

**INTERNATIONAL BAR ASSOCIATION
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**ENERGY IN THE NEW MILLENIUM:
The West African Perspective**

**Topic No. 5
“Transnational Pipeline Projects:
Issues facing the development of regional pipeline infrastructure”**

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TRANSNATIONAL PIPELINE PROJECTS
- issues facing the development of a regional pipeline infrastructure

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1.0 INTRODUCTION

The initial concept for a gas pipeline infrastructure for the West African sub-region contemplated the construction of a pipeline from Senegal to Cameroon taking gas primarily from gas surplus Nigeria to other countries along the pipeline route. This concept was recently moderated with the signing of agreements between the Governments of Nigeria, Benin, Togo and Ghana for the development of the West African Gas Pipeline Project after several years of planning.

The host nations will expect to reap a range of immediate and long-term benefits, which are capable of accelerating the economic development of the sub-region. Spurs off the pipeline will take a cheaper and cleaner source of energy to power generating stations, aluminium smelter plants, mine sites etcetera. This will lower production costs for industry and result in massive employment, transfer of technology and management know-how, utilisation of local goods and services and substantial earnings from taxes.

Beyond that, a country like Nigeria, which is flaring a record \$3 billion in gas annually, will have an opportunity to monetise its associated gas production.

Like any other major resource project, the development of a regional pipeline infrastructure will involve a thorough assessment of a myriad of regulatory, contractual, economic and socio-political issues. This paper shall outline some of the key issues, which the promoters of the pipeline will encounter in the course of the project development.

2.0 EXPECTATIONS

In considering the viability of a regional pipeline project, project sponsors will be keen to ascertain the energy pricing policies of the host countries. This will guide them in structuring their prices to cover operating and capital cost, returns on investment and cater for opportunity costs taking prices of competing fuels into account.

Other issues are:

- The sponsors will be interested in the appointment of an independent regulator competent enough to deal with and not detract from the guaranteed project margins. The regulator will also handle matters relating to tariffs adjudication and dispute resolution generally.
- The complexities of the legal and regulatory framework for a regional pipeline project coupled with the issue of multiple jurisdictions will require well-drafted alternative dispute resolution clauses in the several project contracts and agreements. This is necessitated by an inefficient judicial system throughout the region - disputes in Nigerian and Ghanaian courts for example have been known to last interminably decades without determination.
- Access to land and rights of way will be critical to the project. The grant of eminent domain status to the pipeline would be a solid demonstration of government support to the project on a potentially explosive issue. The resulting issue of compensation for land compulsorily acquired for the pipeline route could then be tackled by a uniform assessment procedure for compensation.
- The environmental laws in the region vary and a harmonized environmental law would guarantee that the project sponsors and operators maintain a high standard of environmental protection in the construction and operation of the pipeline.

3.0 LEGAL AND REGULATORY FRAMEWORK

Arguably, the main challenge confronting the host Governments and the project Sponsors will be how to structure the project around the different civil and common law systems of the participating countries to meet the concerns of all Project stakeholders.

Host governments will be interested in introducing legislation to address their policy objectives. As these changes might affect project assumptions, the project participants will be keen on the introduction of an independently administered

regulatory framework which will be stable and transparent enough to protect the project from unexpected policy changes and also guarantee host country support for project assumptions.

This issue is captured effectively by the Financial Times in relation to the West African Gas Pipeline project in its issue of February 23rd, 1999:

“ Nevertheless, the countries are now discussing a regulatory regime, including access to rights of way and deciding issues such as who will have access to the pipeline and under what conditions. The attitude of the World Bank and the African Development towards a regional gas grid could play a big part in any decision to launch the scheme”.

The clamour for access to the pipeline by competing producers is often attractive to governments of transit states and multi-lateral lending institutions as competition in production and supply will ultimately lead to efficient gas pricing which in itself will positively impact on the operating cost of the consumers.

Project sponsors on the other hand will be concerned about scheduling problems arising from pipeline congestion and with problems of system integrity and pipeline maintenance. They will also be concerned with the impact, which the availability of capacity to third party producers will have on project assumptions. To balance these legitimate concerns, project owners and lending institutions may consider a structure whereby gas supply into the pipeline is limited to the sponsors for a given period of years under firm offtake guarantees.

4.0 INCENTIVES

The viability of a regional gas pipeline will to a large extent be determined by the fiscal incentives and concessions granted by the host nations. The project participants will also be interested in a unified and benevolent fiscal treatment for the project. Possible areas for support include grant of special tax status to the project, capital allowances for companies converting their source of power to gas and a harmonisation of the import policies of the transit states. Also, the Nigerian example of duty-free importation of capital equipment for gas projects could be adopted as a further incentive to investors.

Further incentives include a simplified licensing regime for all the project elements and assurances of Government support to lenders for project implementation.

5.0 PROJECT RISKS

As in any undertaking of this proportion, the risk profile of this project must be accurately assessed, allocated and balanced amongst the project participants. The obvious risks are:

5.1 Market Risk – As lenders and investors assume the risk that sufficient cash flow will be generated to amortise the risk capital in the project, factors likely to affect the viability of the market for the gas in each consumer country must be accurately identified and mechanisms structured to mitigate these risks. The usual mechanisms are take or pay gas contracts.

5.2 Transportation and Environmental risk - Pipeline integrity and safety are related issues since a disaster will not only affect gas supply but also will significantly affect the ecology of the disaster location and, almost certainly, transit economies. The interests of the gas producers, the transmission company and the consumers in an unimpeded, secure and reliable transit therefore coincide.

Not surprisingly, the sponsors of the West African Gas Pipeline Project have reportedly opted for an offshore route in order to mitigate the risk of sabotage of the pipeline by terrorists and aggrieved indigenous communities in the transit countries. Of immense value here is the freedom given in Article 79 of the United Nations Convention on the Law of the Sea 1982 to states to lay pipeline and submarine cables on the continental shelf. This right is of course subject to the consent of each adjoining coastal state for the delineation of the pipeline route.

Regarding safety, the operations and management contractor must commit to operate and maintain the pipeline to acceptable operating, maintenance and environmental standards throughout the length of the pipeline. An obvious imperative in this connection is the necessity of conducting a rigorous environmental impact assessment study into the potential effects of the development of the pipeline on the ecology of the pipeline route. Also, the presentation of an effective disaster containment and contingency plan in projects of this nature is a standard requirement for multi-lateral lending.

5.3 Supply Risk

However, the project sponsors will be concerned to assure themselves, their financiers and their customers of the availability, within the reserves of the gas suppliers, of sufficient quantities of gas to meet the requirements of the customers. Suppliers of gas to the project will therefore be required to warrant the adequacy of their reserves to meet the project requirements. These warranties

are often supported by independent assessments of engineering companies acceptable to the lenders or the consumer group.

Allowing third parties an opportunity to purchase or rent spare capacity in the pipeline might also be considered as a possible mitigating factor for supply risk.

5.4 Political and Country Risk

The arrangements must be sufficiently structured to eliminate or substantially reduce transportation risks that could arise from economic or political disputes between the transit states. As most of us know, the West African sub-region has remained largely politically unstable with military coups and rife insurgency actions in the region. Country risk assumes a serious dimension when one recognizes that there is no alternative source of supply or cheaper gas into the region other than the Nigerian Niger Delta which has been recently plagued with communal strife and unrest resulting in production shut down and loss of capacity.

Political risk is manifested in expropriation, war, breakdown of law and order and sudden changes in government policy. Guarantees against discriminatory laws, expropriation and nationalisation of project assets must therefore be a cornerstone of the concessions granted by the Governments to the investor group and it will be prudent to require such host nations to reduce this guarantee into local legislation.

It is important to note that political risk insurance will be available from international financial institutions as a standard feature in any project of this dimension to protect all project participants against losses from non-commercial risks.

6.4 Currency Risk

Although regulations for the repatriation of funds from the transit countries are a function of the fiscal policies of such nations pipeline owners and the gas producers will expect to be able to repatriate their earnings as and when due in order to service loans, meet operating and capital costs and ultimately return profits to shareholders. The currency in which pipeline tariffs and gas prices will be paid will therefore be a major concern in view of fluctuating exchange rates and the lack of vibrant currency exchanges in the sub-region.

6.5 Technology Risk

The choice of an offshore pipeline route has its own risk implications as the challenges of laying a pipeline in deepwater can a daunting task. The choice of

the EPC contractor and the technology to be applied in the construction of the pipeline over a long distance will be extremely critical.

7.0 PROJECT STRUCTURE AND FINANCING

Having identified the risk profile of the project, the project sponsors will engage the lenders, insurers, the selected contractor and other project participants in negotiations of such terms as will enhance the viability of the proposed project structure. This process will result in the execution of several complex and mutually dependent agreements which are designed to cover all project risks and ensure the commitment of all participants throughout the duration of the project.

In view of the developmental implications of a regional pipeline, its attractiveness to mezzanine financing is reasonably high subject to the risk issues discussed earlier. The usual structure is for portions of the pipeline to be owned by different entities with minimal equity participation of the host governments in equity. The standard is the application of limited recourse financing in conjunction with a Build-Own-Operate or Build-own-Transfer model.

A mix of both BOT and BOO models were employed in the Algerian-Tunisian-Italian pipeline project which was the first transnational gas pipeline project in Africa. In that project, SNAM, the gas trading subsidiary of ENI, the Italian state company, entered into a take or pay gas contract with SONATRACH, the ALGERIAN gas producing company. The gas was to be delivered at the Algerian-Tunisian border into a pipeline to be constructed in Tunisia by a SNAM subsidiary incorporated in Tunisia. Financing for the construction of the pipeline from the custody transfer point through Tunisia and the Sicily Channel was arranged and guaranteed by SNAM under a Throughput Agreement. Ownership of the pipeline in Tunisia was transferred to the Government of Tunisia by the SNAM subsidiary upon completion of the pipeline in consideration for the waiver of future tariffs on gas shipment. Meanwhile, the ownership of the pipeline through the Sicilian channel was a 50:50 venture between SONATRACH and SNAM while the Italian portion of the pipeline was wholly owned by SNAM.

Whilst this model demonstrates that transit governments can negotiate for ownership of the pipeline, it illustrates in the context of financing how a strong offtake contract backed by sufficient credit support through corporate guarantees can be employed as the cornerstone of pipeline financing.

Beyond that, the structure applied for the Tunisian portion of the pipeline is a solid demonstration especially for Governments in West Africa of an optimal infrastructure financing arrangement. This was a similar strategy employed in the Bolivian - Brazilian Gas Pipeline project which was a Build-Own-Operate-Transfer (BOOT) model. When the reluctance of the Bolivian Government to give

sovereign guarantees threatened the completion of the project, financing for the construction of the Bolivian part of the pipeline was provided by PETROBRAS, the Brazilian state oil company in consideration for a waiver of future pipeline tariffs and a pre-purchase of an uncommitted upside capacity in the pipeline on both sides of the border.

8.0 CONCLUSION

It is important to appreciate that the topic of regional pipeline development is a very wide one and I must make clear that each of the issues which I have touched upon in this paper is a major topic in itself, each of which cannot be effectively dealt with within the time allotted for this paper.

Lastly, project implementation for a transnational pipeline project will clearly task the resources of all project participants, including their advisers. However, considering the exciting prospects of giant hydrocarbon discoveries in the West African deepwater, I believe there can be no better time for the development of a pipeline infrastructure and associated facilities in West Africa.