MOZAMBIQUE – POLITICAL DYNAMICS, REGULATORY OUTLOOK AND INFRASTRUCTURE RISKS

Hugely promising natural gas exploration success rates off Mozambique have generated expectations of escalating investment in the country in the coming years. Robert Besseling examines the most significant political challenges to the development of the natural gas sector in Mozambique. Political in-fighting and distractions are likely to stall the formulation of a legislative framework for the sector, motivate the renegotiation of existing contracts and delay the necessary development of LNG infrastructure. In order to mitigate risks, investing companies will become more dependent on local partnerships with the political elite.

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SECTOR OVERVIEW

Significant natural gas reserves – estimated at around 150 trillion cubic feet (tcf) – have been discovered in the Rovuma Basin by Italy's Eni S.p.A and Houston-based Anadarko Petroleum Corporation.

These reserves have the potential to position Mozambique as a major natural gas exporter. Stake sales by first-movers Eni and Anadarko (along with its partner, India's Videocon Industries Limited) are attracting major international players, with China National Petroleum Corporation (CNPC) purchasing a 20% stake in the "Area 4" project from Eni in March 2013.

According to the National Petroleum Institute (INP), a number of companies have previously expressed an interest in future bidding rounds for exploration blocks off Mozambique, including Petroliam Nasional Berhad (Petronas), the Vitol Group, Noble Energy, Inc., Tullow Oil plc, Exxon Mobil Corporation, Royal Dutch Shell plc and BP plc. In addition, there will be opportunities for construction companies in the development of liquefied natural gas (LNG) terminals, ports, new pipelines and associated infrastructure.

The government expects the natural gas sector to attract capital inflows of some USD70 billion over the next ten years – almost five times Mozambique's current GDP (IHS, 2012)– as well as further investment to develop the country's inadequate rail, road and port infrastructure. However, the

new bidding round, although scheduled for 2013, is likely to be further postponed, possibly until 2015, as a result of delays in finalising the new investor code. Furthermore, resources are not scheduled to be brought to market until 2018 and, while the government is considering a new legislative framework for investment, there is currently no effective plan to manage the country's potential windfall, estimated by the INP at up to USD5 billion a year in government earnings from gas exports by 2025.

President Armando Guebuza of the long-time ruling FRELIMO party is one of Mozambique's wealthiest business people

POLITICAL DYNAMICS

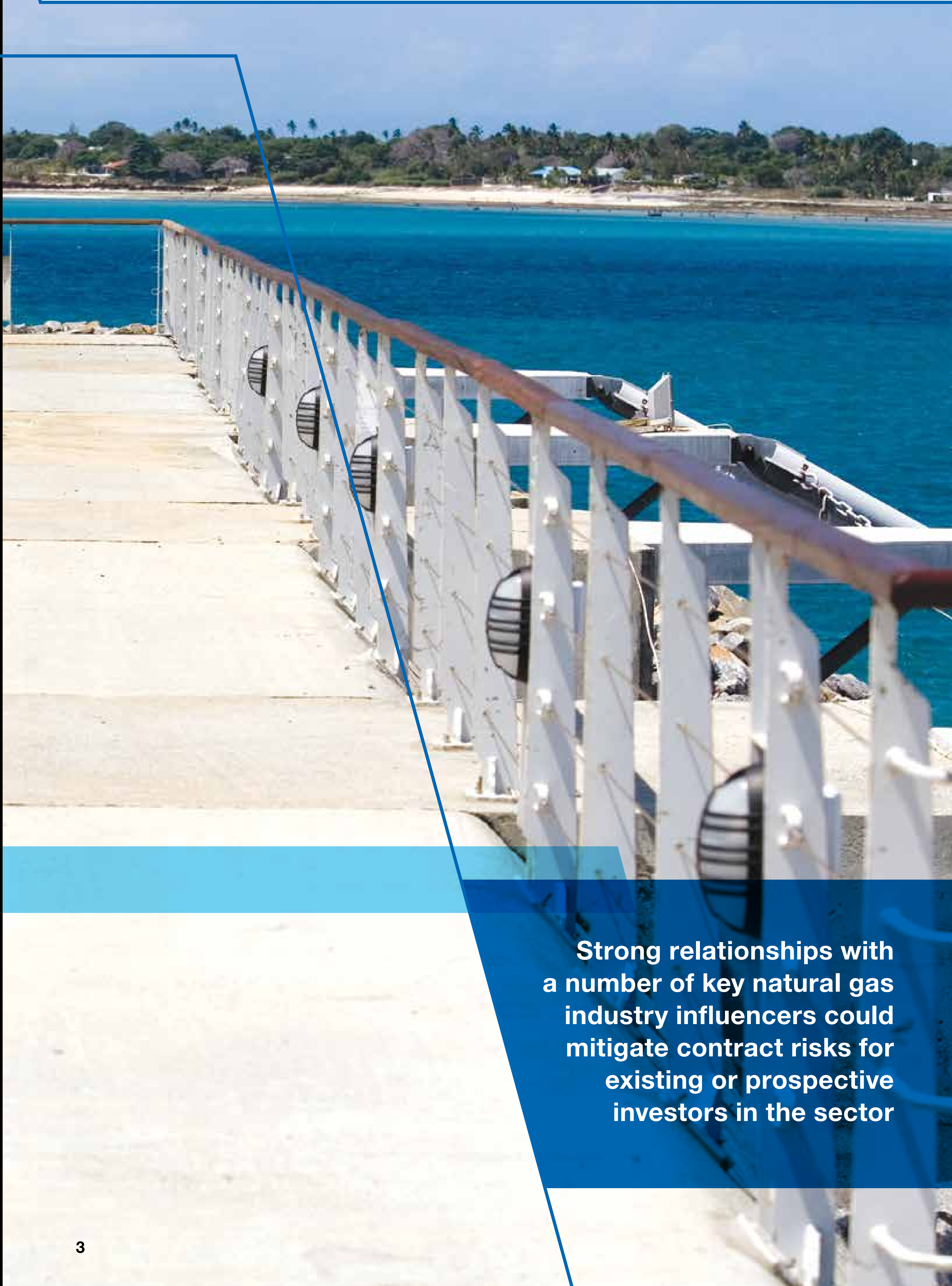
We expect rival political factions to seek to profit from the natural gas sector and to shore up business interests by seeking local participation.

President Armando Guebuza of the long-time ruling FRELIMO party is one of Mozambique's wealthiest business people, with stakes in multiple sectors within Mozambique. As a result of the domination of the executive over policy and legislative development, he has significant power over progress in the natural gas sector.

Due to constitutional term limits, Guebuza is due to step down as national president at the 2014 elections. However, he is likely to remain a crucial influence-broker over the natural gas sector. His role as party president – which is not due to expire until 2017 – gives him substantial power over both party policy and appointments to the next government.

We expect Guebuza to use the remainder of his time as president to try to build up his influence in the natural gas sector. Locally nick-named 'Gue-Business', Guebuza has expanded his business interests while president.

We expect influential political and business figures to encourage foreign investors to form joint ventures with Guebuza-affiliated companies, thus acting as industry 'gatekeepers', or to hire politically connected contractor firms, e.g. in engineering, surveying, equipment supply and other procurement.



Strong relationships with a number of key natural gas industry influencers could mitigate contract risks for existing or prospective investors in the sector

KEY NATURAL GAS INDUSTRY INFLUENCERS

Some influencers are key policy makers and gatekeepers that facilitate the acquisition of licences. Others are likely to broker political influence through local partnerships with politically-connected companies. Strong relationships with a number of such individuals could mitigate contract risks for existing or prospective investors in the sector.

Armando Guebuza President of Mozambique	Major business interest is large conglomerate Intelec Holdings. Stakes in Sasol gas joint venture, Trans African Connection (toll roads) and Cornelder (Beira and Quelimane Port operator).
Celso Correia Chairman, Insitec Holdings and BCI	Guebuza favourite and key gatekeeper and partner for ventures with Brazilian investors. E.g. Insitec and Camargo Corrêa have 40% stakes in the Mphanda Nkuwa hydroelectric dam. Currently lobbying for the construction of an LNG plant.
Sérgio Pantie FRELIMO CP Member	Set to become an influential stakeholder in the gas sector through 30% stakes in a number of Nampula-based companies. Already a key minority partner for mining.
António Sumbana Minister in the Presidency	President Guebuza's right-hand man and chief policy-maker. Owns Mbatine Investimentos Ltd., which co-owns Indopetro SA (oil and gas sector asset management).
Salimo Amad Abdula Chairman, Intelec Holdings	Abdula is a key ally of Guebuza. Intelec is the chief service provider to Electricidade de Moçambique (EDM) and is involved in energy transformation deals for gas and oil.
General Tobias Dai Former Defence Minister	Guebuza's brother-in-law. His cousin Jose Edouardo Dai has formed numerous business ventures with Valentina Guebuza. Sister-in-law Maria da Luz Guebuza is also close to Dai.
Valentina Guebuza Daughter of Armando Guebuza	Head of family holding firm Focus 21. Stakes in logistics, trade, mining, telecoms, and real estate companies. Key gas sector player, along with brother Mussumbuluko and nephew Daude Guebuza.
Tania Romana Matsinhe CEO, Intelec Consulting	Cape Town-based Matsinhe gives advice to companies planning to invest in Mozambique. She is a former economic adviser to the Mozambique Minister of Planning and Development.
Petroline	A pipeline joint venture between the state-owned Petróleos de Moçambique (Petromoc) and South African firms. The commercial viability of its pipeline is threatened by South Africa's Transnet's plans to construct its own pipeline.
SPI Limitada	A holding company owned by influential Frelimo members.
N'Naite Joaquim Chissano Son of the former president	Although not close to Guebuza, Chissano owns stakes in Gasoils SA (search, production and marketing for gas sector) and Tupann (construction).

Loss of support for President Guebuza in the key structure of the ruling FRELIMO party reduces the likelihood that he can handpick a loyal supporter as presidential candidate in the 2014 elections.

In order to retain influence over the gas sector once he steps down as president, Guebuza would need to influence the nomination of the FRELIMO candidate for the 2014 elections, which is unlikely to be made before June 2013. The fragmented nature of opposition parties RENAMO and the Democratic Movement of Mozambique places the FRELIMO candidate in an almost unassailable position in the elections. Guebuza's initial support of the relatively weak Prime Minister Aires Ali failed when he lost his seat on the powerful 17-member party Political Commission (CP) at the September 2012 FRELIMO congress, triggering his departure as prime minister and replacement with Alberto Vaquina. Growing demands from within FRELIMO for a generational change, as well as intensifying factional divisions, are likely to prevent Guebuza from simply hand-picking his successor.

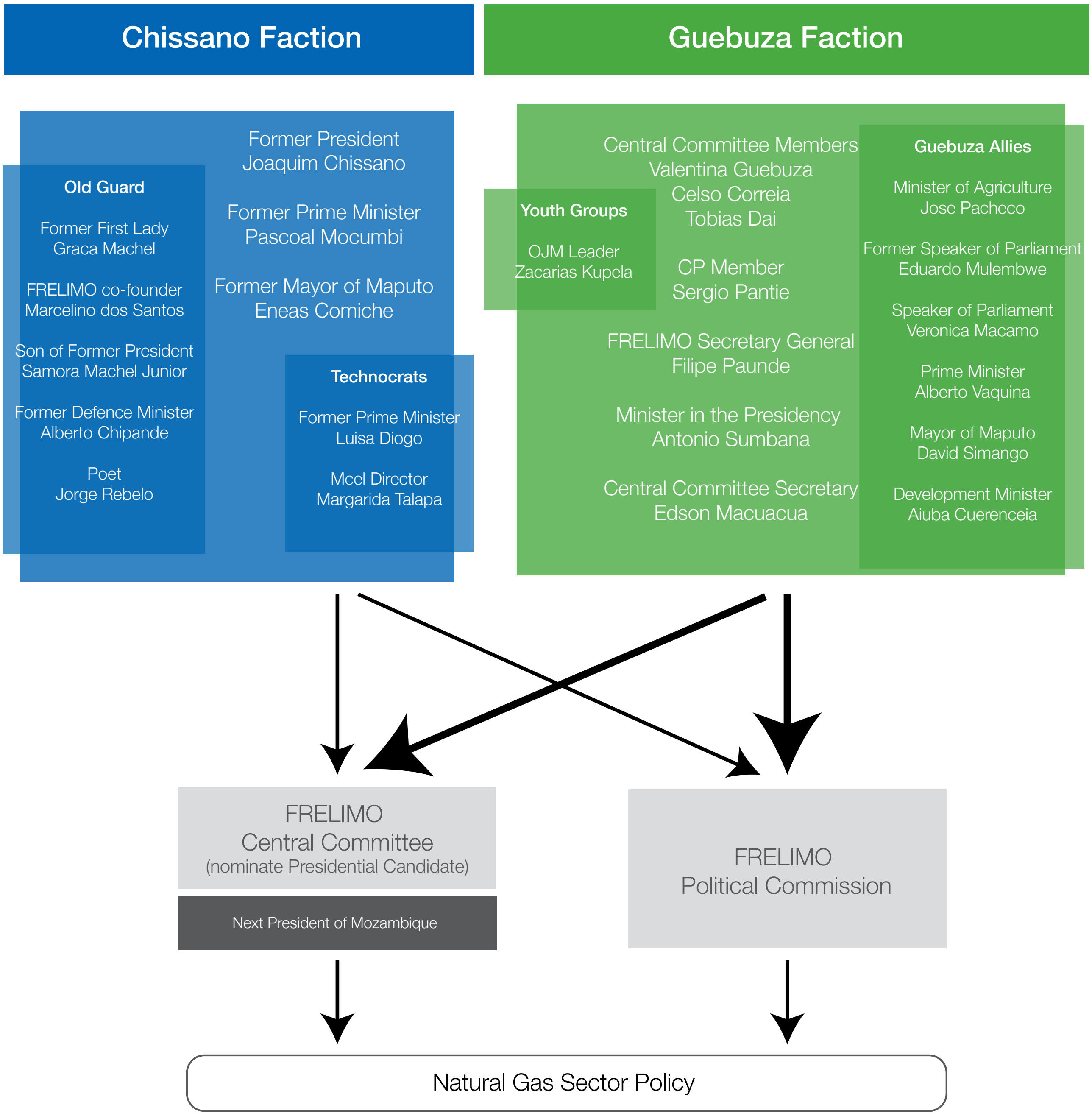
Possible candidates for the party nomination for the 2014 presidential elections.

Filipe Paúnde FRELIMO Secretary General	While a frontrunner after receiving the most votes at the Central Committee elections in 2012, Paúnde is increasingly likely to be rejected by those opposed to appointing a close ally of Guebuza as his successor.
Valentina Guebuza Member of the Central Committee	Valentina Guebuza's elevation has led to speculation that the president is considering a 'dynastic' succession. We believe this would be more likely in 2019 elections.
Eduardo Mulémbwè Former Speaker of Parliament	Mulémbwè is a close ally of Guebuza. He is likely to be supported by Guebuza if Paúnde falls out of favour before 2014, although we believe this is unlikely.
José Pacheco Agriculture Minister	A party favourite who performed remarkably well at the 2012 FRELIMO congress. While loyal to Guebuza, he would be likely to emerge as his own man if elected.
Verónica Macamo Parliamentary Speaker	Another party favourite who received a high number of votes at the FRELIMO congress in 2012. As president, her loyalty to Guebuza would be likely to waver as new gatekeepers emerge.
Tomaz Salomão SADC Secretary General	A former Finance Minister, Salomão is well-respected internationally. His work with regional body SADC has distanced him from power politics in Mozambique.
Alberto Vaquina Prime Minister	Governor of mineral-rich Tete province before succeeding Aires Ali in 2012, he probably lacks sufficient political capital to win the nomination.
Luisa Diogio Former Prime Minister	A Guebuza critic and supporter of former President Joaquim Chissano. The loss of her CP seat in 2012 renders her less viable. She could support Mcel Director Margarida Talapa.
Alberto Chipande Former Defence Minister	Unlikely to secure the nomination given his formation of a new faction critical of Guebuza. But is likely to head the party 'Old Guard' into the party elections.

We now expect Guebuza to lobby the party Central Committee, which nominates the presidential candidate, to select a loyal supporter. However, Guebuza lost a number of key allies on the Central Committee in 2012 and his preferred choice, likely to be a candidate such as long-time ally Filipe Paúnde, is no longer assured the nomination. If this is the case, the next president will be as powerful as Guebuza, leading to the likely emergence of new gas industry gatekeepers over the next five years.

In the unlikely scenario in which a critic of Guebuza is nominated, such as Luisa Diogio or Alberto Chipande, contracts signed since 2005 would be at severe risk of renegotiation or cancellation. Guebuza would be able to continue to influence policy as party president until 2017 but gatekeepers would gradually be replaced by figures closer to the new national president.

Political dynamics influence map



REGULATORY DYNAMICS AND OUTLOOK

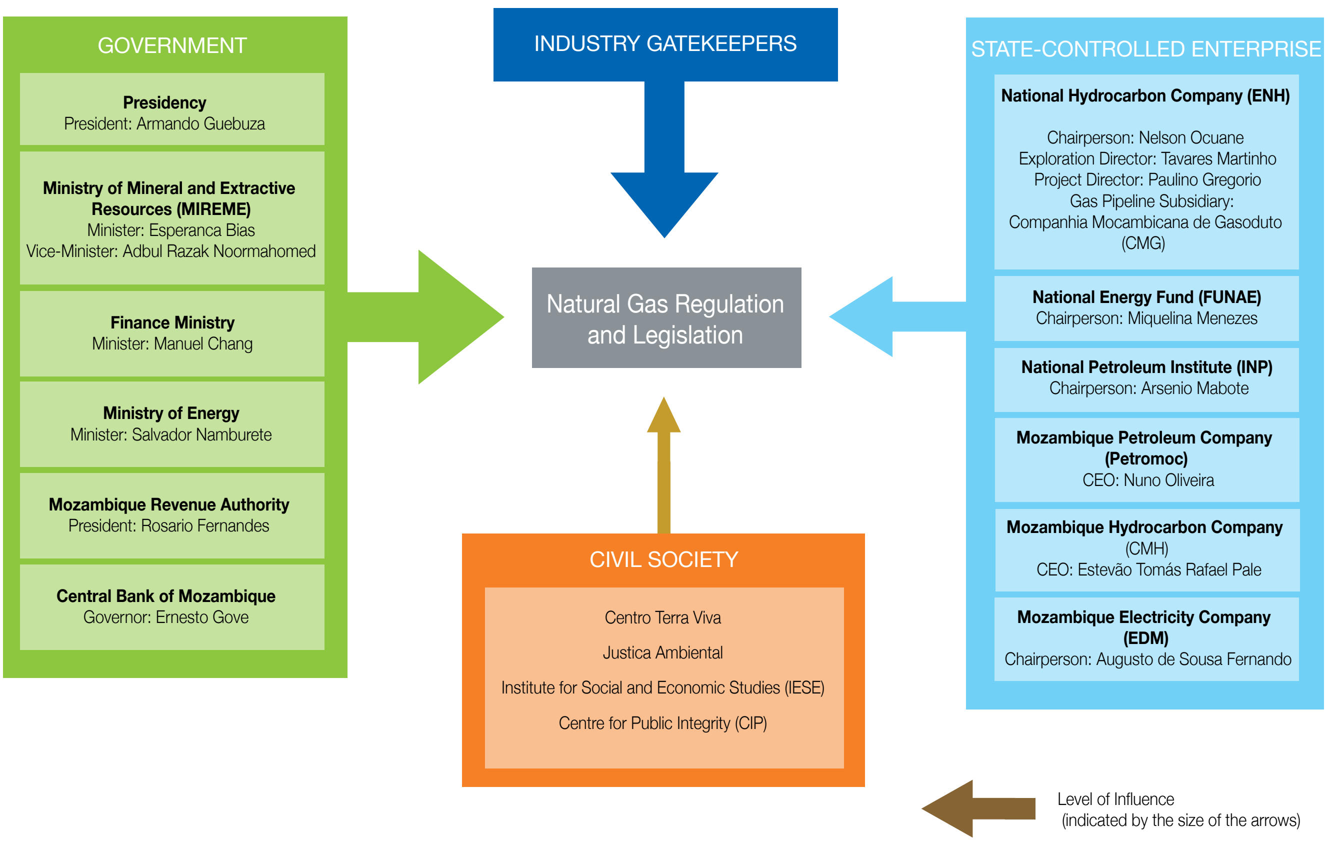
The government and its opponents are both seeking greater local benefits and ownership, making contract renegotiations and the introduction of new taxes for large natural gas projects likely over the next three years.

Contract renegotiations for large natural gas projects are being pursued by groups with different motivations. The current group of gatekeepers is seeking greater local participation and a greater share of revenues in the sector through participation of state-owned vehicles such as the National Hydrocarbon Company (ENH) and politically favoured private companies. Key figures close to Guebuza, especially Celso Correia and Sérgio Pantie, are also expected to encourage the party to review existing licences and to influence future contracts.

The political opposition, civil society and members of FRELIMO have also called for greater local benefits, increased taxes and state ownership of the sector. These groups, which are less influential than Guebuza's associates, are seeking to enhance the benefits from the sector to the state. The Institute for Social and Economic Studies (IESE), Mozambique's most respected think-tank, is likely to advise the Mozambique Revenue Authority and Central Bank of Mozambique, which sets taxation and royalty levels for gas operators. However, the IESE's opposition to the acquisition of personal benefits by the ruling elite, as well as advice on local participation from partners such as the IMF, World Bank and Norway, could be disregarded or at least tempered.

Given this political pressure for greater local benefits and ownership, existing natural gas projects are likely to be listed for review and renegotiation. Finance Minister Manuel Chang is currently taking the lead on identifying contracts for review and is likely to be heavily influenced by both Guebuza associates and government agencies.

Regulatory dynamics influence map



Key regulatory and political risks facing existing and prospective investors in the natural gas sector:

A new legislative framework governing the gas sector is unlikely to be in place before 2016 given the political preoccupation with party succession and growing factional divisions within FRELIMO. This will increase investors' dependence on industry gatekeepers. We also expect gatekeepers to encourage investors to form joint ventures with local politically-favoured partners to lessen risks to their contracts and to avoid risk of arbitrary decision-making. However, such partnerships could expose investors to reputational risks and probes by home regulators.

The state, through ENH, is likely to increase its stake in future joint ventures (from the current 10%-15% to a possible 35%-40%). Existing investors such as Eni, Sasol Limited, Anadarko and Statoil ASA will face a continued threat that the government may increase ENH's share in the future, although this threat would be mitigated by financial constraints to offer market price compensation. We don't expect the stakes in existing projects to be increased over the next year as the government will be preoccupied with internal party elections and preparations for the 2014 elections.

The government is likely to favour South-South partnerships in farm out agreements and the new bidding round, preferring Brazilian, South African, Indian, Thai and Chinese investors. Bids from these countries often incorporate knowledge, technology transfer and local skills development clauses. Investors from other developing economies could also provoke less hostility from local communities, with Western companies more likely to be viewed as exploitative.

Stake sales ahead of production in 2018 are exposed to uncertain capital gains tax demands, with a proposed increase in rate from the 12.8% charged for the sale of Cove Energy plc in August 2012 to 32%. Changes to the tax regime are also likely to affect companies once production has commenced. Tax breaks, currently granted for up to 10 years, are likely to be reduced, affecting existing large projects such as Eni's, Anadarko's and Statoil's. Long-standing and already productive projects, such as Sasol's, are less likely to be affected as they are nearing the end of the period fiscal benefits were originally agreed on. The government is also likely to impose a windfall tax if natural gas prices rise steeply on the world market.

Key risk indicators for the natural gas sector

The table below lists five developments that would indicate a change in the current regulatory or political risk outlook.

Risk indicator	Likely outcome
Irregularities in the 2014 elections result in a decrease in donor aid (30% of the budget).	The government sharply increases taxes and royalties and unilaterally cancels tax exemptions.
A steep rise in natural gas prices intensifies the perception that gas companies make excessive returns.	The government introduces a windfall tax on profits above a set threshold.
Rising fuel prices and associated inflation raise pressure to seek cheaper sources of energy.	The share of gas output allocated for local consumption is increased.
Unrealistic government demands trigger a break-down in the consultation process with gas companies.	Tax exemptions are cancelled across the board and state ownership is unilaterally increased.
Guebuza's failure to handpick a political ally as successor signals a change in government and gatekeepers.	Operators face the risk of corruption probes, contract revision and demands for new bribes.

INFRASTRUCTURE RISKS

The slow development of gas infrastructure, such as the construction of LNG terminals, is likely to be the most serious obstacle to the economic viability of the sector.

The lack of existing infrastructure in Mozambique is a major obstacle for investors in the natural gas sector. Success will be heavily reliant on developments in gas infrastructure, including the construction of pipelines and LNG terminals. A number of new pipelines have been suggested, although a pipeline connecting the Rovuma Basin with consumer centres in South Africa is the most likely to be realised, possibly connecting with existing pipelines from Sasol's oil and gas fields off Beira. The government aims to start exporting LNG from the Rovuma Basin as soon as production starts in 2018, and the INP has plans for at least ten different LNG terminals. The government has identified Asian markets as a key export target for LNG, as demand is increasing, prices are high, and transport to Asia is easier than from US and European suppliers.

Eni also has plans for an offshore floating conversion plant. While the governments of Mozambique and Tanzania are discussing potential cooperation, plans are unlikely to be realised, with the governments seeking exclusive control over their gas sectors and being unwilling to share revenues.

However, given legislative delays and growing risks to contracts, foreign investment in developing LNG infrastructure, which has been estimated by the INP at a required USD20 billion, is likely to be delayed. While Anadarko and Eni have begun talks on the joint construction of an LNG plant for processing offshore gas, neither company has extensive experience of developing LNG. Further stakes are likely to be farmed out to seek assistance with the huge capital costs and technical expertise needed to develop LNG infrastructure. Already, in its March 2013 acquisition of a 20% stake in Eni's Area 4 field for USD4.2 billion, CNPC agreed to fund LNG infrastructure development. Anadarko is looking to sell a 10% working interest in its Mozambique

operations, with partner Videocon Industry's 10% stake also up for auction. In August 2012, Cove Energy, which held an 8.5% stake in Anadarko's block, was acquired by Thailand's PTT Exploration and Production for USD1.9 billion following a protracted bidding war with Royal Dutch Shell. Delays to approval of stake sales and infrastructure development would restrict export potential to Asian markets.

Protests by local communities are also likely to further delay the development of gas pipelines and terminals.

As gas projects enter the construction phase they are more likely to be exposed to disruption and vandalism from local community protests over relocations and demands for greater skills and employment development. Clear examples can be drawn from the coal mining sector, currently dominated by Rio Tinto plc, Eurasian Natural Resources Corporation (ENRC) and Vale S.A.

Violent demonstrations by local communities demanding greater benefits from the mining sector and protests against forced relocations have targeted mining sites and railway lines used by Vale and Rio Tinto. In January 2012, local residents in Moatize blockaded the Sena public railway line, preventing coal from being transported to Beira Port. The railway authority, CFM (Caminhos de Ferro de Mocambique), said that the derailment of a train in Infulene, Maputo on 8 January 2013 was likely to have been an act of sabotage to facilitate the theft of cargo.

As energy infrastructure is developed, it is likely that local communities will also target pipelines and LNG terminal constructions in a bid to pressure the government to accede to their demands. If the Rapid Intervention Force is deployed to disperse protesters, violent confrontations and potentially retaliatory vandalism of gas terminals and pipelines (as in Tanzania's Mtwara region) are likely

The slow development of gas infrastructure is likely to be the most serious obstacle to the economic viability of the sector

“We tell you what we know.
We tell you what we don’t know.
We tell you what we think.
We never confuse the three.”

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