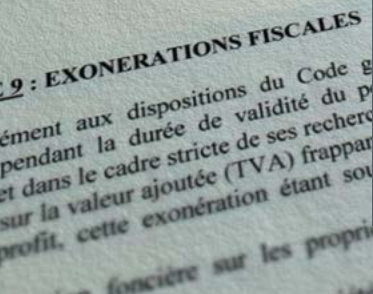
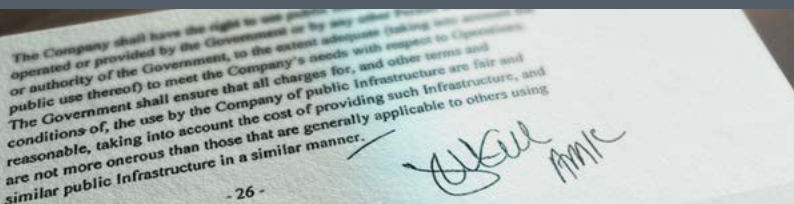


CLAUSE INSIGHTS



Cluses, contracts and
their generational
impacts



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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.

CLAUSE 1

Stabilisation Clauses –

Explore specific clauses and share the knowledge of experts consideration in mining contracts

Welcome to the inaugural edition of “Clause Insights”, 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 investments future generations will be proud of, CONEX’s mission is to empower governments to better negotiate international investments in mining, infrastructure and renewables. Our Advisory Committee consists of global leaders in the contract negotiation and mining space.

Each edition of “Clause Insights” 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....

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.

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?

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.

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

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.



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CLAUSE 2

Navigating Company- Community Relationships through Community Development Agreements

Whether you are a mine manager or investor, a member of a mine-affected community, a leader of a government body or NGO, or are involved in the mining sector in some other way, you likely have a lot of experience with managing change. Parties need tools to help them assess and navigate that change. They may turn to a “Community Development Agreement (CDA)” to generate solutions during times of change, but too often will find an agreement with no mechanism for evaluation or improvement to respond to change. The CDA may be very fixed and inflexible in the face of change. This can amplify frustration for all Parties and misunderstanding in times when open communication, honest evaluation of the options, and proactive responses are needed the most.

This edition of “Clause Insights” explores a Relationship Committee mechanism in a CDA that helps Parties to regularly review, assess, and improve their plans and the outcomes of their overall agreement.

We should clarify the term “community development agreement” as an agreement between a mining company and one or more mine-affected communities (and/or a local government on behalf of a community) to deliver socio-economic benefits such as jobs, social investments, and/or revenue sharing.

Some countries, like Liberia, use a model mine development agreement that requires a CDA; other governments, like Mongolia, have a model CDA serving as a template; and still other governments outline requirements for CDAs, in very general to more specific terms, in national or subnational legislation. CDAs are a tool for managing a mine’s impacts and benefits with varying degrees of success depending on a range of factors. Greater scrutiny of CDAs is needed to ensure improved practice and shared learning within and across stakeholder groups. This is particularly true as legislation begins to require such agreements and as existing agreements reach the end of their term, presenting opportunities to negotiate new and improved deals.

Good practice in CDAs involves the prospective Parties negotiating the agreement. Because the Parties, types of projects, and circumstances vary widely, it is not possible for any one model agreement to be well-suited for all variations without substantial flexibility and room for negotiation. Where legislation requires CDAs, a good

approach may be to provide a list of topics to be included in a CDA but not limit Parties solely to those topics. This can balance establishing some agreed norms and expectations with the benefits of negotiation and developing an agreement that responds to unique circumstances. Guidance can help Parties avoid costly mistakes and can be regularly improved to incorporate lessons learned and good practice.

So, here is our clause....

Establishment of [Relationship Committee]

X. The [Relationship Committee] is established and comprises 4 [Company] and 26 [Community] Representatives.

...

The functions of the [Relationship Committee] are to:

- a. foster and maintain a positive relationship between the parties in accordance with the relationship principles set out [above];
- b. monitor the ongoing implementation of Management Plans and make recommendations to the parties as to how particular Management Plans should be implemented and how implementation of those Management Plans could be improved;
- c. conduct a regular review in relation to each Management Plan and provide to [Company] and [Community] reports succinctly addressing:

- (1) the effectiveness of implementation and resourcing;
- (2) the operational successes and difficulties;
- (3) recommendations for variation of the content or implementation of each Management Plan;

Some agreements will call this committee the “Management Committee.” Other agreements have multiple committees, but far too many agreements have no committee like this at all and miss its many advantages.

The Relationship Committee referenced above is described in pages of detail in the actual agreement’s text, providing a high level of clarity. This excerpt is focused on the committee’s function to monitor ongoing implementation and make recommendations for improved implementation. These functions are often completely absent from CDAs or are so generic that they are meaningless. This results in missed opportunities to improve relationships; to learn through the process of implementation, evaluation, and reflection; and to advance the benefits of CDAs for all Parties involved. The sections below will discuss this excerpt by asking: Who? What? When? Where? Why? How? Then What? and then lay out some pros and cons to the agreement’s approach.

WHO?

In this example, the Relationship Committee included four company representatives and 26 community representatives, each with a three-year term. A company representative and a community representative acted as co-chairs, each with a Deputy Chair of the opposite gender.

This approach's advantage is the opportunity to include many community representatives and their perspectives in the Committee. Broad community representation is important because "the community" will almost never have "a" single perspective. The number of representatives above corresponded to a particular family or estate. The agreement specified the requirement of "opposite gender" for the Deputy Chair. Other agreements have added more detailed requirements, i.e. from specific community groups or categories of qualifications to ensure that men and women, youth, religious groups, etc. are represented. This broad cross-section of the community allows a better understanding of the range of its perspectives, concerns, and objectives.

The balance of 26 community representatives to four company representatives may make the community representatives feel more comfortable and empowered vis-a-vis the company representatives. However, the number of company representatives may limit additional

important knowledge or experience that would enrich discussions and may limit development of company relationships with community representatives that can positively impact company culture and morale.

Company Representatives may feel more comfortable with more of their company counterparts in the Relationship Committee, but such benefits could be outweighed by negative impacts if the Community Representatives felt overpowered by a large company presence. The parties should discuss and evaluate these dynamics. Having one company co-chair and one community co-chair can help establish balance on many levels including meeting preparation, facilitation, and follow-up and can help equalize power and decision-making dynamics for the long-term benefit of the relationship, the agreement, and the project.

WHAT?

This Relationship Committee’s functions went beyond “foster and maintain a positive relationship between the parties”. Many agreements just stop there. The relationship’s principles are present, with its practical, proactive functions, including monitoring and recommendations for improvement. The clause even outlines what will be included in company reports and communicated to the community following regular reviews: a succinct

report stating what worked, what didn't work, and what should be changed in the plan or its implementation to promote improvement.

A Relationship Committee can have many other functions. Here the function includes a detailed monitoring, evaluation and improvement function—so practical yet so often overlooked in CDAs for various reasons which may include:

- » Some Parties are simply new to CDAs or unsure what monitoring and evaluation involve and how to carry this out;
- » Other Parties may be fearful of inviting change to the agreement or to how it is implemented;
- » Companies may be concerned that changes will lead to greater expenditures, possibly at a time when they are not yet making substantial profits or need to assure investors that the project is on budget;
- » However, the monitoring and evaluation function is important for ongoing improvement of the agreement and its implementation. Development of monitoring and evaluation capacity can also improve management of small and medium sized enterprises (SMEs) and support economic diversification and resilience throughout the community.

WHEN?

In this example, the Relationship Committee agreed to meet at least quarterly to monitor ongoing implementation of the Management Plans. The committee also agreed to meet at the request of either of the Co-Chairs. This timeline of meeting at least every three months with additional meetings as needed is conducive to relationship building yet not so infrequent that major issues or opportunities are overlooked in the monitoring and evaluation function. However, these meetings are also time away from other obligations. These variables must be taken into consideration and costs mitigated in a manner deemed appropriate to the Parties.

WHERE?

This agreement established the mine site as the meeting location. This may be a secure place to meet that becomes familiar to the Parties over time. The safety of community representatives to participate in meetings may be a major issue in some regions and at times a top concern. In other regions, the Parties may prefer to meet at a community center or government hall or even a space built for the Parties through the agreement. All relevant factors for the Parties, e.g., safety, distance of travel, and related costs, should be considered when determining meeting locations.

WHY?

Why establish a Relationship Committee? This can be elaborated in the Committee's functions as well as its relationship principles, all detailed in the CDA. As noted above, it is important for prospective Parties to discuss pros and cons, generate options, and negotiate the agreement's particulars. This is not only because of the agreement's quality and relevances, but also because it builds relationships. Relationship principles can be a good place to start. Questions to ask include:

- » What principles do the Parties value?
- » Why are the Parties working together?
- » How will the Parties relate to one another?

HOW?

How will the Relationship Committee operate? Will it have support staff and a budget? In the above agreement, the Committee can set up sub-committees, hire experts, and arrange for trainings to build knowledge and capacity to fulfill its obligations. This is important as both the Company and Community Parties may be completely new to their roles and functions. Having access to trainings, experts, and support can aid implementation of the agreement and enhance development objectives.

Company representatives often find that while building capacity of community representatives takes time and resources, this leads to more successful and lasting negotiated agreements with improved management and outcomes. Companies must invest in building their capacity as well and in investing in the needed experts for the Parties to successfully monitor, evaluate, and improve implementation of their agreement.

THEN WHAT?

What happens if the Relationship Committee wants to change part of the agreement or how it is being implemented? In the above agreement, a unanimous vote of the Relationship Committee is needed, signed by all representatives present at the meeting in which the changes were made. This provides a clear method for variation of the agreement. However, especially where a change is material, the Representatives may wish to specify how they will inform their broader constituencies and solicit input on a proposed change. In this agreement, any community member could attend the meetings of the Relationship Committee as observers. The Committee may also invite guests. This could be helpful when critical discussions will be held and votes cast. It could also possibly be disruptive if addressing a heated or sensitive topic, so some reasonable boundaries for participation could be established and agreed by the Parties in advance.

Many CDAs do not include any clause regarding how the agreement may be amended. However, this can be extremely useful to help navigate change or modify aspects of an agreement that are outdated or simply are not working to meet the objectives of the Parties. To learn more about community development in the mining sector or to share your experience, check out the Community Development in Mining Collection, a new resource recently launched by the International Institute for Environment and Development (IIED), Sustainable Development Strategies Group (SDSG), and the Columbia Center on Sustainable Investment (CCSI).

The collection includes community development laws and agreements for the mining sector and already contains almost 300 pieces of legislation from 54 countries in an interactive map and searchable online database. The online resource aims to facilitate research, inform public debate about policy design, and improve local development outcomes. View the website and access news about the launch in English, Spanish, and French at the below link.

<https://www.iied.org/mapping-community-development-requirements-mining-sector>



From left to right, **PERRINE TOLEDANO**, **MARTIN DIETRICH BRAUCH** and **JACK ARNOLD** are members of the Mining & Energy team at the CCSI. Perrine is Head: Mining & Energy, Martin is Senior Legal and Economics Researcher, and Jack is Program Associate. The team conducts research, training, and advisory work on investment in extractive industries, renewable energy, and economy-wide decarbonization. Their work focuses on policies and practices to support resource-rich countries in achieving the Paris Agreement objectives and broader SDGs.



CLAUSE 3

Climate change –

aspects that should be given special consideration in mining contracts

With climate change reaching a fever pitch on the international policy stage and the physical impacts already being felt in numerous countries, we wanted to highlight some of the issues that mining contracts specifically should keep in mind regarding climate change.

This is an evolving field of interest and given that contracts usually exist over the course of (at least) one generation, it is important for governments to consider tomorrow's potential impact today.

For this edition of “Clause Insights”, we are very pleased to have a trio of experts from the Columbia Center on Sustainable Investment (CCSI) providing thoughts on how not only governments, but also companies, can prepare for the perhaps uncomfortable, but very necessary discussion around addressing climate change when it comes to a mining community and an operation. Martin, Perrine and Jack bring up some excellent points and very practically frame the topic.

In the 2015 Paris Agreement, the world's governments set an ambitious goal of limiting global temperature rise to 1.5°C over pre-industrial levels. To achieve this goal, global anthropogenic CO₂ emissions must decline steadily and reach net zero by about 2050, through a fundamental shift away from fossil fuels and toward clean energy technologies.

This transition will be very mineral-intensive. The World Bank estimates that mineral production could increase more than 450% by 2050 to meet the demand for clean energy technologies. How these minerals are produced will have a lasting impact on the clean energy transition.

MINING AND CLIMATE CHANGE

The mining and metals sector currently contributes 4–7% of greenhouse gas (GHG) emissions globally. Without adequate regulation to incentivize climate-friendly sustainable operations, increases in mineral extraction risk increasing the sector's carbon footprint. In addition, climate change acts as a risk multiplier – it increases the risk of flooding, drought, and landslides – and, as such, exacerbates the negative externalities caused by poor mining practices.

To address these issues, climate change considerations should be incorporated into the climate, environmental, water, forestry, energy, or mining laws of mineral-rich

countries. Unfortunately, legislative processes are often slow – and in countries where the legislation does not include climate change mitigation and adaptation requirements, governments may turn to contractual provisions to compel the mining sector to shift to climate-sensitive practices.

A recent CCSI publication assesses whether climate considerations were included in 21 publicly available mining contracts which states in Africa signed since the adoption of the Paris Agreement. Section 2.2.1 of the publication zooms into the role of contract clauses on climate adaptation strategies, climate risk assessments, and community vulnerability assessments in the context of mining.

ADAPTATION STRATEGIES

Climate change adaptation in a mining context refers to how companies can incorporate climate considerations into their processes, practices, and structures to mitigate climate-related risks. It relates to companies' "ability to adapt to changes, anticipate what might happen next, and absorb weather and climate-related shocks when they happen." Importantly, adaptation also refers to the role of mining companies in strengthening the resilience of mining-affected communities to climate-related impacts.

Climate change poses risks to the mining sector and mining-affected communities with the increased frequency and intensity of severe weather events that affect mining operations both directly – damage to infrastructure (during the mine’s life or post closure), access to water, and more dangerous working conditions – and indirectly, when their supply chains are similarly impacted.

A climate adaptation strategy can help ensure that mining-related assets are better able to withstand more frequent and severe climate events. It can also help to mitigate the project’s impact on the surrounding environment and community, including water, during the life of the mine or post-closure. Such a strategy is most effective when mining companies integrate climate change considerations into their own corporate strategies and then make investment, construction, and operational decisions based on global climate change models tailored to local, site-specific conditions.

Integrating climate adaptation strategies into the lifecycle of a mining project benefits all stakeholders. It makes business sense for mining companies, reducing their costs and improving their performance and efficiency. For states, it helps ensure and even increase tax revenues from mining activities. In addition, it builds climate resilience in mining-affected communities.

RECOMMENDATIONS FOR MINING CONTRACTS AND CLIMATE ADAPTATION

Despite these advantages, none of the contracts reviewed includes provisions on climate adaptation strategies. CCSI developed the following policy recommendations for host governments that do not already have robust laws that operationalize adaptation goals:

- » In mining contracts, governments should expressly require mines to comply with national adaptation plans (NAPs) and climate adaptation guidelines developed by the country.
- » In the context of the EIAs (Environmental Impact Assessments) and EMPs (Environmental Management Plans), governments should contractually require mining companies to assess climate risks and impacts and develop management plans to address them. In the same way that contracts often prescribe the contents of an EIA and EMP, they could similarly define what a climate risk assessment and related management plan entail.
- » The climate risk assessment should also cover incremental changes in climate conditions as these can affect the mining design and impact the surrounding environment on a cumulative basis.
- » Climate risk assessments should be conducted as if no adaptation measures were in place to apprehend maximum risk.

- » Risk mitigation strategies should be regularly (at least annually) revised to reflect the latest available data and predictions.
- » Emergency preparedness plans should also be put in place, reviewed, and updated to reflect best practices with respect to climate-related risks.
- » In the mining development plan, mining companies should integrate results of the climate risk assessment into management decisions on mining assets siting and infrastructure design.
- » Since mining companies are well placed to assist communities in improving their resilience to climate-related risks, such as developing emergency planning practices, supporting communities to develop and implement climate change and adaptation plans, or supporting infrastructure, community development agreements (CDAs) could require companies to contribute to community climate change adaptation strategies if communities deem it appropriate.

RESILIENCE: A DUTY FOR GOVERNMENTS AND AN OPPORTUNITY FOR MINING COMPANIES

To facilitate the transition to climate-resilient organizations and infrastructure, significant amounts of funding will be needed, and more will need to come from private sources. Our recommendations may in practice lead to higher upfront costs for mining companies—for example, by conducting climate risk assessments or

investing in climate-resilient infrastructure. However, research indicates that these measures tend to result in long-term savings, significant financial returns through net benefits that outsize the initial investment, and crucial societal benefits in the form of revenue streams for governments as well as climate resilience for mining-affected communities.

Therefore, while working toward adopting a robust legal framework for climate action, governments should use mining contracts as legal tools to impose climate change adaptation and resilience obligations on mining companies, leveraging their resources for resilience-building efforts in line with national adaptation strategies and plans.

In turn, mining companies that prioritize climate resilience—besides reducing GHG emissions and limiting other negative externalities—have the unique opportunity to become leaders in this new era. They will benefit from the continued availability of resources; the security of workers, infrastructure, and supply chains; and the prosperity of their stakeholders, while supporting the achievement of the Paris goals. Accordingly, governments have a strong case to make that companies should not resist adaptation and resilience obligations as profit-reducing burdens, but should rather embrace them as leadership or even survival opportunities.



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CLAUSE 4

Negotiating sliding-scale royalties – leveraging the boom, cushioning the bust

Royalties are an important part of the mining fiscal regime, compensating host states for the loss of their finite natural resources. Their design is often crucial to the mining sector's performance and the revenues generated for host states. A royalty set too high can deter investment and production, resulting in lower government revenues. But a royalty set too low can mean the state fails to collect enough revenues from its mining sector, particularly when mineral prices are booming.

In recent years, many countries have moved from the model of a fixed percentage royalty on sales value to a sliding-scale royalty. Sliding scales vary the royalty rate based on criteria aiming to increase the royalty rate when profits are higher, and reducing it when profits are lower. These sliding-scale royalties potentially improve the fiscal regime's "progressivity", – so the state collects a larger financial share from the mine when profits are higher. This tends to reduce domestic political pressures for windfall taxes and other changes to the fiscal regime.

In turn, when mineral prices are low and mining companies are under greater financial strain, the sliding-scale royalty automatically reduces the fiscal burden, helping to support investment and production.

In this version of “Clause Insights”, Stefanie Heerwig and Iain Steel of Econias look at the key design issues for sliding-scale royalties using a clause from the royalty regime of a Latin American country:

“ [...] The mining concessionaire... must pay a royalty equivalent to a percentage on the sales value of the main mineral and secondary minerals of between 3% and 8%, in addition to the corresponding payment of income tax and other taxes attributed to the State in accordance with this Law [...]. In order to establish the royalty rate to be paid, criteria of progressivity, production volumes of the mining concessionaire and/ or type and price of the minerals shall be observed, as established in the Regulations to this Law [...].

This clause provides for the royalty base, the range of royalty rates, and the possible criteria for the sliding scale. However, some key details are omitted and, as we set out below, these details can have significant impacts on the royalty's performance.

SETTING THE ROYALTY BASE

The royalty base in this clause is the mine's "sales value of the main mineral and secondary minerals". A royalty on sales value is relatively simple to administer, although whether deductions for items such as treatment and refining charges, marketing costs, and international shipping are allowed can impact revenue generation, the ease of administration, and the risk of tax avoidance. It is important to consider carefully what deductions are permitted and to specify this clearly in the law or in contracts to remove uncertainty. The clause specifically includes sales of secondary minerals. Mines often produce more than one mineral, for example a copper deposit might also include gold and silver, and the clause ensures that the host state also receives compensation for the loss of those secondary minerals. An alternative to sales value is to use operating profits as the royalty base, as in Chile and Peru. This approach is more "efficient", as operating profits better reflect a company's capacity to pay royalties than revenue from sales. It is therefore less likely to deter investment and production.

However, compared to a royalty on sales value, royalties on operating profits are more complex to administer and at greater risk of tax avoidance. This is particularly important when mining companies transact with affiliated companies and can potentially inflate costs to reduce the royalty. A royalty on operating profits also does not guarantee the host state compensation on all units of minerals produced, because if operating profits are zero or negative, no royalty would be paid. To overcome this drawback, Peru, supplements the operating profits royalty with a minimum royalty on sales value.

SETTING THE ROYALTY RATE

This royalty rate fluctuates between 3% and 8% but does not specify the sliding scale's mechanism. Instead, regulations can establish the sliding scale based on:

- » the criteria of progressivity;
- » production volumes;
- » and/or type and price of minerals.

VOLUME

If the intention is to improve the royalty's progressivity, volume is rarely used as the main criterion because production volumes do not necessarily correlate with profitability. In some cases, such as coal mining in Colombia, a lower rate is used for smaller mines.

This approach could also be used as a simplification measure, for example excluding smaller operations from more complex sliding-scale royalties. However, governments should ensure that the threshold does not inadvertently provide an incentive for mining companies to artificially reduce production to remain below the threshold and benefit from a lower royalty rate.

PRICE

Setting a sliding-scale royalty by reference to mineral prices improves progressivity. In this case, the contract applies higher royalty rates at higher prices, and lower royalty rates at lower prices. Prices are used as a proxy for profitability, as it is often the case that profits increase when mineral prices increase.

The benefits of a sliding-scale royalty at higher prices are potentially large, as we have recently seen. For example, a large-scale copper mine producing 400,000 tonnes per year before Covid-19 would have paid an annual royalty of US \$120 million at 5% of sales value in 2019 when copper prices hovered around US \$6,000/t. When copper prices increased in 2021 to record highs of US \$9,300/t a fixed 5% royalty would have generated US \$185 million. However, a sliding-scale royalty with an 8% rate would have generated US \$300 million – an additional US \$115 million of government revenue to fund the country's development.

Similarly, the sliding-scale royalty could reduce the royalty rate to 3% at lower prices, boosting company cash flows by USD \$50 million in 2019 when prices were lower. During years of sustained low prices, reducing the royalty can be the difference between a mining company remaining financially viable and continuing to invest in a project, or incurring losses that threaten the sustainability of operations.

The main advantages of the sliding-scale royalty by price are that it is relatively easy to administer and less prone to tax avoidance, especially when the rate table refers to mineral prices listed on a public exchange, and thus easy to verify. More detailed design issues include:

- » setting the precise rates and price thresholds for each mineral;
- » how the sliding scale applies to secondary minerals;
- » how to adjust the price thresholds for inflation. This approach is used in Burkina Faso, Cote d'Ivoire, Mauritania, Zambia, Zimbabwe, and elsewhere in Africa.

However, sliding-scale royalties based on prices are not always efficient. In some cases, input costs can increase by more than prices, which means a sliding-scale royalty based on prices can impose a higher royalty on a company even when profits are falling. For this reason,

Peru and Chile, among others, use operating profits to determine the applicable royalty rate. Operating profits are more efficient as the royalty rate increases only when actual profits increase, but are more complicated to administer and have a higher risk of tax avoidance – especially when both the royalty rate and base are determined by operating profits that include high-risk related-party transactions.

Royalty Rate for Copper	5%	Sliding Scale 3% low, 8% high	Impact on royalties
2019 US \$6,000 / tonne	US \$ 120 million	US \$70 million	- US \$ 50 million
2021 US \$9,300 / tonne	US \$ 185 million	US \$300 million	+ US \$ 115 million

The potential impact of a sliding-scale royalty by prices compared to a fixed-rate royalty, for a large-scale copper mine at low and high copper prices in 2019 and 2021.

CONCLUSIONS

No single approach to royalties is optimal in all situations. A royalty's design involves trade-offs between different objectives, such as efficiency and progressivity on the one hand, and simplicity and minimising avoidance risks on the other.

Governments need to consider their specific objectives and circumstances and design the royalty accordingly, rather than follow approaches used elsewhere. This should include an assessment of the royalty “in the round” with the fiscal regime's other elements - income tax, withholding taxes, and any other general taxes or special mining imposts.

Sliding-scale royalties can improve the royalty's progressivity, but other options exist to improve the overall progressivity of the fiscal regime. The options include a progressive income tax or resource rent tax (a tax on accumulated cash flows of a project once the investor has made a minimum return on investment). Using financial models to assess the fiscal regime's anticipated performance and the impact of different royalty designs on overall results across a range of economic scenarios is critical to designing a modern, efficient, and progressive fiscal regime.



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CLAUSE 5

Force Majeure – Preparing for the future today

Force majeure (FM) clauses are contractual provisions that excuse a party from fulfilling contractual obligations due to unforeseen circumstances beyond the party's control that hinder or prevent the party from performing those obligations.

In civil law jurisdictions (for example, those patterned after the French legal system), these protections may be included in the law. However, if parties have included a specific clause in the contract (which occurs frequently in investment contracts), the contractual language will likely prevail. In common law jurisdictions (for example, those patterned after the English legal system) the scope of protections is based on the contract's language. These “boilerplate” FM clauses receive comparatively less attention than more widely discussed provisions such as stabilization and arbitration, both of which have been the subject of many publications on balancing investor and state interests.

However, the pandemic's onset and the ensuing global disruptions have put the spotlight on these often-overlooked clauses. Parties were (perhaps for the first time) scrutinizing what kinds of protections and requirements were included in their force majeure provisions.

With the pandemic's major disruptions receding, governments should not become complacent when negotiating force majeure clauses. Indeed, they should look at the recent past and the potentially very uncertain future to guide them.

Climate change and the growing frequency of extreme weather events present increasing risks to mining projects and their operations. Responsibility for managing these risks must be properly allocated under the contract. Governments should require companies to build climate resilience into their project design, construction and operations. Force majeure clauses are one way to allocate risk and assign climate resilience responsibilities, but many standard clauses do not yet adequately address climate impact preparedness.

Force majeure clauses should include the following elements:

- » Definition of a force majeure event; the criteria of progressivity;
- » Mitigation, notice and evidence requirements;

- » Consequences of force majeure – e.g., specifying whether obligations are merely suspended and the time frame for performance is extended, whether a party may be excused from performance altogether or whether the party may terminate the contract;
- » Ongoing obligations – e.g., specifying that the party must fulfill obligations that the FM event did not directly affect, specifying that payment obligations remain in effect or noting any ongoing obligations post-termination of the contract if the clause allows for termination under specified circumstances.

At a minimum, governments should ensure their force majeure clauses provide clarity on all the above issues. This particular analysis will focus on the implications of definitions and mitigation requirements for climate impact risk allocation.

“ ...governments should require companies to embed climate resilience in project design, construction, upgrades and operations based on climate risk assessments....”

DEFINITION

FM clauses will often list events that qualify as force majeure and often include a “catch-all” provision for other events beyond a party’s reasonable control. For example, the below FM clause from a mining contract includes the following (rather expansive) definition:

“For the purposes of this Agreement, Force Majeure shall include war, insurrection, civil disturbances, blockades, riot, embargoes, strikes, lock-outs and other labour conflicts, land disputes, epidemics, volcanic eruptions, earthquakes, cyclones, floods, explosions, fires, lightning, governmental restrictions, change in applicable law, unavailability of materials or equipment, failure by [government] or any of its applicable ministries, departments or agencies to grant or issue to the Company (as consultant/operator) or contractors or subcontractors appointed by the Company (as consultant/operator) the necessary consents and permissions to enable them to operate in [country] or to import equipment into [country] or to grant or issue the necessary permits for non-[country] employees of the Company to enter into [country] and take up employment in a timely fashion and any other event which the Party claiming Force Majeure could not reasonably be expected to prevent or control and which prevents a Party from complying with any of the terms, conditions or provisions of this Agree-

ment (provided that [government] shall not be entitled to give notice of the occurrence of Force Majeure nor be excused from performance hereunder as a result of any of its actions or inaction or any of the actions or inactions of its applicable ministries, departments or agencies)."

Unlike the above contract example, some contract clauses may also require that the event be unforeseeable. For example, one extractive sector contract specifies that an event will only be considered force majeure if: "it is unforeseeable, unavoidable and beyond the control of the Party that declares Force Majeure." Reference to extreme weather events is very common in FM clauses in extractive sector contracts. I recently reviewed 34 petroleum contracts and model contracts signed or issued since adoption of the Paris Agreement. All but one of the 34 contracts included extreme weather events such as storms, lightning or floods as a basis for force majeure claims, with only 12 of them explicitly requiring that the event be unforeseeable. This clause provides for the royalty base, the range of royalty rates, and the possible criteria for the sliding scale. However, some key details are omitted and, as we set out below, these details can have significant impacts on the royalty's performance.

Notably, none of the contracts specifically required companies to prepare for climate change events.

However, changing weather patterns now call into question when extreme weather events should be deemed “unforeseeable.” Indeed, some experts have explicitly advised that climate change events are no longer unforeseeable due to their increasing frequency and the growing sophistication of climate data and models.

Instead, governments should require companies to embed climate resilience in project design, construction, upgrades and operations based on climate risk assessments. They should also require companies to obtain insurance to cover climate events. Others advise that contracts should define “unforeseeable” or what can be considered “extreme” or “unusual” weather based on agreed data sources. Given this increasing frequency of extreme weather events, governments must include climate change considerations in contracts, particularly given the decades-long duration of many extractive contracts.

The above FM definition also includes “change in applicable law” and “government restrictions.” However, governments should be mindful that change in law inclusions, especially when combined with stabilization clauses, could impede their ability to strengthen environmental, climate, health and safety, labour, and other regulations over time.

One extractive contract I recently reviewed included government regulation as a force majeure event where it leads “to the inability of the company to meet its obligations in a timely manner”. It equally placed responsibility for any resulting cost on the government by providing that “[g]overnment shall incur no responsibility...for any damages, restrictions, or loss” as a consequence of the force majeure event “except a force majeure caused by any order, regulation or direction of the government whether published in the form of a law or otherwise.”

Governments must think very carefully about including these kinds of protections in contracts, as they could increase the costs of improving regulations over time.

MITIGATION

FM clauses generally require the company to take some kind of action to mitigate the event’s effects, and under English common law a party will be required to do so. For example:

“The Party affected by the Force Majeure will exert all reasonable efforts to remove the cause, keep the other Parties fully informed of the situation and the current evolution of the Force Majeure event, and will promptly notify the other Parties as soon as the Force Majeure event is over and no longer prevents it from complying with its obligations or conditions under this Contract.”

However, it is equally important for governments to specify that the company must take prior precautionary action to avoid or to mitigate the event's impact, rather than solely mitigating after the fact.

One extractive contract I recently reviewed required that "if reasonably foreseeable [the company] shall have prior thereto taken all reasonably appropriate precautions..."

Another extractive contract defined a force majeure event as any event that "materially and adversely affects the performance by such affected Party of its obligations under or pursuant to this Agreement; provided, however, that such material and adverse effect could not have been prevented [emphasis added], overcome or remedied by the affected Party through the exercise of diligence and reasonable care."

Such a precautionary action requirement should be seen as complementary to new definitions of foreseeability with respect to extreme weather events, as well as clearly articulated climate resilience requirements. In short, the important risk allocation function of force majeure clauses must not be ignored or underestimated, especially in light of changing global risks and challenges.

Governments that strategically negotiate these clauses will be better prepared and more resilient over a contract's duration.

HOW CONNEX WORKS

GLOBALLY FOCUSED: Africa, Asia and Latin America.

MULTIDISCIPLINARY: Providing technical, financial, legal, strategic, environmental and social expertise.

CROSS-SECTORAL: Capable of supporting mining, infrastructure, and renewable energy sectors (including green hydrogen).

EFFICIENT: Tailored short-term measures lead to long-term and sustainable development impacts.

DEMAND-DRIVEN: Responding to country demand.



REQUESTING OUR SUPPORT

A few weeks to a few months

Informal exchange with government

Get in touch with support@connex-unit.org

Official request from government

e.g. IPA or Investment Commission, PM Office, Min of Mines or Energy, etc.

Check and approval through CONNEX structure

Together with negotiation team (inter-ministerial)

Definition of scope of support

Identification of experts

Provision of advice and support

Evaluation Review Adjustment

A few weeks to multiple months

POTENTIAL SUPPORT AREAS

- » Financial modelling
- » Assessing technical feasibility
- » Reviewing environmental and social impact assessments
- » Structuring of investment and legal drafting
- » Developing and adjusting negotiation strategy
- » Preparing tender processes
- » Supporting mine closure processes

NOTES:

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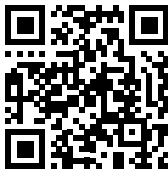
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A GOOD CONTRACT IS THE SUM OF ITS CLAUSES

*For further information visit our website or
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