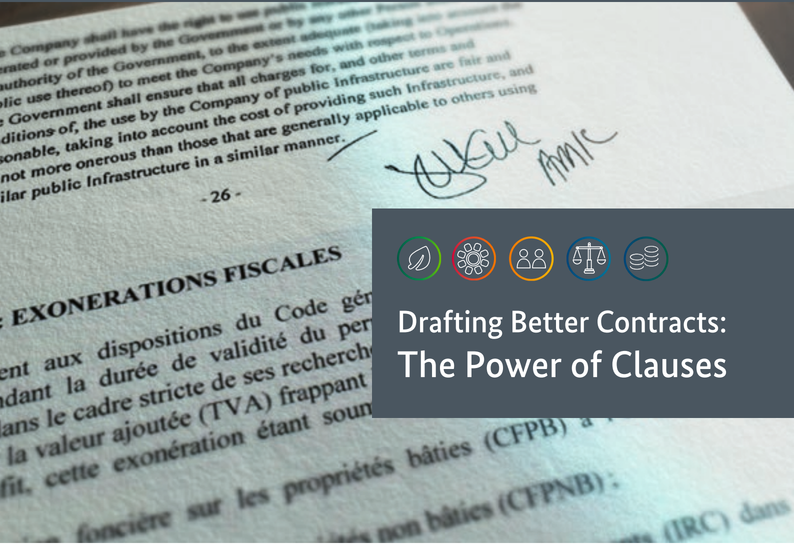
CONNEX

Contract Negotiation Support

CLAUSE INSIGHTS



Drafting Better Contracts: The Power of Clauses

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CONNEX

Contract Negotiation Support

Our Mission

Empowering governments to better negotiate international investments.

Our Vision

Investments that future generations will understand, accept and be proud of.

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Please note: The following articles represent the views of the authors themselves and do not necessarily reflect the views of the CONNEX Governing Board, its Advisory Committee or its Secretariat.

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CONNEX's series *Clause Insights* is designed to support government officials, who are negotiating contracts in mining, infrastructure and renewable energy, to better understand specific clauses and aspects to consider when negotiating them.

Clause Insights has also covered force majeure, community development agreements, take or pay clauses in power purchase agreements, lock-in clauses for public private partnerships and climate change.

We would be pleased to send electronic versions of these articles to you - just drop us a line at support@connex-unit.org or visit our website at www.connex-unit.org.

Of course, should your government require our multidisciplinary negotiation support, please let us know and we could discuss. Please note that there is no charge to requesting governments.

A member of CONNEX's Advisory Committee, **LOU WELLS** spent 47 years teaching at Harvard Business School. A substantial part of his consulting work has focused on negotiation support in the extractive sector. His numerous books and articles have reached many government offices and academic desks worldwide. Lou has travelled the globe 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, CONNEX’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....

“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:

Are "stabilization" provisions something that countries ought to include in extractive agreements?

1. **If they are to be included, what should they stabilize and for how long?**
2. **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.

JEFF GEIPEL leads the Mining Shared Value program of Engineers Without Borders Canada working to improve the development impacts of mineral extraction in host countries through increasing local procurement by the global mining industry. Jeff co-developed the Mining Local Procurement Reporting Mechanism (LPRM) with the German Development Corporation (GIZ), now used by a growing number of global mining companies to improve transparency and dialogue on local sourcing.

CLAUSE 2

Leveraging local procurement clauses in mining contracts

In the last number of years, governments hosting mining activity have more frequently been using local procurement requirements to increase the participation of domestic supplier firms in the sector's operations and value chains. The goal is to increase sourcing of inputs from local firms in order to provide local employment and business development. Starting in 2010, in part due to the references to backward linkages in the Africa Mining Vision (2009), Burkina Faso, Ghana, Mali and Tanzania, among others, introduced stricter local procurement requirements. In Latin America, Colombia and multiple Argentinian provinces have also introduced similar regulations.

Requirements for local procurement have fallen into two categories:

» Demand-side: Encourage, incentivise, or require mining companies to support local suppliers, through spending targets, reserving particular goods and services for national businesses, and requirements for international suppliers to form joint ventures with national firms to be able to supply the mining sector.

» Supply-side: Use policies, programmes and investments to build supplier capacity to competitively supply the mining sector (e.g. supplier training programmes, grants and targeted finance for supplier businesses).

While the oil and gas sector has commonly included local procurement clauses in production sharing agreements (PSAs) and other types of contracts, contract clauses in the mining sector appear to be less frequent.

Using local procurement clauses with mining companies will not always be appropriate, and governments need to carry out significant research to determine if they are suitable, and if so, what they should entail.

An alternative to clauses in individual agreements is legislation that covers a country's entire mining sector (as well as other types of local content requirement such as local hiring quotas). General legislation can, however, be a blunt tool. Approaching local procurement through clauses in individual mining contracts, may offer the advantage of putting in more appropriate measures specific to the company and asset involved.

CHARACTERISTICS OF CLAUSES IN EXTRACTIVE INDUSTRY CONTRACTS

From those contracts that are not confidential, it is possible to determine the following characteristics:

» Local procurement clauses are more common in the oil and gas sector than in mining;

» Most publicly available examples of local procurement clauses in both mining and oil and gas contract avoid strict, binding language, and rely on requirements to give preference to national suppliers “where possible” or “provided they meet the same quality and price requirements as international suppliers”;

» Some contracts require the mining or oil and gas company to report to the government on their procurement of goods and services and measures taken to support suppliers that can inform their supplier-side measures.

Very importantly, under the World Trade Organisation Agreement on Trade-Related Investment Measures (TRIMs) requirements for investing companies to procure from only national businesses are technically illegal, which helps explain why most – though not all – of the clauses on local procurement that are publicly available avoid binding language. International investment agreements, such as bilateral investment treaties, often include further restrictions on policies that affect procurement, such as bans on technology transfer requirements.

TYPES OF CLAUSES

For this article, I investigated 35 contracts in the mining and oil and gas sectors available at www.resourcecontracts.org. The following types of clauses were found:

» **"Best effort" clauses:** Loosely worded clauses that mirror counterparts in some local content legislation like that of Botswana, where a mining contract states that the company must give preference to national suppliers including phrases such as "where possible".

Because these clauses lack specificity, they are difficult to meaningfully enforce.

- **Preference requirements:** Specific thresholds or types of goods and services. In these cases, the company must give preference for national suppliers similar to a best effort clause, but language also mentions specific criteria on which enforcement could be based. For example, two contracts below say that the company must purchase from national suppliers if the price of the good or service is within 10% of the price offered by an international supplier (as long as the product is of similar quality), providing a regulator some specific means for comparison.

- **Procurement process requirements:** These clauses stipulate conditions that intend to ensure national suppliers have fair access to supplying opportunities. These include requirements that all tenders are published nationally, not only to international suppliers, and that tenders must be available in the national language.

- **Local procurement plan requirements:** Mirroring regulations on local procurement in Ghana and Tanzania, these clauses require a company to submit to government a plan for local procurement of goods and services. They are also usually accompanied by requirements to report on the progress of these plans based on a stated schedule.

- **Local procurement reporting requirements:** Clauses that require mining companies to provide data on its local procurement spending, such as the percentage spent on national suppliers versus international ones, what types of goods and services will be purchased and in what amount, and from which specific businesses the company is procuring.

Of the above five types, only the second, preference requirements, appears to conflict directly with the World Trade Organisation TRIMs Agreement, but the interpretation of the Agreement has varied. There still is subjectivity as to interpretation and in enforcement. In the example clause below that says insurance must be purchased of a comparable quality as long as it is within 10% of the price of an international supplier, there still is subjectivity in terms of the government's ability to claim the quality and other factors are the same.

Actual clauses

Below are sample provisions in each of the five categories drawn from publicly available contracts. They are provided to illustrate the categories, not to provide recommendations to governments.

Best efforts

The Company, including its subcontractors, shall use its best efforts to purchase goods and services in [country]. If there are available in [country] goods and services of suitable and reasonably comparable quality and delivery time, and at comparable price than goods available from abroad including freight.

or

Give preference to such goods and services which are produced in [country] or render by [country] nationals, provides such goods and services are offered at equally advantageous conditions with regards to quality, price, availability at the time and in the quantities required.

Preference with some form of specificity

Preference to [country] services

The Contractor and its subcontractors undertake to give preferences to [country] services, materials, equipment, consumables and other goods whose quality and time of delivery are comparable to those available internationally, provided that the cost in [country] is no more than ten percent (10%) above the cost of similar services, materials, equipment, consumables and other goods available internationally.

or

Nevertheless, the Contractor and its subcontractors agree to only import the goods indicated in article 26.1.a) insofar as said are not available in the [country] at similar quantity, quality, price, payment terms and conditions, subject to special technical requirements or urgency presented by the Contractor, its agents, contracts or its subcontractors.

Requirements for procurement processes

Commitment of the Concessionaire to Local Content

20.1 The Concessionaire must:

20.1.1 Meet the Local Content disposed in Annex IX.

20.1.2 Ensure preference to hiring [country] suppliers, whenever their offers present good conditions of price, time and quality that are more favourable, or equivalent to those of non [country] suppliers.

20.2 The process of acquisition or hiring of goods and services targeted to the fulfilment of the object of this contract shall:

a. Include [country] suppliers among the suppliers invited to submit proposals.

b. Provide the specifications of hiring also in [country] official language.

c. Accept equivalent specifications, provided the Best Practices of the oil industry are met.

20.2.1 The acquisition of goods and services supplied by affiliates is also subject to the specifications of this Clause, except in cases of services that, in the accordance the Best Practices of the oil industry, are usually made by affiliates.

Procurement plan requirements

8.14 The Development Plan referred to in Article 8.13 shall be based on detailed engineering studies and shall include: ...

m. Contractor’s proposals with regards to the procurement of goods and services obtainable in [country];

n. Contractor’s technology transfer plan;

Procurement reporting requirements

And its contractors may freely contract with any person. The Company must report to the Minister within 60 days following the end of the Financial Year on the extent to which the Company and Major Contractors acquired during such year materials, goods and services from the preferred sources describe in the first sentence of this Section [x]:

Within sixty (60) days after the end of each calendar year, the Licensee shall provide the Government with a report outlining its achievements in utilising [country] goods and services during the calendar year.

or

(4) The Contracts shall –

a. On or before the beginning of each calendar year to which it applies, submit to the Minister a tentative schedule of the contemplated services and supply contracts with an estimated value exceeding the equivalent of Five Hundred Thousand (USD 500,000.00) United States Dollars per contracts, to be entered into during the forthcoming calendar year, showing the anticipated tender date and approximate value and the goods and services to be provided.

MONITORING LOCAL CONTENT

Enforcing such clauses depends heavily on the state's capacity. The limited ability of governments to enforce best effort clauses is further weakened by the government's lack of knowledge to engage with claims from mining companies as to whether a nationally supplied good meets quality needs. Likewise, even if there is more specificity in a clause, such as a 10% price threshold as seen above, the clause's enforcement still requires meaningful assessment of issues such as quality.

Similarly, requiring data on procurement spending, types of goods and services purchased, and a company's existing suppliers can be extremely useful to government. These data could lead to policy changes and investments for particular suppliers and the surrounding ecosystem. One such investment could include vocational schools providing skills required to produce necessary goods. However, without the capacity to ensure these data are provided on time, and to analyse and communicate it properly, the information can and usually does end up sitting on a shelf.

In negotiating with the company, the government may also want to make an informal assessment as to how much human and financial resources will be needed for monitoring the clause and ensure that this figure is somehow informally built in through one of the government's revenue streams.

POTENTIAL APPROACHES IN AUSTRALIA AND CANADA

While both countries are federations, Canada and Australia do provide inspiration for local or approaches to individual mining operation, as both countries make extensive use of community development agreements (CDAs) between Indigenous communities and mining companies. Canada has what are usually called impact benefit agreements (IBAs), while Australia typically has Indigenous Land Use Agreements (ILUAs).

Neither country has national demand-side local procurement requirements for the mining sector, but these IBAs and the ILUAs at the local level typically include local procurement requirements. Because the agreement covers one mine site and community, the requirements can be more specific, more appropriate and thus far more effective.

GOVERNMENT'S OWN CONTINUOUS EFFORTS

If using clauses in contracts with mining companies, government must conduct research on the types and volumes of goods and services that a mining company will buy for a particular project and compare that to the current ability of national businesses to provide those products competitively. While some governments focus on a company's best efforts, governments may want to consider their own "continuous efforts" in their journey towards more local procurement. Some options include:

» Create incentivising policies regarding local content – “rewards” for those company’s using local content through the reduction of taxes, or “penalties” for not implementing the government’s perceived potential of local content in a certain procurement area;

» Facilitate a regular dialogue between the company and potential bidders to ensure that opportunities are communicated with enough warning to make it feasible for local companies to bid;

» Provide short-term bridge loans (and ideally at lower interest rates) to local companies to ensure that they have enough liquidity to meet upfront costs.

The Ministry of Economy could potentially implement programmes that develop emerging sectors of the economy to meet some of the potential local procurement opportunities.

UNDER-TAKING DUE DILIGENCE	As part of any negotiation process, governments should carry out extensive due diligence regarding experience, liquidity, the workforce and the company's approach regarding key themes such as ESG issues and local content. Governments should ask companies for very specific examples in other countries, including frank feedback from companies themselves on what worked and did not work.
MEASURING LOCAL CONTENT	What is the government's priority with regards to local content? Is it a minimum of people working on a project? Is it hours dedicated to the project? Is it tonnes of steel, cubic metres of concrete? Is it the financial spend "in country"? Perhaps the "intellectual" input in designing infrastructure needed for a mine (i.e. a railway)?

EDUCATION/ TRAINING	Are there programmes that companies could support, which will contribute to the growth of local content? Supporting a mining engineer programme with the obligation to absorb a certain percentage of graduates to the company? Another programme may be very practical business skills – business plan writing, financial planning, costing and human resource management.
TIMING	Many governments want results immediately – both production and employment. However, a balance will have to be struck. “Quick” or “quicker” production may need more employment from outside the country. However, that comes at a cost in local procurement.

MONITORING	As noted above, some clauses want reports at year's end, some want to examine a company's upcoming plan. A government needs to decide for itself, if it wants to only receive information (after contractual awarding) or steer a potential increase through company engagement before procurement starts.

The typology and examples of clauses provide "food for thought" for countries that are trying to encourage local procurement by mining firms. The economic opportunities, company acceptance and most of all, government policy, to procure goods and services locally is rising in many resource-rich countries. These conditions provide governments with more leverage than ever to increase spend in their countries, delivering priority projects in the mining sector, while further developing local, regional and national economies.

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A founder of Econias, **IAIN STEEL** is an economist specializing in fiscal policy and the extractive industries, advising governments in Africa, Asia-Pacific, and Latin America on mining, oil and gas, and infrastructure projects.

CLAUSE 3

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.

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.

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.

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 4

Third party access in infrastructure – rethinking excess capacity clauses in concession agreements

THE CONTEXT

Infrastructure is very capital-intensive and typically requires a certain minimum scale to effectively function. For example, it is not possible to build a functional railway with less than a full track. This minimum scale inevitably creates a baseline capacity that may exceed the immediate or long-term needs of the primary user. Typical examples of such infrastructure include railways, ports, desalination facilities, power and electricity transmission systems. This issue is becoming increasingly important with the myriad of corridor projects currently under development around the world.

In concession agreements – particularly those related to mining, energy generation, or green hydrogen production – infrastructure may not be the primary subject of the concession but can be absolutely critical to the operation's viability. In such cases, the operation of infrastructure is frequently outsourced to specialist service providers, while the infrastructure itself may remain publicly owned. A potential scenario includes the following:

Investor A developing Mine A builds railway A to export its minerals. The investor will be essentially building the railway and gaining complete access to it, with the government likely retaining ownership. What happens when Investor B comes along, discovers minerals in the region and would like access to railway A? Unless the reserves are enormous, it would hardly justify a second railway line. So, the key question is: what are the conditions in which Investor A (and the government) allow Investor B (or any other investor) access to the railway?

Well, it depends on how the agreement between Investor A and government was negotiated. Indeed, was access by another investor to the railway even discussed, really discussed, when Investor A negotiated with the government? Another investor aside, what has the government negotiated with regards to the transport of goods and people? Or has it? As this railway likely involves more than EUR 1 billion in capital investment, a great deal is at stake.

These agreements should include provisions that allow third parties to access spare or excess capacity in such infrastructure. These clauses are particularly relevant where the private operator (the “incumbent”) is granted use rights, rather than ownership, over public infrastructure. Typically, such provisions aim to ensure that third-party access is permitted (Investor B), provided it does not adversely impact the operations of the current user (Investor A) and does not require the current user to incur additional costs.

THE CHALLENGE

While the rationale behind excess capacity clauses is sound, their practical implementation presents several difficulties:

1. Ambiguity in Measuring Excess Capacity

Determining excess capacity objectively is complex. It involves calculating total capacity minus current and anticipated usage, both of which can fluctuate substantially due to fluctuating market conditions. Additionally, capacity itself is not fixed – it is influenced by how the infrastructure is operated. For instance, railway capacity depends on train speed, frequency, and configuration.

Incumbents may therefore be reluctant to agree to assessments that are based on assumptions outside their control or that would impose additional costs on its operations or require changes to its historical operating systems. An example of this would be running longer trains, requiring investments in rolling stock and changes to loading and unloading facilities and operational procedures.

2. Operational Impact of Shared Use

Introducing third-party users often reduces operational flexibility. This flexibility is typically factored into the incumbent's planning and day-to-day operations. This hidden 'use' of the infrastructure may seriously reduce the excess capacity available. This loss of flexibility can be considered a legitimate and acceptable adverse impact where the incumbent is expected to operate in a manner that reasonably maximizes the efficient use of the government's infrastructure.

3. Interruption Due to Expansion

When infrastructure capacity needs to be expanded to accommodate third parties, current operations may be disrupted by the expansion works. Even when initiated by third parties, such expansion works can interfere with the incumbent's efficiency and reliability of infrastructure use. This is likely a short-term issue, which can be compensated, and should be negotiated at the outset.

4. Cost Allocation Challenges

New users may gain access to infrastructure without bearing the initial capital (sunk) costs. While marginal costs of use may be low, this creates equity concerns if newcomers benefit disproportionately without contributing to past investments.

RECOMMENDATIONS: STRUCTURING EFFECTIVE CLAUSES

To address these challenges and ensure that excess capacity provisions are both enforceable and equitable, the following measures are recommended:

1. Shared Policy Objectives

The contract should clearly state that optimizing and sharing infrastructure use is a joint objective of the government and the incumbent user to avoid discussion about legitimate adverse impact (point two above).

2. Retention of Expansion Rights

Governments should reserve the right to expand infrastructure capacity as needed, affirming the limits of private use rights where infrastructure remains publicly owned.

3. Unilateral Access Rights

Governments should retain the authority to grant third-party access without requiring incumbent consent, subject to independent assessments ensuring no long-term unreasonable adverse impact, that is not properly compensated. There should be express latitude to determine what is "reasonable interference" or existing infrastructure use in the context of a multi-user system, particularly, as an expansion or rehabilitation project will often temporarily impact the existing available capacity of infrastructure.

4. Multi-User Models

Where substantial excess capacity exists, which is almost always the case when infrastructure has been built for a single user, a multi-user model with independent infrastructure management should be considered. This enables fair and efficient use among various stakeholders. Multi-use in this context does not only capture use by different, often competing companies, for transport infrastructure like rail and port, it also includes the use across different categories of goods and even passenger traffic on infrastructure. This allows the development of multi-use corridors that can have a major regional development impact.

5. Transparent Capacity Assessment

A clear methodology for calculating infrastructure capacity and usage should be defined in the agreement and applied by an independent party, ideally incorporating dynamic operational models, that do not give undue weight to existing operational inefficiencies of an incumbent user.

6. Equitable Cost Sharing

Expanding existing infrastructure may be relatively cheap compared to the capital outlays on initially building the infrastructure. Cost-sharing mechanisms should be put in place to compensate incumbents for sunk cost (like historic capex – Investor A above) and lost flexibility, ensuring a fair balance of benefits and burdens.

7. Refined Definition of Adverse Impact

The concept of “no adverse impact” should be limited to unreasonable interference, as assessed by a neutral third-party and aligned with the broader objective of optimizing infrastructure use. Again, if infrastructure use if optimized and leads to larger capacity for all, then all investors should welcome this, despite short-term downtime.

8. Separate Dispute Resolution

A dispute about the (third-party) use of infrastructure should ideally be resolved outside of the dispute resolution mechanisms of the broader concession agreement. Agreeing this upfront clarifies the position of the government vis-à-vis the multi-use of infrastructure, uncoupling the infrastructure rights and obligations from other economic rights given to an investor. Given what is at stake for company returns and government revenues, a culture and practice of dialogue is a key factor for resolution.

9. Define the Process of Third-Party Access

Parties should beyond writing down the principles of multi-use and put effort in detailing the process of third-party access or expansion of infrastructure. This provides upfront clarity on who or which agency(ies) is/are to decide, how safeguards for existing users are applied and whether or not compensation is to be paid.

TURNING CLAUSES INTO CATALYSTS

Access to infrastructure embedded within broader concessions can play a vital role in unlocking economic value beyond a single project or operator. However, to be effective, third-party access clauses must be extremely carefully crafted. They require clear definitions, independent assessments, and balanced cost-sharing arrangements to ensure that public infrastructure serves wider development goals without compromising the rights and operational integrity of the incumbent. With well-designed provisions, governments can leverage infrastructure more strategically, thus promoting inclusive growth, efficiency and fair competition.

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CLAUSE 4

Sustainable infrastructure – contractual aspects

With today's infrastructure investment gaps measuring in the billions of USD, enormous opportunities exist for new infrastructure contracts to bring value to people and to the environment. These opportunities come with a convincing business case and create generational projects which offer more for less. Below are a few aspects that governments should thoroughly understand and consider before concluding a contract of that scale.

WHAT DOES "SUSTAINABLE" INFRASTRUCTURE IN A CONTRACT ACTUALLY MEAN?

The term "sustainability" usually focuses on climate change mitigation or environmental safeguards. This is really only ¼ of the whole story. Sustainability has four extremely relevant contractual dimensions:

» **Economic or financial** refers to value for money and an adequate cost recovery supported by (if necessary) well-targeted subsidies to address affordability. Project risks must be transparent and fairly distributed between partners.

- *Economic and financial provisions: Think about clauses that ensure the investor is creating value for money (and the economy), such as prescribing a project business case in the annex or using locally-sourced goods and services (and measuring very specifically what that means, including facilitating the use of local goods and services). Has the business case been triangulated with government experts? At the same time, the government needs to ensure that a favourable rate of return for the company does not leave the state or its citizens with lost value.*

» **Environmental** spans the use of sustainable construction materials, the application of technologies for increased resource efficiency as well as circularity or the incorporation of innovative approaches to climate resilience.

- *Environmental and Social impact management plans: Incorporate a clause on the compliance* *with the environmental and social impact management plan, including monitoring.*

- *Examples here may include reducing the use of concrete or steel (and their large carbon footprint) or keeping track of trends, which may reduce the scope of a project, such as more public mobility solutions instead of traditional private, individual options such as cars.*

- *Technological advances may mean that a certain financial outlay or aspect of operation and maintenance could be significantly reduced as technology advances. How will the state and the company agree to its introduction, potential experimentation and to also rewarding of the technology?*

» **Social** represents infrastructure that is inclusive, accessible, and affordable for everyone. Infrastructure procurement should be transparent to civil society, comply with human & labor rights and manage cultural/heritage preservation.

- *Disclosure clause: a clause describing the disclosure of non-confidential information and data throughout the project lifecycle for the general public.*

- *For projects which have a large physical footprint, leading to resettlement or impacting livelihoods, CSOs should be kept informed and also be provided an opportunity to comment. CSOs can serve as an important bridge to impacted communities and not including them may adversely impact the project.*
- *Ignoring the social issues dramatically increases "non-technical risk", which erodes project economics and can considerably delay projects.*
- *Some infrastructure (such as a port) will not have a traditional market, so this aspect of accessibility or affordability may not be as relevant. However, a project with a broader market, such as transport, should take into consideration the market, potential users and price the service accordingly. This may also include how much access to the general public is provided outside of the project's main purpose (so-called third-party access).*

» **Institutional** refers to robust governance systems and institutional capacity that define procedures for planning, procuring, and operating the infrastructure asset and its services.

- *Monitoring clause: A clause ensuring institutional sustainability could mean monitoring the asset in accordance with the design and planning requirements of the contracting authority;*
- *While one ministry may be in the lead, it is important that governments include all relevant ministries, to avoid any potential surprises or pitfalls. Monitoring agencies need to not only be aware, but plan on allocating the appropriate human and financial resources to properly monitor the project.*

PRACTICAL INSIGHTS FROM SUSTAINABLE INFRASTRUCTURE CONTRACTS IN DIFFERENT SECTORS

The following examples showcase how the different aspects of sustainability can be upheld in the contract of different types of infrastructure.

1. **Economic and financial provisions for road infrastructure:** The project business case should be annexed in a contract and include a “Value for Money” analysis comparing the PPP model to the cost of delivering and operating the road using

alternative means. An assessment of the cost and risks of delivery using public sector resources should be externally audited or reviewed. Public officials can learn from other jurisdictions and involve experienced advisors. In roads with toll concessions, a thorough analysis of demand should be included in the business model annex.

2. **Environmental and social management plans for port infrastructure:** The construction and expansion of ports can negatively impact marine biodiversity as ship traffic increases. Traffic congestion and starkly deteriorated air quality from the increase in heavy vehicles are also common challenges. These risks need to be mitigated as part of E&S management plans through stakeholder consultations and expert analyses. A baseline study for each potential impact is crucial – what has not been measured cannot be monitored.
3. **Monitoring in bridge construction projects:** The condition and quality of bridges have a significant impact on the safety of people, so continuous monitoring needs to identify damaged bridge segments and potential safety hazards. The contract should prominently cite monitoring and ensure

public enforcement through sufficient capacity in oversight bodies. Monitoring can also include innovations in the form of digitization using sensors to collect data or the use of drones to assess any damage or cracks. This type of infrastructure technology (InfraTech) can increase bridge use safety and save public funds. It is equally important that state budget lines are allocated to these important functions. The all-too-common practice of having the private company pay for state inspectors is widely perceived as a conflict of interest.

FOUR RECOMMENDATIONS TO CONSIDER BEFORE DRAWING UP YOUR SUSTAINABLE INFRASTRUCTURE CONTRACT:

1. **Value for money is value for your people –** every infrastructure project will cost money over its lifetime (roughly 10-30 years) and this means that calculating the funding for the project’s entire life when planning it is crucial. This also means that the investor provides a sound project business plan with a fair return on investment.

2. **Rethink how the government procures infrastructure services –** collaborate with procurement and sustainability experts to identify potential gaps (e.g., sourcing local materials and incentivizing companies to buy more locally) in your procurement policies to prevent uneconomic, costly and unsustainable partnerships with private contractors. How have habits changed since Covid-19? Any project drawn up before Covid-19 should have a thorough reexamination to ensure that it is still viable, i.e., a transport project, which may have decreased demand because of new rules of working from home.

3. **Thoroughly engage stakeholders and sustainability experts before the contract –** creating environmental and social management plans for infrastructure requires input from those that depend on the infrastructure - local communities, civil society, trade unions and business associations, as well as sustainability and urban planning experts. Many projects will leave crucial impacts to the environmental impact assessment (EIA) process. Some issues are too important to be discussed in the EIA process three or six months after the contract's signing. An initial overview of the options

and the implications (such as design and impacts on land, people and natural resources) will save considerable time and money during the EIA process. *Remember, it is better to dialogue, design and deliver a project than design, deliver and then have to defend it.*

4. **Mainstream standards for planning and monitoring –** increasingly multilateral and bilateral donors look out for standards (e.g., IFC Performance Standards or the G20 Quality Infrastructure Investment Principles) to track financial, institutional, environmental and social targets and impacts of projects. Demonstrating that you have incorporated and are monitoring these standards in your project design will increase the attractiveness of your investment opportunities.

Meeting the Sustainable Development Goals and the Paris Agreement requires governments to value and monitor these sustainability considerations in all their contracts. Infrastructure projects can and should play an active role in contributing to continued socio-economic development and sustainable growth in emerging economies. Better understanding the larger themes and the small detail of infrastructure contracts (with the help of legal and technical experts) will ensure that governments negotiate a better deal, allowing more value, as well as better service to their people.

To find more information on sustainable infrastructure and identify the right tool to better plan and develop your infrastructure project or portfolio, GIZ has together with UNEP set up the Sustainable Infrastructure Tool Navigator, an online tool database with guidelines, standards and rating systems that you can access here: Home - Infrastructure Tool Navigator (sustainable-infrastructure-tools.org). Start navigating today and create infrastructure that brings value to people and the environment!

HOW CONNEX WORKS

The G7 CONNEX initiative supports governments of emerging economies in their negotiation of large-scale, complex investment contracts.

GLOBALLY FOCUSED: Africa, Asia and Latin America.

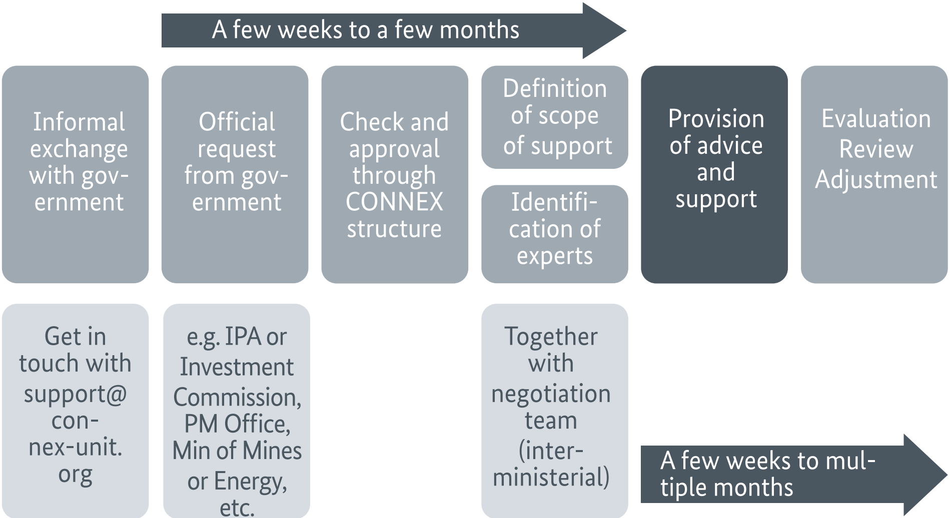
MULTIDISCIPLINARY: Providing legal, strategic, financial, environmental, social, geological, and technical expertise.

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



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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A GOOD CONTRACT IS THE SUM OF ITS CLAUSES

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