It’s just a clause, isn’t it?

clauses, contracts and their generational impacts No. 1

Welcome to the inaugural edition of *“It’s just a clause, isn’t it?*”, with the goal of informing, provoking, inspiring and finally creating appreciation on the part of readers regarding the importance of contract clauses for raw materials. As we say, the impact that they have for this generation and for future generations is enormous.

With the global demand for critical raw materials rapidly rising to meet the energy transition, the contracts governing the exploration and production of these raw materials - lithium, cobalt, nickel, graphite, copper and many others - have become even more crucial.

With a vision of achieving better deals for resource rich countries, CONNEX’s mission is to provide requesting governments with short-term, tailored multidisciplinary negotiation assistance in mining, mining-led infrastructure and renewables. Our Advisory Committee consists of global leaders in the contract negotiation and mining space.

Each edition of ***“It’s just a clause, isn’t it?”*** will explore specific clauses, tap into a colleague’s knowledge and share this knowledge with negotiation teams who may be facing challenges related to these very clauses. So, without further ado, Lou Wells (LW) takes on the thorny issue of stabilisation clauses....

> *“If, following the Effective Date, there is any change, or series of changes, in the laws or regulations of [host country] which materially reduces the economic benefits derived or to be derived by Licensee hereunder, Licensee may notify the Government accordingly and thereafter the Parties shall meet to negotiate … the necessary modifications to this Agreement to restore Licensee to substantially the same overall economic position as prevailed hereunder prior to such change(s). In the event that the Parties are unable to agree … then either Party may refer the matter for determination [to international arbitration].”*

LW: This “stabilization” provision, from an extractive-industry contract between an African country and a multinational firm, raises important policy questions, as well as matters of clarity in drafting:

1. Are “stabilization” provisions something that countries ought to include in extractive agreements?
2. If they are to be included, what should they stabilize and for how long?
3. Is this particular provision clear? If not, what kind of dispute would you predict for the future?

This particular provision

1. Investors often ask host governments in developing countries to provide guarantees that laws and policies will be frozen at the point when the agreement was reached. Or, as in this case, insist on compensation to the investor for the impact of future changes.

I have strongly encouraged governments to resist such provisions, protection that investors would not receive in their home countries. If, however, the host government decides that some assurances are necessary, I would try to negotiate a clause with a shorter duration, less broad in coverage, and clearer.

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2. The sample provides stabilization for the life of the contract, but stabilization provisions usually do so for only a limited time. Stabilization for life, say 20 to 30 years, binds governments' hands for far too long a period.

3. This particular provision protects the investor from all government actions that affect profitability. But modern stabilization clauses typically limit guarantees to fiscal provisions: taxes, royalties, and specific fees, for example. They leave room for new laws and regulations that govern environmental impact, safety, health, and other issues.

4. This provision provides compensation for any changes. Measuring the impact and determining compensation for even a simple change in tax rate is problematic. If compensation is to be by changing other provisions, how does one measure their impact into the future? Seemingly simpler, a largely antiquated approach to stabilization calls for the continued application of laws and regulations that were in force at the time of the agreement. Tax rates and regulations and, often, all laws and regulations, continue to apply as they were when the agreement was signed. This kind of provision leaves authorities with the costly burden of administering different regimes for different investors.

5. The sample provision seems to allow a one-way guarantee for the investor: if tax rates go up, the investor is to be compensated for the increase, but if the rate goes down, the investor benefits from the lower rate. I find no convincing argument to support this one-way approach. If the project would have been profitable at the original tax rate, it should remain so regardless of rates for others; in export industries prices are set in international markets. I would resist giving the investor the benefit of future lower tax rates if it refuses the possibility of future higher rates.

6. The drafting of this provision leaves many questions unaddressed:
• What does "materially" reducing benefits mean?
• What happens if tax rates rise, but they are accompanied by other policies that offset the effect of the increased rates?
• Are the benefits to be ignored?
• What if the beneficial changes occurred earlier than changes that reduce benefits?

If the host country should nevertheless decide to acquiesce to demands for stabilization, it can charge for the "insurance."

In fact, a dispute did arise: the government lowered the tax rate and the investor benefited. Let's say that the starting tax rate was 50%, it was lowered to 25%. But soon it was raised to 35%. The investor claimed that the 25% rate, set a new standard for judging the impact of the eventual increase to 35%, regardless of the fact that 35% was lower than the rate at the time the original deal. Claiming compensation for the increase to 35%, the investor turned to international arbitration. The government eventually prevailed, but international arbitration is expensive, consumes valuable time of officials, and threatens the reputation of the host country.

More generally

Investors do worry that, after they commit funds, host governments will take steps that reduce their expected returns. At home, they feel armored against unreasonable actions by government because of their industry's access to the political process and general assurances of non-discrimination. Abroad, they feel naked, especially in countries with a record of changing regimes and policies.

Investors can be reminded, informally, that bilateral investment treaties and investment provisions in trade agreements now offer a degree of stability, in the form of protection against discriminatory actions and violations of "legitimate expectations."

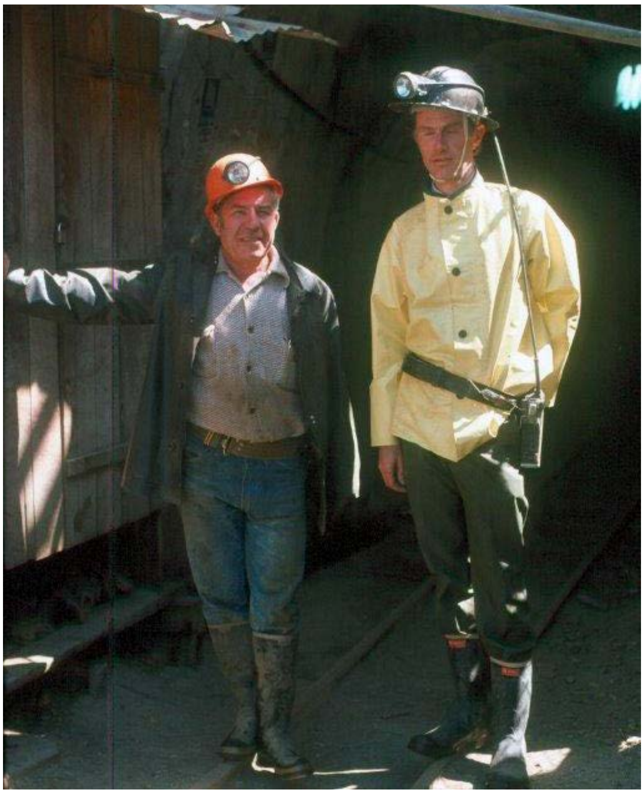
If the host country should nevertheless decide to acquiesce to demands for stabilization, it can charge for the "insurance." One country has offered investors an option: pay a frozen tax rate slightly higher than the rate at the time of negotiation, in exchange for guarantees of no increases. This makes sense to me: offer to stabilize, but at a cost for the "insurance policy."

Well constructed agreements can themselves reduce the political pressure for future changes in fiscal provisions. History suggests that long-term extractive agreements are particularly likely to become unstable if product prices rise sharply or if the "find" turns out to be especially profitable. Political pressures demand that government capture a larger share of the "windfall" from extracting non-renewable national wealth.

When oil prices rose to $140/bbl in the early 2000s, governments increased their take from petroleum extraction across much of the world, not only in developing countries. Conflicts arose especially over agreements negotiated in the mid-90s, when oil prices in the mid-teens resulted in contracts with low shares for government. Stabilization provisions did not always protect investors. Governments increased their take, and some investors turned to international arbitration, but the result often was huge legal fees, damaged reputations, loss of attractive assets, and awards that could be collected only years later, if at all.

The risks to investors from changed circumstances can be partially mitigated if agreements take into account the possibility of their occurring. State reactions to windfalls can be made more predictable with well designed fiscal provisions: progressive royalties or income taxes, for example. Of course, investors resist such provisions, hoping they can capture the windfalls for themselves. History suggests that the hope may be in vain.

In conclusion, if a government feels compelled to offer stabilization provisions, they need to be limited in time and scope, manageable, and drafted to create as few ambiguities as possible. But, some original thinking might lead to less controversial terms that provide investors with adequate assurances without government's yielding its right to respond to future needs and conditions. ⚒



A member of CONNEX's Advisory Committee, Lou Wells spent 47 years teaching at Harvard Business School. A substantial part of his consulting work concentrated on negotiation support in the extractive sector. His numerous books and articles have landed on dozens, if not hundreds, of government and student desks around the world. Lou has also clocked up tens of thousands of miles working with governments to achieve a better deal.

Lou (right, in yellow), in Bolivia in 1974 at a tungsten mine with the mine manager.

Please note: The above article represents the views of the author himself and does not in any way reflect views of the CONNEX Support Unit, its Board, its employees or its funders.

Do you have suggestions of types of clauses or any other comments?

Are you a government keen to discuss CONNEX's negotiation support services on a confidential basis? Let's talk....

Richard Dion
Senior Advisor
dion@connex-unit.org / www.connex-unit.org