COMMENT ON INSTITUTIONAL INVESTMENT IN MINING AND PETROLEUM RESOURCE PROJECTS

By W. M. Blanshard

My commentary on Mr. Alan Coates' paper accepts his emphasis on equity participation by institutions rather than on debt financing. I shall comment under several headings, at the same time making reference to particular points in the paper.

1. REASONS AND ADVANTAGES

The first heading is the reasons for institutional investment and the advantages which flow from it. As a group the institutions represent an Australian source which is capable of significantly contributing to the scale of funds required.

There is also the shortage of other opportunities. The inability of the share market to absorb the funds available and the downturn in property development have been factors. Our larger life offices are large by world standards and on the Australian scene they are major mobilisers of funds. The possibility of consortia of smaller insurance companies and pension funds participating too should not be overlooked.

The institutions have the financial capacity to take a long view and to withstand the escalation of costs and fluctuations in world markets which characterise most natural resource projects and investment in them is a role to which the institutions have become accustomed. However to place their contribution in perspective I should quote from the address of a leading banker given at the C.E.D.A. Forum in November:

> The life office and pension funds have specific obligations to their members and some statutory obligations to meet. While they can be expected to make reasonable contributions to development finance, it is clear that the sums available from them will still fall well short of the amounts required in total over the years ahead. The picture that emerges is one where the capacity to totally fund expenditures from domestic sources in the time scale envisaged is not evident. If we are to achieve our potential, then overseas borrowing of substance is going to be required.[1]

This brings me to the foreign investment rules to which Mr. Coates refers and which have been a major factor in the growth of institutional investment in this field. This growth has coincided with the demise of the Petroleum and Minerals Authority and the reduced role now being played by the AIDC as an equity participant as distinct from a lender. Governments have not vacated the role of direct participation and one example which illustrates both government and institutional involvement was the acquisition in 1977 by the Queensland State Government Insurance Office of a 20 per cent shareholding in the Australian subsidiary of an American oil company. However we have not seen a successor to the Petroleum and Minerals Authority and a role of providing Australian ownership has fallen on the institutions.

A further advantage which may result from participation by Australian institutions is exemption from withholding tax on interest paid to non-resident lenders which could be available if the Australian content in an entity or enterprise is sufficiently high.[2]

2. CONSTRAINTS

Under the next heading let us look at some of the constraints on institutional investment.

First of all there are the limitations imposed by the institution's own constitution. It may be incorporated under the companies legislation or it may have been established by its own act of incorporation. In either case the limits on its powers or capacity may be relevant.

Other limiting factors may be found in the legislation governing the industry in which the particular institution operates. For example the Life Insurance Act prohibits a life company from giving any charge over assets otherwise than to secure a bank overdraft.[3] This provision may inhibit certain types of borrowing although at the present time there appears to be no reason why the life company cannot form a wholly owned subsidiary in order to hold assets and to charge them if required.

Apart from the solvency requirements there is broadly no relevant supervision or regulation of investments under either the Life Insurance Act[4] or the Insurance Act at the present time. However the Federal Treasury has recently proposed amendments to the Insurance Act including specific restrictions on real estate and mortgage investment. Amendments to the Life Insurance Act were enacted in 1977 and although the relevant ones have not yet been gazetted there is cause for concern that their ultimate form may hamper investment.

Of course the thirty/twenty rule[5] requiring life offices to put 30 per cent of their moneys into public securities in order to qualify for available tax benefits has a major impact on investment policy and on the availability of funds for natural resource projects.

Another taxation constraint to which the paper refers is the treatment of institutions in respect of investment allowances. Given the Federal Government's wish to encourage Australian equity it is anomalous that an Australian institution can be a member of a joint venture comprising foreign as well as Australian companies, all members of which except the institution are entitled to the investment allowance. The disqualifying factor in this instance is that the institution does not satisfy the "wholly and exclusively" test under s.82AA of the Tax Act.

The paper also refers to the provision of infrastructure and again there appears to be need for amendment to the Tax Act in that a life office would not qualify as an equity partner in a leasing transaction under the current definition of "leasing company".[6]

Although one may not question the emphasis given by Mr. Coates to direct equity participation, this form of investment could give rise to unlimited liability on a massive scale and there is a limit to the percentage of its assets which an institution would invest in any one project. While the extent to which governments may seek to regulate these aspects remains to be seen, it is an inhibiting factor for trustees or managers of superannuation funds that investment of this kind is longterm, difficult to value and liable to unforeseeable cost increases. Perhaps these factors will lead to the creation of "venture" or "natural resource" units in which trustees or fund managers could invest a proportion of their moneys conscious that different performance criteria will be applied than, for example, to units invested in ordinary shares which are more readily valued and saleable.

The paper focuses on the life offices but one can foresee increased investment in natural resources by other institutional investors. For example, the New South Wales Superannuation Board recently had its Act amended to considerably expand its

investment powers.[7] Government or semi-government funds of this kind enjoy a competitive advantage in that they are not subject to the 30/20 rule.

Further constraints on institutional investment may arise from the nature of the project itself. In a situation in which an institution is entitled to its share of production this share can be sold on its behalf to end-users. However when the other participants in the project are themselves end-users and there are take-or-pay obligations problems could arise for an institutional investor or indeed for any participant not actively engaged in the industry. Similar problems could arise in the supplier as distinct from the consumer context. A processing project would be an example. If all participants were expected to supply their share of raw materials an institutional investor without assured sources of supply may find participation impracticable.

A final point under the heading of constraints is that of overseas investment by institutions. This may seem to be outside the scope of the present topic but a project could be involved in mining raw materials in Australia and processing them abroad. The requirement of the Life Insurance Commissioner that assets be matched with liabilities in each country might in such a case require relaxation. As you are aware the Reserve Bank administers requirements for direct overseas investment and limits overseas portfolio investment.

3. VEHICLES OR STRUCTURES

Under the next heading I shall make a few disjointed comments on vehicles or structures. As Mr. Coates observes the joint venture approach has been preferred for domestic tax reasons of both foreign and Australian participants. I agree with his observation that the really successful joint venture is the one in which the parties never have cause to look at the documents and most of us are aware of cases in which the parties did not even get around to signing the documents.

Reference is made to provision of funds on an unsecured basis protected by a strong negative pledge. Recent examples of this by Australian public companies have been Wormalds and Pioneer Industries both of which have substantial overseas assets. In the resources field it should be possible to structure a project so that security to the lenders falls away once a certain level of cash flow is achieved. Benefits of unsecured lending would include increased flexibility for a borrower in dealing with its mineral titles and possibly considerable stamp duty savings in that registration of a charge over such titles with the State Mines Department would not be required.[8]

I shall not cover old ground by discussing the comparative advantages of incorporated and unincorporated joint ventures or shareholding as against direct ownership interest. Various types of preference shareholding have been used combining for example certainty of return with provision for super profits. Trusts have also been examined but given the current tax laws here their use is somewhat restricted. I understand that a unit trust arrangement was considered as a vehicle for investment by institutions in the North Sea but for various non-legal reasons was shelved.

Earning an interest by exploration or development expenditure is a well trodden path for mining companies but Mr. Waite will be commenting on a recent institutional investment by this method which encountered problems.

The paper makes reference to customer finance, a recent example of which was the lending by Shikoku Electric Power Company to Queensland Mines to finance the Nabarlek uranium project.

There are also a number of recent examples of foreign customers acquiring substantial equity positions in mining companies which are potential suppliers, including Japanese investment in New South Wales and Queensland coal. These moves appear to have been encouraged by State Governments and acquiesced in by the Federal Government. However it is interesting to speculate what influence they will have upon the Federal Government's export controls, upon the currency in which development funds will be denominated and upon decisions amongst the participants themselves in relation to production, expansion and marketing.

It may be that the limited partnership vehicle utilised in some of the American states may have a role to play in natural resource development here particularly for institutional investors. It is still possible in three Australian states to form a partnership in which the managing or general partner has unlimited liability and the liability of the other partners is limited to a specified amount.[9] In cases in which the parties could live with a partnership structure for tax purposes its use might be worth consideration.

The paper refers to the carried interest to which an exploration company may be reduced and which in many cases it would welcome. Taking this a stage further purchasing the carried interest or royalty rights may become a role for the institutional investor. The flow of income would be tax-free if a superannuation investment, and the explorer would receive a capital sum leaving him free to turn his attention to fresh ventures. The buying into Hampton Gold Mining Areas by the Colonial Mutual seemed to have some of these characteristics.

4. GOVERNMENT ACTION

The next heading for comment might be termed government action. The paper contains cautionary remarks on the effect of changes in the rules of play and I daresay this applies to changes in the rules by the governments of customer and lender nations as well as by those in the host country. The following are recent examples:

A. The re-introduction of the export marketing guidelines in October 1978.

B. The hint by the New South Wales Premier in February this year that royalties on privately owned coal in New South Wales may be diverted to the Government.[10]

C. Notwithstanding the existence of a special Act of Parliament adopting an agreement for the Bluff aluminium smelter in New Zealand[11] the government increased the rates payable for the power being supplied to that project.

D. In some instances the introduction by State Governments of measures to regulate foreign investment have amounted to changes in the rules of play and, particularly on the occasions in which they have been directed against "foreigners" from interstate, they have detracted from a national approach to this topic.

Whilst the securing of political advantage or community acceptance might make it too much to hope that the background against which an investment was undertaken will not be altered, nevertheless it might be possible to entrench the manner in which any alteration can be made. The problems of doing so were discussed in a paper given at the first annual conference of this Association.[12]

At the same conference Mr. McCrossin of the Resources Bank expressed the view that if a major Australian lender had been involved in Fraser Island, particularly one which gathered in private savings within the country, the Federal Government may have hesitated to intervene.[13] Perhaps on the same analogy governments may be less ready to change the rules if Australian institutions have an equity stake.

In the context of a mineral processing project, I recently studied the legislation covering the supply of electricity in all States and that covering emergency powers. This exercise leads me to comment that apart from changes in the rules of play the possibility of detrimental consequences under the existing rules[14] presents a challenge to the lawyer.

The paper's references to bringing in major partners and to "sweeteners" highlights the need for governments to be receptive to dealings with tenements and licences and not to adopt the rigid approach shown in some States that any so-called trading in interests is unacceptable.

5. OVERSEAS EXPERIENCE

My next heading is overseas experience. Time does not permit a detailed comparison between institutional investment here and abroad. However broadly speaking it can be said that insurance companies and pension funds in the United Kingdom have taken an active role in equity investment whereas their counterparts in the United States, or in any event the life offices, have been lenders rather than equity investors.

So far as investment in natural resources is concerned valuable material is to be found in a United Kingdom report entitled "The Financing of North Sea Oil" published in May 1978 by the Wilson Committee.[15] On the involvement of United Kingdom financial institutions the report had this to say:

> The financing needs of North Sea Oil exploitation have drawn upon the skill and resources of many parts of the U.K. financial system. By far the greatest contribution has come from the banks, who have had the task of mobilising very large sums of development capital. But other institutions also sought out opportunities for involvement mainly through equity investment in exploration companies.[16]

The report contains several case studies one of which deals with the Lasmo and Scot companies formed in response to a perceived demand from institutional investors for some means whereby small direct stakes could be taken in North Sea exploration. The original shareholders in these companies included such names as General Accident Fire & Life, Scottish Equitable Life, The Commercial Union, The Prudential and the W.H. Smith Pension Fund.

Lasmo/Scot holds interests in the Ninian Field upon which oil was discovered in January 1974. In order to raise its share of the development finance it issued unsecured loan stock to which was attached the novel "Oil Production Stock" which offered holders a percentage of the value of production.

Another useful United Kingdom publication is the January 1978 issue of the Law Society Gazette devoted entirely to the subject of oil and containing several articles by practising lawyers.

By and large it has been unnecessary for United Kingdom life companies and other institutions to take a direct stake in natural resource projects by reason of the other opportunities available to them. Compared with their counterparts in other countries the Australian institutions have taken on almost a unique role by reason of the combination of factors which I have mentioned.

6. CONCLUSION

Finally, let me pose two related questions upon which the paper was silent but which may stimulate discussion at the conclusion of this session:

1. The first question is how can the institutions reconcile their desire for direct equity participation with the risk of unlimited liability?
2. And secondly will the institutions be prepared to enter some projects before feasibility has been established and the development risks evaluated thereby increasing the slice available for Australian ownership and reducing the price though not the risk of entry?

FOOTNOTES

1. M. Brunckhorst, Committee for the Economic Development of Australia, 8th November 1978
2. Division 11A of Part III of the Income Tax Assessment Act.
3. Section 38(3) of the Life Insurance Act.
4. *Ibid.* s.39(1).
5. Section 110A of the Income Tax Assessment Act.
6. *Ibid.* s.82AQ(1).
7. Section 5C(4)(e) inserted into the Superannuation Act 1916 by Superannuation (Amendment) Act No. 143 of 1978.
8. See for example the N.S.W. Mining Act 1973 s.107.
9. Western Australia, Limited Partnership Act 1909; Queensland, The Mercantile Act of 1867; Tasmania, Limited Partnerships Act 1908.
10. Address to the "First National Energy Conference" in Newcastle 7th February 1979. See page 1 of Australian Financial Review 8th February 1979.
11. The Manapouri-Te Anau Development Act 1963.
12. First Annual Conference of AMPLA, paper by K. D. MacDonald page 29 of Volume 1 1977 No. 1.
13. *Ibid.* page 178.
14. See for example s.83 of the N.S.W. Electricity Commission Act 1950.
15. Committee to review the functioning of financial institutions — research report No. 2 — "The Financing of North Sea Oil" published by Her Majesty's Stationery Office London May 1978.
16. *Ibid.* paragraph 2.22 page 14.

COMMENT ON INSTITUTIONAL INVESTMENT IN MINING AND PETROLEUM RESOURCE PROJECTS

By J. H. Waite

Mr. Blanshard has commented from the viewpoint of the institutional investor. I would like to make some comments and observations from the viewpoint of the project sponsor.

Because the paper is largely devoted to an expression of views upon the likely shape of investment in the development of Australian resource projects in the future the commentators should ideally be international investment or merchant bankers. For it seems to me the international bankers, better than anyone else, can take an overview of the Australian investment environment in the natural resources sector and make meaningful comparison with the investment environment in other countries.

I must stress at the outset that my observations on Mr. Coates' paper are made from the rather introspective position of an Australian lawyer. In the main my observations are based upon impressions gained from working in an advisory capacity with the mining and petroleum industries over a number of years.

My first observation is upon the statement by Mr. Coates that the interest of his organization lies essentially in equity participation in resource development rather than debt financing. He states the reason for this preference is that as custodians of long term savings, the effects of inflation are such that the prospect of a fixed return over periods as long as forty and fifty years holds very little or no appeal.

It seems to me that equity participation in resource development usually carries the high risk. I question whether it should really be the major thrust of an institutional investor, who is the custodian of the funds of others, to concentrate on equity, and relatively high risk, investment. It may be that the emphasis, at least by Mr. Coates' organization, will be to seek to avoid the more risky projects in favour of projects with substantial sponsors and which are, technically, less likely to run into trouble. As Mr. Coates said this morning, it is hoped that the successful ventures will yield such profits as will enable losses on some lemons to be absorbed.

Perhaps the answer lies in loans convertible to equity at a future time when, at best estimates, at least much of the front end risk will have passed. Alternatively, or additionally, the debt portion of the investment could have a variable rate of return, for example regular interest reviews, or an indexed principal sum, so that returns would keep pace with inflation.

The next aspect upon which I would like to comment is the view expressed by Mr. Coates that due to the need for economies of scale it is likely that only large scale resource ventures sponsored by relatively large corporations, either domestic or foreign, are likely to proceed from the grass roots level.

I could not agree more where there is a substantial over supply of the relevant resource on world markets. However, should the reverse be the case, then I can foresee a need to develop smaller mines, with smaller corporations participating. Smaller mines can be brought on stream more rapidly and for less cost. Also, there is the important factor that the absolute amount of cost overrun is bound to be less in a small or medium sized project. A cost overrun of 10 per cent on a $3,000 million project is a substantial sum, and someone has to be found to carry that risk. The same

percentage on a $30 million project is considerably less and could be readily covered by the project sponsor, or a bank or other third party guarantor.

It would be my hope that Australian institutional investors will look at ways and means of assisting small and medium sized resource projects, and not ignore them in favour of the billion dollar projects.

Another aspect mentioned by Mr. Coates is the lack of faith of lenders in the concept of cash flow security. He refers to such factors as inflation of operating costs, inflexible pricing arrangements and diverse international attitudes to the sanctity of sales contracts having collectively led to this lack of faith.

My particular experience has been that lenders to resource projects in this country have never felt particularly comfortable about the concept of cash flow security. They always want something more, and for this reason so called pure "non-recourse" financing is virtually unknown here.

In my experience lenders to resource projects have always acknowledged the legal and commercial difficulties inherent in enforcing international sales contracts. I do not think anything has occurred in recent years which has led to the faith of lenders in the concept of cash flow security having been, as Mr. Coates puts it, "materially shaken".

The acknowledged weaknesses of cash flow security are sometimes sought to be alleviated by having the buyer of the resource product as a lender to the project, or even as an equity participant. The theory of buyer credit is that the buyer will have an incentive to take or pay for product to keep the project whole.

In my view the concept of buyer credit is very much a two edged sword. In times when market conditions are poor (that is, in over supply situations) there should be no difficulties. On the other hand, when market conditions are favourable (that is, when it is a sellers market) considerable pressure can be exerted by the provider of the buyer credit to keep the price to him of the product low.

This pressure is more easily exerted by a buyer who is an equity holder in the project sponsor, through Board participation. However it can also be exerted by a buyer/lender, particularly if the amount of its lending to the project is significant.

It is a matter of judgment in each project as to whether buyer credit should be introduced. My view is that buyer credit is generally unsatisfactory because of the potential conflicts of interest.

Mr. Coates indicates that much of the participation in resource projects which comes into the hands of institutional investors in Australia results from the operation of the Federal Government's foreign investment guidelines which compel the foreigner to cede part ownership to Australians. I do not disagree, but perhaps feel the institutional investors in Australia could be more aggressive in seeking equity and debt positions in resource projects without, as it were, relying upon the foreign investment guidelines to invite them to participate.

Mr. Coates indicates that because world political instability is increasingly becoming the norm, he sees no problem in attracting the necessary loan funds from international markets. But perhaps that is only part of the story.

I understand from various items that have appeared recently in financial publications, that interest rates overseas have recently moved up at a fairly rapid rate. Some of the economic commentators attribute this movement to worldwide political instability, and state that interest rates are traditionally lower in times of political stability. My friends at the Australian Resources Development Bank have confirmed to me this is also their experience.

Interest rates also move up as the prospects of higher inflation increase — and there does seem to be a widespread fear that a renewed bout of worldwide inflation may be upon us. The present resurgence in commodity prices, while a welcome boost to many of our clients, does not auger well for the fight to restrain inflation. After all it was the 1973 boom in commodity prices, not just OPEC's hike of oil prices, but steep rises across the board, which precipitated the last bout of this global disease.

Should global political instability and high inflation rates continue, then one would expect interest rates to continue to rise. If this assumption is not fallacious, then the cost of money being offered to Australian resource projects from international money markets can be expected to increase. Accordingly, while the loan funds might be available from overseas for investment here, the cost of those funds in times of world wide political instability and high inflation might operate as a deterrent to development. This would be particularly so in cases where the viability of a project in the early years is only marginal in any event.

Many practical difficulties occur when there are substantial hikes in interest rates on a world wide basis.

Rising interest rates will often (although not always) lead to a declining share market as dividend yields become decreasingly attractive. Borrowers whose assets include shares in listed companies can see a rapid decline in the worth of their assets, and this may lead to breaches of borrowing limitations such as asset to liability ratios in loan agreements.

Rising interest rates can also make public share issues less attractive. The dearth of new prospectuses for equity raisings from 1972 until the Ashton, Samantha and Sterling floats over the past nine months bears testimony to this fact. For the newer company it can accordingly be difficult to obtain sufficient equity to entice the further loans required to get a new project off the ground.

It pleases me to see Mr. Coates proposing that infrastructure financing, in various forms, can be provided by institutional investors. It will, however, be a matter of convincing governments that many of the roles traditionally filled by them can be adequately filled by private enterprise. The best argument to advance in this regard would be economic. Private enterprise would lift the financial burden from the government, thus freeing funds for use in other areas.

Appropriate regulatory controls over infrastructure could be left in government by legislation, but with ownership and control vested in private enterprise. Of course, this seems somewhat counter to current thinking among State Governments who only last year, after decades of frustration, have won approval of the Loan Council to finance infrastructure by State statutory authorities borrowing direct from overseas.

Again to be somewhat controversial, it seems to me institutional investors should not be spreading their risk amongst resource projects by amount, but rather by type of investment. Many resource projects would benefit from the assistance of institutions in the provision of back up funds to finance completion. In particular, finance for such things as pipelines and conveyor and gathering systems is not easy to obtain.

This type of financing would seem to be well suited for loans convertible to equity.

Mr. Coates makes a plea for government to ensure that the rules of the game be spelt out and adhered to over time by the government. Recent events in South Australia demonstrate the enormous risks to investors and project sponsors if the

rules can be changed unilaterally by government in any significant respect. Even in Queensland, that bastion of free enterprise, unilateral government decisions on royalty payments have occupied the time of the highest Courts — even the Privy Council.

The Commonwealth Government's flirtation with a resources tax — which the opposition promises to reintroduce in an as yet unresolved form if they are returned to government — is not designed to soothe equity investors or lenders.

Unfortunately political risk in a resource project in Australia can no longer be disregarded or downgraded as used to be the case.

It perhaps should also be said that if the mining industry as a whole is sincere in seeking less government involvement, it should be less ready to seek government props when in trouble. Mr. Coates says he has not had the experience of a hand-out from a sympathetic government when an enterprise has been in trouble. While that may be true of the projects with which his institution is involved, I understand it is certainly far from true of such mines as Mt Lyell, Mary Kathleen, Mareeba and Greenvale.

While on the subject of government involvement in natural resource projects, I would put the view that a more positive definition of the Federal Government's guidelines on foreign investment is necessary. Also, it seems to me, a more rapid decision making mechanism is needed within the Foreign Investment Review Board.

When a natural resources project falls within the express guidelines that is not the end of the matter. Because the foreign investment guidelines on resource projects are relatively brief, and in any event must be considered with the guidelines and ministerial directions and statements, on export sales, it is virtually impossible for the lawyer to advise with certainty on many foreign ownership matters. All kinds of considerations beyond what a lawyer would regard as ownership and control may be taken into account by the government in determining whether its guidelines have been met in a particular case.

An article appeared in the "Australian Financial Review" of 19th April this year relating to the Federal Treasury's attitude to compliance by the Yeelirrie uranium project with the Australian control provisions in the foreign investment guidelines. According to that article Western Mining Corporation will be providing a 75 per cent equity interest in the project, but will be financing 35 per cent of its capital costs through the prepayment of sales to its 15 per cent equity partner, Esso. Such an arrangement seems clearly to adhere to the foreign investment guidelines. Yet export sales matters which are not subject to the foreign investment guidelines, but over which the Commonwealth Government has control by other means, were apparently being considered by the Treasury as being relevant to whether Western Mining Corporation had the requisite degree of ownership and control of the project.

That seems to be a case of the government confusing questions of foreign ownership and control of the project and questions of the relationship of the buyer of the product to the project sponsor. This type of apparent uncertainty at government level will not aid the development of natural resource projects in this country.

The effect of the Income Tax Assessment Act on institutional investment, and the form that investment might take, should not be overlooked.

It should be noted that the ability to carry forward allowable capital expenditure under ss.124AA and following of the Act applies only to a taxpayer who incurs the specified types of expenditure "in carrying on prescribed petroleum operations and on buildings, other improvements or plant necessary for carrying on

such operations". In particular, s.124AH Sub-s.(1) enables a taxpayer to deduct from income from any source the expenditure incurred by him on exploration or prospecting in Australia for the purpose of discovering petroleum.

During last year I was involved in two proposals which unfortunately were found by the Commissioner to not satisfy the test prescribed in Sub-s.(1) of s.124AH. The gist of the proposals was that an institutional investor would contribute a sum of money to exploration and prospecting expenditure on a specified area, being expenditure that would otherwise have been spent by a joint venture participant in that area. For various reasons the institutional investor could not become a member of the joint venture, but was to have made the expenditure direct to the operator in satisfaction of the joint venturer's obligation to do so. The expenditure was to have been the joint venturer's contribution towards the drilling of an exploratory well.

The proposals went on to provide that following the making of the expenditure by the institutional investor the joint venturer would assign to the institutional investor a specified percentage of the joint venturer's share of the net clear proceeds of sale (if any) referable to any discoveries that might be made in a defined area. The institutional investor had the option, after having made the expenditure and by a certain date, to assign back to the joint venturer the right to the proceeds of sale of a share of production in consideration of an allotment of shares to the institutional investor in the joint venturer.

Thus the institutional investor had the option to continue with its percentage interest in the sale proceeds, or alternatively to reconvey that right to the joint venturer in return for an equity investment in the joint venturer.

The Commissioner's ruling was sought on the question of whether the expenditure to be incurred by the institutional investor on behalf of the joint venturer in the drilling of the exploratory well would qualify as an allowable deduction for the institutional investor pursuant to s.124AH of the Income Tax Assessment Act and, in particular, whether that deduction would be allowable against income of the institutional investor from any source.

The ruling received from the Commissioner was that the expenditure to be made by the institutional investor would be for an acquisition of an equity interest in the joint venturer, or alternatively would be regarded as consideration for the acquisition of an interest in the joint venturer's sales proceeds. Consequently, the expenditure would not be incurred on exploration or prospecting in Australia for the purpose of discovering petroleum and would therefore not qualify for deduction under Sub-s.(1) of s.124AH of the Act.

The Commissioner's ruling went on to state that in any event the transaction would not be one that would satisfy the Commissioner that the institutional investor would be carrying on a business of, or a business that included, exploration or prospecting in Australia for the purpose of discovering petroleum as required by Sub-s.(4C) of s.124AH.

This latter observation by the Commissioner points to the possible need for institutional investors to have subsidiary corporations established specifically for the purpose of carrying on prescribed petroleum operations. This would make it more readily apparent to the Commissioner that the entity seeking to claim the deduction did in fact qualify for the purposes of Sub-s.(4C). However, this course has the disadvantage that deductable expenditure by the subsidiary would have to be offset only against income derived by the subsidiary, and could not be passed up and made available for deduction by the parent from its income from any source.

Section 122J of the Income Tax Assessment Act is the Division 10 (General Mining) counterpart of s.124AH. Sub-section (2) of s.122J provides that a Division 10 deduction is not allowed unless, in the year of income, the taxpayer carried on a mining business or mining businesses (other than a business of mining for petroleum). Thus it would seem wise for institutional investors to have subsidiary corporations established for these purposes for the same reason as I mentioned earlier in relation to Sub-s.(4C) of s.124AH. Because the scheme of the legislation relative to general mining is such that Division 10 deductions are only available from mining income, there is not the same disadvantage of operating through a subsidiary as there is in the case of petroleum exploration.

The ruling also points to the possible need for legislative assistance to enable expenditure of the type envisaged in the proposals to qualify for tax deductibility as a means of attracting institutional investors to participate, on a modest scale, in the extremely high risk business of grass roots petroleum exploration.

Before concluding I would like briefly to draw attention to the possible effects of the United Kingdom Law Reform (Frustrated Contracts) Act 1943 on certain types of non-recourse or limited recourse project financing arrangements alluded to by Mr. Coates. That Act would apply to all contracts governed by English law. The Victorian Frustrated Contracts Act 1959 is in all material respects very similar to the United Kingdom legislation, and would apply to all contracts governed by Victorian law. There is a New South Wales Frustrated Contracts Act, enacted at the end of 1978, which is somewhat different in structure from the United Kingdom and Victorian legislation.

Although the United Kingdom Act was passed in 1943, there had been no decided case under the Act until 1978 when the case of *B.P. Exploration Co. (Libya) Ltd.* v. *Hunt*[1] was decided. The case is unreported and is, I am told, currently subject to appeal.

In summary, BP "farmed-in" to Mr. Hunt's oil concession in Libya to the extent of one half interest. The consideration provided by BP was in cash and oil and an agreement to undertake exploration of the concession, and if oil was found, the development of, and production from, the field. BP was to provide all necessary finance until the field came on stream. Thereafter BP was to receive in addition to its 50 per cent share of production, three-eighths of Mr. Hunt's 50 per cent share of production until BP had received in value from Mr. Hunt's share of production 125 per cent of their farm-in contributions and one half of the money spent by them in the exploration and development of the field. After the field came on stream, the costs of production and future development were to be borne equally by BP and Mr. Hunt.

Thus BP was advancing all necessary finance before the field came on stream and was taking the risk of oil being found in commercial quantities.

A giant oil field was discovered by BP in 1961, and came on stream in 1967. In 1971 the Libyan Government expropriated BP's interest in the concession. In 1973 Mr. Hunt's interest was also expropriated.

At the time of the expropriation of its interest BP had received some, but not all, of its entitlement to three-eighths of Mr. Hunt's share of oil.

The contract between BP and Mr. Hunt was governed by English law. BP commenced proceedings against Mr. Hunt in England, and claimed an award of a just sum under Sub-s.(3) of s.1 of the 1943 Act. BP was awarded a sum provisionally assessed by the Court at $US35,403,146.

Sub-section (3) of s.1 of the 1943 Act, (which is similar in its terms to Sub-s.(3)

of s.3 of the Victorian Act of 1959) provides, broadly, that where a party to a contract has, by reason of anything done by the other party in performance of the contract, obtained a valuable benefit (other than a payment of money) and the contract is frustrated, that other party may recover a sum from the party who received the benefit, not exceeding the value of the benefit, as the court considers just.

In arriving at the award in favour of BP the court found that BP's performance of the contract had enhanced the value of Mr. Hunt's interest in the concession. Some rather complex arithmetic was then applied by the court to arrive at the value of that interest for the purpose of the provisional assessment of the award.

It is important to note that Sub-s.(3) of s.2 of the United Kingdom Act of 1943 and Sub-s.(3) of s.4 of the Victorian Act of 1959 contain provisions which enable the parties to, in effect, contract out of the operation of the legislation.

The United Kingdom Sub-s.(3) of s.2 is as follows:—

> Where any contract to which this Act applies contains any provision which, upon the true construction of the contract, is intended to have effect in the event of circumstances arising which operate, or would but for the said provision operate, to frustrate the contract, or is intended to have effect whether such circumstances arise or not, the court shall give effect to the said provision and shall only give effect to the foregoing section of this Act to such extent, if any, as appears to the court to be consistent with the said provision.

Thus it is not a matter, in the contract, of stating that the legislation shall not apply but rather to provide in the contract provisions which are to apply in the event of circumstances arising which would, but for the provisions, frustrate the contract.

The contract between BP and Mr. Hunt contained a provision that Mr. Hunt would have no liability to repay any sums advanced by BP for Mr. Hunt's account or paid to him, and that BP's right to recover any sums advanced or paid was limited to recovery solely out of three-eighths of Mr. Hunt's half of production.

Mr. Hunt contended this limited recourse provision was unqualified and as such should be held to apply whether or not the contract was frustrated. The court rejected this argument, and held the clause did not preclude an award of damages to BP. The court found, on the evidence, that the provision in the contract had been inserted for the purpose of minimizing Mr. Hunt's tax liability. The application of the provision should not be extended, said the court, to the radically changed circumstances which arose when the contract became frustrated by the expropriation of BP's interests.

Sub-section (2) of s.1 of the 1943 United Kingdom Act which is followed in substance in Sub-s.(2) of the Victorian Act, is also worthy of note. It enables a party to a contract to recover sums paid pursuant to the contract before the time of discharge by frustration. The court is empowered, however, to permit the party who has received the payments to retain them, in whole or in part as an offset against his expenses, prior to the time of discharge, in performance of the contract.

This legislation, as was revealed by the *BP Case* could have some unforeseen, and rather nasty, consequences for borrowers under "no recourse" or "limited recourse" financing arrangements.

For example, a borrower may provide to the financier a royalty interest or production share interest in an oil field for repayment of his loan, together with a charge over the borrower's interest in that field and in his share of production, or proceeds of sale of production from the field. There would be no other recourse for the lender generally to the assets of the borrower. If the arrangements were subject to English, Victorian or New South Wales law and the oil field was to be expropriated or

some other frustrating event such as supervening illegality was to discharge performance, then on the basis of the *BP Case* the lender would have general recourse to the balance sheet of the borrower.

Similar considerations would apply if a provider of buyer credit had provided funds to the project on the basis of pre-payment for sales from a particular mine or oil field, without any other recourse to the project assets, and the mine or field was expropriated or some other frustrating event was to operate to discharge the parties from performance of the arrangements. My advice to borrowers for natural resource projects which are subject to English or Victorian law, or to the law of any other place which has legislation similar to the United Kingdom Act of 1943 and the Victorian Act of 1959, would be to ensure an effective "contracting out" of the operation of the legislation. However, a "contracting out" requires, under the legislation, the inclusion of satisfactory and unequivocal mechanisms to be built into the contractual arrangements to clearly provide what is to occur in the event of circumstances operating which would, but for that provision, operate to frustrate the contract.

The New South Wales Act, in s.6(1)(e), unlike its United Kingdom and Victorian counterparts, does permit an express "contracting out", simply by stating that the legislation will have no application to the contract.

Finally, Mr. Coates requests the legal fraternity to show a willingness to look for non-conventional solutions to non-conventional problems.

I would like to think there is no lack of willingness or ability of lawyers in this country to be inventive. However, as mentioned earlier I believe useful amendments could be made to the income tax legislation to encourage institutional investment in attractive forms in the natural resources sector.

Mr. Blanshard referred to the Wilson Committee Report on the financing of North Sea Oil.[2] That most interesting document analyses in some detail the various financing techniques undertaken in relation to each of the North Sea oil and gas fields. There is certainly no lack of inventiveness in the variety of techniques employed. These techniques were developed principally by New York and London lawyers to meet the exigencies of each particular case.

I have no doubt that lawyers in this country will adequately answer the challenge.

FOOTNOTES

1. Refer to R. Goff and G. Jones, *The Law of Restitution* (2nd edn. 1978) at p.564 *et seq.*
2. Report of the Committee to Review the Functioning of Financial Institutions — Chairman, The Right Hon. Sir Harold Wilson — "The Financing of North Sea Oil" Research Report No. 2, May, 1978.