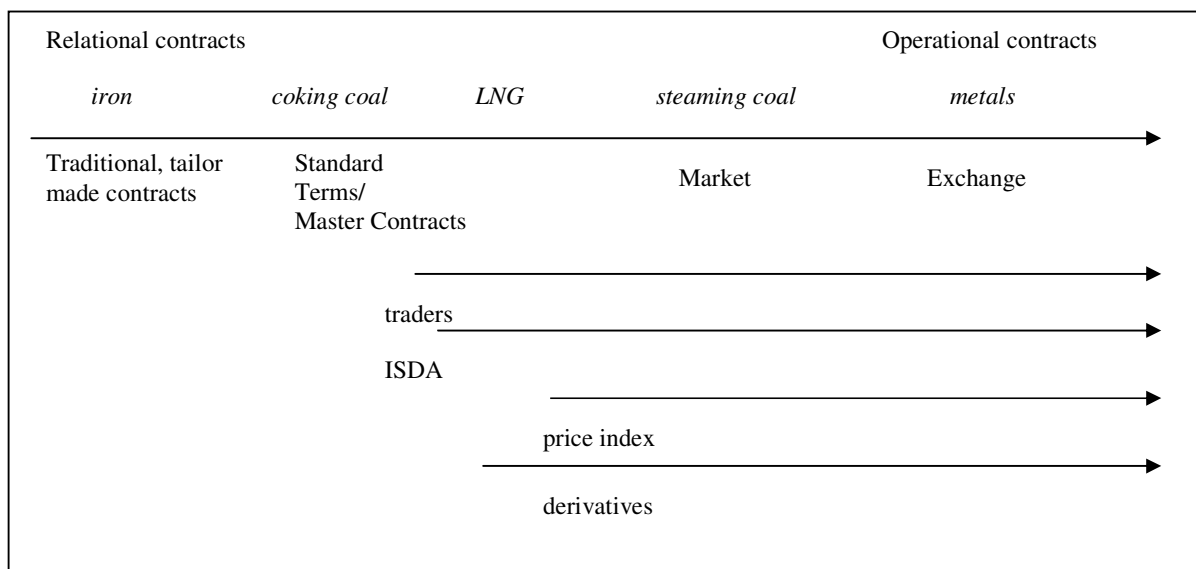


Commoditization

Regardless of the commodity, the long-standing often personal relationships between our traditional customers and their suppliers were somewhat static and isolated. The changing business models discussed above are now forcing our buyers to actively manage their procurement by participating in the markets in order to minimize fuel and raw material costs, secure added value opportunities and gain greater flexibility. The new “managed portfolios” of resource supplies involve a greater variety of transactions, including shorter term contracts and spot transactions, the on-sale of cargoes the buyer is entitled to or has on the water, the purchase of such cargoes from other buyers and traders, cargo swaps, and transactions that are settled financially rather than physically.

These changes are in turn leading to the standardization of quality and other terms, an increase in the use of master contracts, removal of restrictions on the seller in terms of where he can source the commodity and on the buyer in terms of where he can use the commodity, the quoting of market prices, the entering of contracts (and trading of contracts) on markets and exchanges and derivatives trading. Many of the contractual distinctions between contracts for physical delivery and those for financial delivery are disappearing. The trend is illustrated in the following table.

Trend towards commoditization



Different commodities are at different points along the trend line. Iron ore contracts fall towards the traditional end, there being few sellers and few buyers, no other use for the product, a high degree of interdependence between the buyers and sellers, simple contracts and much adjustment taking place outside the contract. In contrast steaming coal is toward the market end of the spectrum, with GlobalCoal providing an on-line market trading place, a Standard Coal Trading Agreement (SCoTA) and standards for FOB deliveries and a price index. The multiple of the paper trade to the physical trade is growing. Since steaming coal in essence competes with oil and gas as a fuel source it is inevitable that it move faster towards commoditization than coking coal and iron ore.

Part of this commoditization trend has been the increasing incorporation into the contracts of ISDA type terms, which tend to be used as the standard for all types of traded contracts⁴³.

Although suitable for spot or short term contracts, these terms seem to be creeping into resource contracts generally, without much consideration of whether they are appropriate for a longer term relationship. Standardized terms of this kind preclude the possibility of the buyer requesting specific performance, and many of the reassurances the parties may wish to include, such as: restrictions on sellers dealing with reserves, ownership of the reserve, most favored treatment of the buyer, and from the seller's viewpoint, special force majeure events, sharing of risks, good faith, and other flexibility mechanisms.

Contractual Cross-Fertilization

There are no model long-term sales contracts generally used in the market for iron ore, coal (except for SCoTA) or LNG. However for each of those commodities there is a more or less common understanding of the issues open for negotiation and the range within which those negotiations take place. What is interesting is that there are many legal and commercial issues which are common between the commodities but for which the generally accepted solutions differ. Sometimes the different approaches can be explained as arising from technical differences between the commodities. Often, however, they seem to be more a consequence of particular practices having grown and been perpetuated in the particular "intimate market." Examples include differences in: approaches to pricing mechanisms, dispute resolution, hardship, force majeure, sourcing and destination flexibility, quantity flexibility, assurance of cash flow and liability caps. Similar observations can be made of the joint venture agreements used for different commodities, including the treatment of relationships with the operator, decision making majorities, deadlock breaking, consequences of default, and restrictions on assignment.

⁴³ For example, terms such as: netting, close-out, settlement of differences, caps on liability, and termination.

One might anticipate that following the “de-intimisation” of some of the markets as a result of factors mentioned above, there will be greater movement towards the sharing of best practices across the contracts used for different commodities.

Agreements to agree, re-openers, hardship and good faith

Parties to long-term contracts generally realise that events are likely to arise during the term which are unforeseeable when the contract is entered into, or which, if foreseen, are better not raised or dealt with contractually at that time.

Accordingly, long term contracts typically include a variety of “open” provisions, including “agreements to agree,” and re-openers, under which a party is given the right to re-open either specific provisions of the contract (such as price) or the contract generally. Some such clauses may be invoked at specified intervals, such as every third anniversary, while others can be invoked anytime, for example if a party claims hardship. Sometimes the clauses provide that if no agreement is reached there is no change, or the matter goes to arbitration. More often than not however the clause is not clear, implying that if no agreement is reached there will be no change.⁴⁴

Sometimes the ambiguity is unintended. There is a finite limit on the ability and interest of parties (and even lawyers) to foresee every combination of events that may arise. Often however the ambiguity is conscious. The parties realise the events may arise but are not sure whether, in the circumstances that may arise, they will be better or worse off with a particular solution (“conscious ambiguity”).

Such “open” provisions sometimes contain a requirement for the parties to act in good faith. In other cases the provision itself seems to give the parties unfettered discretion, but there is a general good faith clause in the agreement. In those cases where there is no express provision that the parties act in good faith, inclusion of the “open” provision may make possible the implication of a requirement for good faith.

The question lawyers are being asked to advise on frequently is the extent to which each party (in the case of open clauses) or the non-requesting party (in the case e.g. of hardship clauses) has a duty to take account of the other party’s position, in deciding whether to acquiesce to the request or exercise its discretion. A related question is whether such a requirement would apply to the substance or merely to the process.⁴⁵ The answers to these questions often depend on how important the relevant legal system considers the need for certainty to be: whether it pays a high level of respect to the sanctity of contract, or applies views of fairness taking into account moral, economic political, institutional and other considerations. It is of course theoretically open to the parties to choose the system which best suits their objectives. Indeed in economic theory the parties would weigh the benefits of a flexible provision against allowing the decision maker to devote his/her attention elsewhere.⁴⁶

This is a developing area of the law which has been well canvassed in previous AMPLA conferences.⁴⁷ However it would be helpful if, for example, model forms could use one form of words, with commentary on the meaning thereof, in the hope that parties will start to use them consistently and that a greater body of legal authority will emerge around them.

Joint venture arrangements: changes and resulting issues

Investment by the “supra corporates”, NOCs, sovereign funds and IOC aspirants

“We [Australia] [must] go to the back of the queue because we are safe, we are secure for investment and companies can get to Australian assets when others are not available.”⁴⁸

⁴⁴ The author recently counted 9 such “agreements to agree” in a long-term LNG SPA, all worded slightly differently.

⁴⁵ Daintith, op cit n 29.

⁴⁶ See eg, L Nottage, “Changing Contract: Renegotiations in English, New Zealand Japanese, US and International Sales Law and Practice”; L Nottage, “Tracing Trajectories in Contract Law Theory: Form in Anglo-New Zealand Law, Substance in Japan and The US” (2007), Sydney Law School Research Paper (2007b, forthcoming); S Gifford, “Limited Attention and The Optimal Incompleteness of Contracts” (1999) Journal of Law, Economics, and Organization, Volume 15, Number 2.

⁴⁷ See eg, Daintith, op cit n 29.

⁴⁸ Resources Minister Martin Ferguson, The Australian Financial Review, 16 January 2008. Criticisms on big oil abound, including theories that “a leading company such as ExxonMobil, or some shadowy corporate collective is engaged in a vast

This quotation contains two interesting messages. One is that Australia has now almost unique standing as a stable host country for resource investment and supply. The other is that there is a widely held fear, sometimes bordering on paranoia, of entities with sufficient economic power to execute global strategies. Criticisms in the past have focussed on the IOCs who have been viewed as more powerful than some sovereign states and yet beholden to no electorate other than their shareholders and to their own self-adopted codes of conduct. (“supra corporates”)

Fear that Shell, if it had gained control of Woodside, might not “develop the resource to the maximum” or might not “promote NWS sales in preference to competing sales from projects in other parts of the world” were reasons the Treasurer gave for prohibiting Shell’s acquisition.⁴⁹

A variety of similar fears are now being expressed about the NOCs, as they flex their economic muscles on the international market, other foreign state owned enterprises, sovereign wealth funds and the “IOC aspirants” that Japan and China have both announced they aim to nurture. Concern has also been expressed as to investments by buyers, particularly where the investment gives the buyer control over an existing project.⁵⁰

The Australian government has recently taken an admirable step forward in articulating its concerns with respect to such investments and the factors it will be taking into account in evaluating them. These include whether the company will be responsive to shareholders and whether investment and sales decisions will be driven by market forces rather than external strategic or political considerations.⁵¹

The policy does not appear to be inconsistent with the need to continue to encourage foreign investors to fund speculative exploration and development of resources. Hopefully it will be possible to develop more specific guidelines which will satisfy foreign investors’ needs for transparency and predictability.

Minority interest holder issues

While wanting a strong and experienced local operator as joint venture partner, the minority interest foreign investor typically has a fear of “losing control” or “writing a blank cheque.” The answer in older joint venture agreements was to focus on the “veto” or “supermajority” list of matters, decisions on which would require the minority investor’s approval. The list was fiercely negotiated and often the result made little sense. Frequently the list would include decisions which, if not made would essentially close down the project (e.g. annual programs and budgets), decisions which even if not made would not stop the project (e.g. expansions) and checks on the operator (e.g. dealings with companies related to the operator). Often these provisions were accompanied by an ill-considered “deadlock breaking” mechanism.

Experiences over the years with deadlocks in the decision-making process and a greater understanding by minority venturers that ownership may change and that it may not be in their best interests for another minority venturer to be able to obstruct the project, have led to more sophisticated protection mechanisms including a combination of:

- More carefully negotiated definitions of the scope of the venture;
- More sophisticated super majority and deadlock breaking mechanisms;
- More widely accepted standards of care and limitation of liability on the part of operators⁵²;
- Clearer procedures for dealings with the related bodies corporate;

conspiracy to deprive humanity of its rights and of the benefits that should properly flow wherever crude is found in abundance.” D Clarke, *Empires of Oil: Corporate Oil in Barbarian Worlds* (Profile Books, 2007), p 41.

⁴⁹ P Costello, “Foreign Investment Proposal – Shell Australia Investments Limited (Shell) Acquisition of Woodside Petroleum Limited (Woodside)”, media release, Australian Government Treasury, Canberra, 23 April 2001.

⁵⁰ Speech by the Treasurer Mr. Swan to the Australia-China Business Council, 4 July 2008.

⁵¹ Ibid. Drysdale and Findlay doubt that any additional restrictions or tests are required to protect Australia’s interests where foreign buyers interest. Drysdale and Findlay, op cit n 21.

⁵² There are coalescing views within industries on the level of responsibility an operator should have, although the standards, caps etc differ somewhat between mining, oil and gas.

- Rights to opt-out of new operations which are commercially severable from existing operations (e.g. new mines, new fields, expansions);
- Ability of the majority operator to sell out without triggering pre-emptive rights, including tag-along and drag along rights for smaller minority interest holders; and
- A tag along to protect against changes in control of the majority participant/operator.

The long-term sales contract/equity combination

The combination of a long-term sales contract with an equity interest presents a distinct range of legal problems.

Are the equity holding and the product sale interdependent?

Issues include: can the buyer terminate the long term sales contract; if the long-term sales contract terminates, can the other venturers insist that the buyer investor withdraw from the venture; can the buyer insist on being bought out? Does it make any difference if the termination is due to breach or the result of operation of the contractual terms (e.g. because of failure to agree on price at a regular price review)? At the beginning of the project the equity/sales components are treated as a package. However in Australia they are typically documented separately and no mention is made in the joint venture agreement of the sale arrangement (or at most, only a mention in the recital) and no mention is made in the sales contract of the fact that the buyer is an affiliate of a venturer. When the issue arises often the lawyers are left to unearth the heads of agreement and other documentation from the time the package deal was originally negotiated and delve into the law of implied terms, estoppel, collateral agreements and entire agreement clauses, to the fascination of buyers unfamiliar with these topical but abstruse elements of our law.

Does the buyer have greater than usual duties under the sales contract?

Another question is whether the seller under the long term sales contract is able to argue that the buyer has a higher level of duty than would be normal under a sales contract because of fiduciary type duties applicable under the joint venture agreement.

In at least two instances of which the author is aware, the Australian parties have in effect sought to impose good faith obligations on the foreign long-term contract buyer, by claiming that the Australian subsidiary of the buyer which held the joint venture interest was the alter ego of the overseas buyer. Issues include the nature of the obligations between the venturers and how they are affected if the venture is incorporated, or if, although the venture is unincorporated, sales are made through a jointly owned sales company.

To what extent should the buyer be involved in marketing and sales?

The “national interest” concerns of buyers investing in suppliers are referred to above.

As between the buyer and the other investors, a major issue in the equity/long-term sale combination is the extent to which the buyer’s representative on the management committee (or the marketing organ), should have access to information concerning marketing policies, potential customers, the status of negotiations with such customers, prices, and a say in the final decision on who to sell to.⁵³

On the one hand, the foreign buyer as venturer feels it should have access to all important venture information and should be represented in decisions concerning major commitments. On the other hand the fear is that it may use such information or influence such discussions for its own interests, and that other customers will not be interested in dealing with the project if details of their dealings are known to their competitors.

At law, where the venture is incorporated, a director’s right to access information in the company, and the circumstances in which that right is circumscribed, have been reasonably well defined. Even where the venture is unincorporated, the structure often provides for sales to be made through a jointly owned marketing company,

⁵³ From the viewpoint of the overall economic efficiency of the sale, economists suggest avoidance of “asymmetrical information” is likely to lead to smoother adjustments of the relationship. See S Wiggins, “The Comparative Advantage of Long-Term contracts and Firms” (1990) *Journal of Law, Economics, & Organization*, Volume 6, Number 1, at 165.

which imports the corporate law confidentiality regime. However there is often a suspicion, and sometimes an expectation, that nominee directors will in fact be passing information back to their appointing venturers.

Joint venture agreements sometimes clarify the position. There seems to be no common approach. In some cases the buyer's representative is allowed to participate in such discussions on the understanding that he will act only in the interests of the project and not disclose information to the buyer. At the other extreme some ventures entrust all marketing and sales commitments to the operator.⁵⁴ A middle course is to put in place a marketing procedure that prescribes the discussions the buyer's representative can join, when he must absent himself, what information he may receive, what access he has and what information he is permitted to disclose to his appointing buyer.

CONCLUSIONS

Australia's relationships with its resources customers are moving away from the traditional strategic equity stake/long-terms sales contract model. Customers will continue to move towards more active management of their "procurement portfolios" by entering into a greater variety of more sophisticated transactions, both physical and paper. Various changes, including the increasing intervention of intermediary traders and the introduction of buyers from China and India, will continue to drive the move away from the traditional relational agreements towards more operational and commoditized transactions.

The move by customers to higher levels of equity ownership gives rise to national interest issues for Australia and conflict of interest issues for its resource suppliers. As Australia's resource customers accumulate experiences in the more hazardous host countries, and in controlling and operating projects, I predict that they will reassess the current rush to higher levels of upstream ownership, and take a more considered approach to the relative merits of ownership as against long-term contracts and reliance on the markets. We are likely to see customers moving in and out of ownership positions as their internal corporate strategies change from time to time, reflecting market forces.

The NOCS and the new IOC aspirants will lead to a larger and more diversified pool of owners, operators and customers in the oil and gas sector. Similar changes are happening in the other sectors.

The agility of Australia's resource developers will enable them to remain in the forefront of such developments, and Australia's relative political stability, rule of law and proximity to Asia should ensure it continues to be uniquely attractive to customers as a supplier of resources.

⁵⁴ Often the foreign buyer is appointed exclusive representative for his home country, or for Asia, which gives rise to interesting discussions as to whether the operator can visit customers alone and who has to report to whom on customer contacts etc.