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Abstract

This essay discusses the Julietta gold mining project and the categories of risk that investors and lenders look at when assessing the suitability of a project. The financing of projects on a limited recourse basis in the emerging markets is a subject that has received much attention over the course of the last several years. This has been particularly the case with respect to mining projects where declining commodity prices worldwide have led to the need for mining companies to access minerals in countries where the costs of extraction are lower than in the developed markets. The recent decline in the popularity of hedging as a means to enhance the attained price with respect to any metal produced at a project has only accelerated this trend. This has led to a concentration on the development of projects in sub-Saharan Africa, the former Soviet Union, South East Asia, and–although now less of an emerging market– South America.

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INTRODUCTION

The recent closing of the financing for the Julietta gold mine in the Magadan Oblast of Russia has attracted significant attention and comment in each of the financial, mining, and legal communities. Work in connection with the financing of the project commenced in 1996. Four years, two owners, several bank syndicates, and multiple financing structures later, the financing finally closed in September 2000. This Essay describes the tortuous history of the project and its financing, and goes on to address some of the issues that were faced in the context of problems generally encountered in the financing of projects in the emerging markets.

The Julietta gold mining project is situated in one of the most inhospitable areas of the world. Located in the Magadan Oblast of Russia (in the far east of that country, almost as far as the Kamchatka Peninsula), the project is significantly closer to Alaska than Moscow. The nearest evidence of civilisation is the city of Magadan, located many kilometres to the south of the project. The project is capable of access by road for only part of the year. During the extreme winter, climatic conditions mean that the project must be accessed by helicopter, although an ice road has been constructed to alleviate this problem. The attraction of the area to that group of explorers known as "gold bugs" is that the geology in the area is such as to encourage the formation of gold and other precious metal deposits. One gold mine (the Kubaka project) is already up and running in the region.

In 1996 Arian Resources Corporation, a company based in Canada, owned the Julietta project, and it was with that entity that the original bank group (led by Standard Bank London Limited, the London based subsidiary of the large South African bank) set off to structure and implement the financing. What were the problems that were faced? First and foremost, the pro-

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ject is located in Russia. Beyond the hostile physical environment, the legal system in that country is in the very early stages of development, and a definitive analysis of rights and remedies frequently defies standards familiar to European and North American lawyers. There also are a plethora of constituencies that need to be satisfied. Both the federal government based in Moscow and the local government based in Magadan need to be kept informed, and a variety of consents need to be issued by regulatory authorities within those governments.

As an emerging economy, the export of foreign exchange is severely limited. Gold is sold in the international markets for U.S. dollars, and both foreign investors and foreign lenders require that the project have the ability to remit U.S. dollars outside Russia both to provide a return on the equity investment and in order to repay the project loans. Accordingly, extensive negotiations with the Russian Central Bank—the regulatory authority with jurisdiction over the remission of foreign exchange from Russia—were required. To compound the problem, governments jealously guard gold and other precious metals and extensive consents are required in order to sanction their extraction, refining, and sale.

In common with all such projects that are now seeking financing in the private arena, the Russian governmental authorities originally owned the assets constituting the Julietta project. The assets were privatised several years ago, and therefore, the initial legal task was to ensure that the privatization had effectively and legally occurred. There are several horror stories that have happened in the past (and which continue to occur) where privatisation of private sector projects have not taken place thoroughly in accordance with Russian law and procedure with the result that title to the relevant assets have been under attack by a variety of vested interests in Russia and elsewhere. (Indeed, at the time work on the Julietta project commenced in 1996, one of the largest potential gold deposits in the world—the Sukhoi Log deposit located in Siberia—was experiencing a similar problem.) The problem is compounded by virtue of the fact that some of the laws relating to privatisation are not easily available, nor are records relating to the method in which the privatisation has been accomplished.

The original bank syndicate, led by Standard Bank, labored through the legal and regulatory issues involved for some consid-

erable period of time until the position was reached where all involved felt able to close the transaction in the summer of 1998. Finding lenders willing to participate in a facility of this nature had obviously been a challenge, although a group was ultimately put together, political risk insurance obtained, and other relevant issues taken care of. Unfortunately, virtually simultaneously with the proposed closing, Russia defaulted on its sovereign debt, and there followed an immediate collapse in the availability of the capital markets and other credit sources to Russian borrowers. As a result, the financing did not close.

The ensuing period saw virtually no availability of credit for anything with a Russian flavor, never mind a yet-to-be-constructed gold mining project in Magadan. The existing owner sold its interest in the project to Bema Gold Corporation, a mining company based in Vancouver on the west coast of Canada. Bema had experience with the development of mining projects in equally inhospitable environments, such as the Andes. In late 1999, and with the (relative) decline in concern about projects in Russia, the attempt to finance the project re-commenced. Standard Bank reorganized the lending syndicate bringing in the large Munich based bank Bayerische Hypo-und Vereinsbank AG as a co-arranger of the financing.

In its original incarnation, the financing had been organized as one that would be supplied solely by commercial banks. In the new environment in Russia following the 1998 crisis, it was felt prudent to involve a multi-lateral lender, and the International Finance Corporation ("IFC") agreed to participate in the financing. However, unlike other projects in the emerging markets involving the multi-laterals where the multi-lateral in question fronts the entire loan to be effectively funded in part by commercial banks, the structure utilized in the Julietta project financing involved two separate (but parallel) loan agreements with the commercial lending group and the IFC. It is understood that this was a first for projects in Russia.

The principal risk to be covered off in connection with a transaction such as the Julietta project is political risk, particularly given the level of concern about political stability in Russia and the perceived ability of Russian governmental departments to interfere with the smooth running of any project located in the country. The Multilateral Insurance Guarantee Agency ("MIGA"), which is an arm of the World Bank, was approached

to provide political risk insurance for the commercial banks. This was ultimately secured, thereby taking care of an area of substantial concern for that group of lenders. With this in place, the financing and legal teams swung into full action in late 1999/early 2000. Faced with very real timing deadlines, due to the fact that construction of the project was scheduled to take place during the summer months prior to the onset of the winter icepack, all involved worked throughout 2000 to attempt to accomplish a closing to address that practicality.

With this factual background, what can be learned from the project? In order to answer this question we need to understand the categories of risk that investors and lenders look at when assessing the suitability of a project. The financing of projects on a limited recourse basis in the emerging markets is a subject that has received much attention over the course of the last several years. This has been particularly the case with respect to mining projects where declining commodity prices worldwide have lead to the need for mining companies to access minerals in countries where the costs of extraction are lower than in the developed markets. The recent decline in the popularity of hedging as a means to enhance the attained price with respect to any metal produced at a project has only accelerated this trend. This has led to a concentration on the development of projects in sub-Saharan Africa, the former Soviet Union, South East Asia, and—although now less of an emerging market—South America.

I. *CATEGORIES OF RISK ADDRESSED WHEN ASSESSING THE SUITABILITY OF A PROJECT*

The problems inherent in financing mining projects on a limited recourse basis in the emerging markets are well rehearsed. Some of these problems are described generically below. We will then go on to explore how some of these issues were addressed in connection with the Julietta project.

A. *Legal System Risk*

The basis of the legal systems utilized in the various emerging markets is diverse. In many of the countries of the former English Commonwealth located in sub-Saharan Africa, an English based common law system prevails. Thus, for example,

transactions involving projects in Ghana and Zambia might be structured on the basis of traditional English law concepts of taking security and attendant filings, etc. In Francophone countries in the same region, such as Mali and Mauritania, French civil law systems are common, frequently based substantially on the French Civil Code. In each of these jurisdictions where the legal system is based on an established Western European model, there is some certainty as to the theoretical operation of the legal system and the necessary filings, etc. However, practical operation of the legal system and remedies available upon the occurrence of an event of default, etc., may still be problematic. In South America a civil based system is common and frequently affords a very developed system of law. In the former Soviet Union, the situation has evolved with far less clarity due to the uncertain nature of both the laws involved and the interpretation thereof. The developing nature of the legal system and the almost complete absence of precedents with respect to remedies available in the event of a default or similar problem compound the problem.

Practically, of course, a lender must take the legal system as it exists. There is no way of contracting around statutory requirements. The only real method of ameliorating any difficulties presented by legal systemic risk are by retaining sponsor support past completion for any perceived legal risk, which is unacceptable to a sponsor from a credit perspective, and by taking the benefit of political risk insurance to guard against the precipitous act of any local government or related body.

B. *Title Risk*

Part and parcel of legal risk is the nature of the right of the mining company in question to develop the deposit that forms the basis of the mining project. In some countries, the mining company might have full legal right to both surface and sub-surface assets together with the unrestricted right to exploit those assets. However, this is unusual in the context of the emerging markets. Frequently, the ownership right in minerals is vested in the central government, and all that can be obtained is a license to mine the minerals in question. In some jurisdictions, for example the Russian Federation, the situation is exaggerated by virtue of the fact that the operator will be unable to obtain even

surface rights. It will merely be granted whatever attendant rights are necessary in order to effectively mine the deposit pursuant to the mining license granted by the government.

In many countries, particularly in sub-Saharan Africa, the central government will have the right to retain a carried interest in the project, maybe in a proportion of up to 20% of the equity. In other jurisdictions, this interest may take the form of a royalty payment to the government in respect to minerals extracted from the ground. Whatever the format, virtually all emerging markets will require that some economic interest in the project be granted to the central government. This is clearly understandable as mineral resources may represent the most significant, if not sole, source of wealth for those countries.

C. *Tax Risk*

Potential taxes assessable on a mining project are numerous. The local project company may be subject to a profits tax, value added tax ("VAT") on services, or other forms of local taxation. In addition, there may be withholding taxes on interest and dividend payments made offshore. Fortunately, most emerging markets recognize the economic advantages in attracting offshore mining companies to develop deposits, and therefore offer tax packages for individual projects that are available to be negotiated on a project-by-project basis. These will frequently result in tax holidays in connection with profit and related taxes in addition to exemptions from VAT and withholding tax on both interest payments and dividends.

D. *Political Risk*

This, again, is something that may not be contracted out of and, therefore, must be covered by the sponsors or by insurance. The former will be resisted for balance sheet and precedential reasons. The latter may be available through one of the multilateral agencies (for example, and as utilized in connection with the Julietta project, MIGA), through a national export credit agency from the home jurisdiction of a participant in the project, or in the commercial markets. Political risk coverage is available for the majority of the emerging markets, even those perceived to be riskier than most, such as the Russian Federation. Of course, some emerging markets have now emerged.

So, for example, whereas political risk insurance for transactions in Chile may have been common several years ago, that may no longer be the benchmark. Deals in certain sub-Saharan Africa countries such as Ghana also have been completed without any perceived need for political risk insurance. The insurance is frequently expensive and can add significantly to the cost of any individual project financing.

E. *Insurance Risk*

Comprehensive insurance for any particular project is an essential part of the package that will be required by any provider of limited recourse finance. Prima facie this should not create any difficulty as commercial insurance for a project (third party liability, construction risk, delay in start-up, etc.) should be available irrespective of location. However, a complication arises by virtue of the fact that many of the emerging markets (particularly in sub-Saharan African and the former Soviet Union) require that the primary insurance be provided by a local insurance company. This raises both performance and credit risk issues.

While such local insurance will be reinsured by coverage in more traditional insurance markets, such as the London market, that is not the end of the problem. For example, reinsurance is just that: it is a secondary cover with respect to the primary insurance policy. Accordingly, if the primary insurance policy is not valid, then neither will the reinsurance. In those jurisdictions (such as Russia) where the primary insurance with the local insurance provider must be governed by local law, then comfort must be obtained with respect to the validity and efficacy of that insurance. Note that these issues will not be circumvented by the so-called "cut through" provision present in many reinsurance arrangements, which provides for the reinsurers to pay beneficiaries of the primary insurance policy directly rather than being put through the necessity to pay through the primary insurer as a conduit.

F. *Foreclosure Risk*

The analysis of the risks inherent in any project in the emerging or other markets frequently ends, at least from a legal perspective, with the documentation. However, this is short-

sighted. Enforceable documentation is obviously critical to any project lender, but this does not give the whole picture. The rights available in connection with any enforcement of that documentation are paramount. The traditional common law analysis, for example, assumes that any secured party will have a self-help remedy that will enable it to sell the secured asset on its own motion without the need to involve any third party. In civil law countries, and in most emerging markets other than those sub-Saharan countries with an English common law tradition, this is not possible. In those jurisdictions no self-help remedy is available, and foreclosure will usually need to be performed with the assistance of the court system. This usually implies an auction following some defined period and can involve a lengthy delay. During a period when a project is in trouble and unable to meet the needs of its trade creditors, this can be a significant issue. In addition, some auction procedures may not permit the lenders to bid in debt, rather than bidding in cash, thus potentially materially increasing the exposure of the lenders to the project as a whole if they wish to avoid defeating some wholly inadequate bid made at auction by a third party.

G. *Foreign Currency and Export Risk*

While governments in the majority of South American and many African countries will issue licenses with respect to any particular project that will permit the unfettered sale of metal offshore and deposit of proceeds in an offshore account, this may not apply to other jurisdictions, particularly those in the former Soviet Union. In those countries and particularly in the case of projects including precious metals, the mined metal may have to be sold through a local agent, which will result in the collection of domestic currency. In addition, there may be restrictions on the holding of foreign currency offshore.

II. *RISK ASSESSMENT AS ADDRESSED IN THE JULIETA PROJECT*

Many of the difficulties faced by lenders and sponsors in Russia are not unusual for a project finance transaction in an emerging market. However, due to a legal heritage and culture derived from Russia's communist past, combined with the measures introduced following the Russian debt crisis in 1998, the

solutions to these problems are often more complex, time consuming, and ultimately, more expensive than those found in other jurisdictions. Some of the difficulties associated with the development and project financing of the Julietta project are discussed below.

A. *Sale of Mine Output*

This issue has given rise to a number of difficulties over the past few years. For example, in 1998 it was reported that a subsidiary of Kinross Gold Co. was forced to stop production at its Kubaka mine as a result of difficulties in selling gold and silver produced at the mine. Russian law requires precious metals to be sold either locally to a federal agency (Gokhran) or to an authorized Russian bank. Gokhran has a right of first refusal to purchase all precious metals produced in Russia or offshore through an authorized Russian bank. Some local government agencies (e.g., in Magadan) also have a right of first refusal to purchase precious metals produced within their jurisdiction. Importantly, a percentage of the precious metals sold either locally (e.g., to Gokhran) or offshore through an authorized Russian bank must be paid for in Roubles. The actual percentage paid is determined by the Central Bank of Russia and is normally a significant amount (more than 50%) of the project output. This leads to an additional cost in transferring Roubles into hard currency. There also is the risk that the Central Bank may increase the percentage of the precious metals that must be sold for in Roubles, that Roubles may not be convertible into hard currency, or that the Dollar/Rouble market may not be liquid enough to purchase hard currency.

B. *Currency Issues*

Ownership of foreign currency by Russian citizens and commercial entities has been highly regulated following the debt crisis of 1998. The amount of foreign currency that may be held by mining project companies is a matter of negotiation with the Central Bank of Russia. A typical structure would involve permission to hold an offshore and an onshore Dollar account. The offshore account might be kept either with the foreign branch of a Russian bank or with a foreign bank. The Central Bank will only permit a limited amount of foreign currency to be

held in the offshore account. The Central Bank also has indicated that it is more comfortable with an offshore account being held in a foreign branch of a Russian bank—meaning they will allow more funds to be held offshore in U.S. dollars. This has obvious credit implications and would need to be weighed up by sponsors and lenders. Normally, an onshore Dollar denominated account can only be used for Dollar payments that are due to be paid within seven days of the transfer from Roubles into U.S. dollars. The remaining funds owned by the project company must be held in Roubles. This could be a significant amount of money and project companies need to structure their working capital with this issue in mind.

C. *Security of Tenure*

A number of existing and proposed mines are, or have been, the subject of privatization. There have been at least two well-publicized cases (Dukat and Sukhoi Log) that have demonstrated some of the serious difficulties associated with the privatization of Russian mining enterprises. Russian law prescribes a number of key requirements for privatization and their violation may provide grounds for invalidation of the privatization. These requirements include the following elements:

1. the privatization of the enterprise must not be restricted,
2. the relevant state bodies must have approved the privatization,
3. the privatization procedures to be followed and privatization options selected must be in accordance with certain detailed regulations,
4. the proper evaluation and publication of information, and
5. the proper establishment of the enterprise to be privatized.

The rules for each of these elements are detailed and require a significant amount of due diligence. Obviously the invalidation of a privatization would be catastrophic, and lenders and sponsors should be careful to pursue a detailed due diligence process to minimize the risk of the privatization of a mining project being set aside.

D. *Security*

Russia has a number of mandatory laws that cause difficulties for lenders taking security over the assets of a mining project. It is very difficult to take effective security over bank account balances, which are crucial to a project financing. It also is not possible to take security over mining licenses, and lenders are prohibited from taking security over business interruption insurance, which is also critical to many mining projects.

The lack of security over these types of assets is particularly disastrous if the project company becomes bankrupt and third party creditors have a claim against the project company. In the event of a bankruptcy, third party creditors will have an equal claim to project lenders against such insurances, bank account balances, and mining licenses. In order to avoid this situation, lenders should ensure that the project company is only permitted to incur a very small amount of third party debt.

Enforcement by secured creditors is also very difficult in Russia. Enforcement without a court order is virtually impossible, and obtaining a court order can take a significant amount of time.

E. *Insurance*

Like many other emerging markets, Russian insurance law only permits Russian entities to take out insurances with Russian insurance companies. Although not an unusual requirement in an emerging market, Russian insurance law has some added complexities that must be dealt with by sponsors and financiers.

Lenders in particular normally are reluctant to take on the added layer of local risk that results from insurances being issued by a local company. The normal method of avoiding this risk is to require the local insurance company to take out facultative re-insurances of the underlying insurance policies with an international reinsurer (e.g., Lloyds). The local insurer also is required by lenders to grant a security assignment over such reinsurances in favor of the project lenders. This gives the project lenders the comfort of a direct claim (via the assignment of reinsurances) to an international insurer, rather than a local insurer.

This structure, while viable in Russia, is not desirable. Generally speaking, contracts (including insurance agreements) between two Russian entities must be governed by Russian law.

This gives rise to an added layer of Russian risk as lenders and sponsors will be accustomed to insurance policies issued under English or United States law. Further, it is not clear that Russian insurance law is comparable to English or U.S. law, or that Russian insurance law recognizes standard international insurance concepts such as "lender's interest" clauses or loss payee provisions. Additionally, the assignment of reinsurances requires the special permission of the Russian Central Bank, which is both difficult and time consuming to obtain.

In any event, there is some doubt as to whether such an assignment is enforceable—Russian law does not permit the benefit of a reinsurance contract to be transferred to any entity other than a Russian insurance company. It is not clear if this would also extend to any debts payable under such a re-insurance policy (which is normally the subject of the assignment of re-insurances).

Finally, as a practical matter, payments of claims under Russian insurance policies must be paid in Roubles, adding another level of currency risk to the project.

One method for lenders to mitigate some of the risks mentioned in the preceding paragraphs is to obtain some form of offshore insurance for the lenders (as opposed to the project company's) insurable interest, e.g., through a "non-admitted" or "difference in coverage" policy. Unfortunately such a policy does add an additional cost to the project. It also adds a level of complexity to the insurances, as it is necessary to co-ordinate any offshore insurances with any local policies.

CONCLUSION

Although Russia remains a difficult market, project finance transactions, as illustrated by the Julietta experience, are possible. Unfortunately, the "solution" commercial banks will most likely require for a number of the risks outlined above is an increased return (i.e., margin) and/or additional sponsor support (i.e., through the assumption of some risks). However, successful completion of projects is possible and, with the news that this is possible in Russia, the final frontier in the emerging markets may have been breached.