

Legal Framework

Navigating the Web of Laws and Contracts Governing Extractive Industries

KEY MESSAGES

- The rules, rights and obligations of companies, governments, and citizens are set forth in a system of legal documents called a legal framework.
- Documents in the legal framework include a country's constitution, legislation, policy, regulations and contracts.
- Laws and policy are supposed to have more authority than a contract. However, contracts can also be written to explicitly override the laws and regulations.
- Legal documents that cover broad principles, like constitutions, are generally more difficult to change. More specific documents, like laws and contracts, can often be more easily amended.
- Countries with detailed laws and policies often have more stable and predictable legal frameworks than those that leave more aspects open for negotiation in individual contracts.
- In some countries, national courts resolve scenarios where legal documents conflict or parties have different interpretations about what the documents mean. However, extractive industry contracts often stipulate that any disagreement go to international arbitration.

“The rules, responsibilities and institutions governing the behavior of actors are central to optimal resource management.”

– Natural Resource Charter, Precept 1

LEGAL FRAMEWORK

For each project to extract natural resources from the ground, there are rules that govern the rights and responsibilities of governments, companies, and citizens. Together these rules are called a *legal framework*, or *legal architecture*. Who is involved in making these rules and what documents they use to define them differs from country to country.

The legal framework that governs the extractive industries rests inside a broader set of rules governing the organization of the state and economic activities. A well-designed legal architecture should provide rules for how state institutions are structured; how companies acquire and manage licenses; the fiscal terms governing payments between companies and the state; environmental management; relationships between extractive projects and neighboring communities; the behavior of public officials active in the sector; public information disclosure and accountability; and how the government

This reader is intended for use in conjunction with Precepts 1, 3 and 4 of the Natural Resource Charter.

will manage natural resource revenues. When companies begin to engage in a country, they must check that they are *in compliance*, or following, all of the rules in the legal framework of a country.

Legal frameworks comprise a set of documents that include the constitution, legislation, regulations, and contracts. How these documents relate to one another, which has more force than the other, is often referred to as a *legal hierarchy*, as illustrated in the pyramid below.

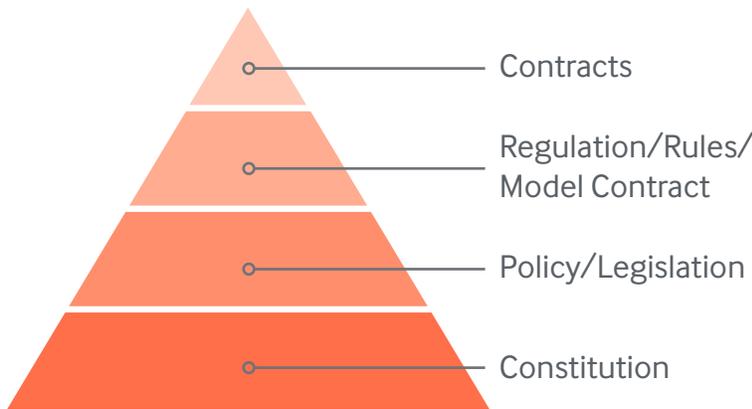


Figure 1. The Legal Hierarchy

Source: NRGi

Moving from the bottom of the pyramid to the top, each instrument becomes increasingly detailed or specific. Each instrument on the pyramid should be consistent with the instruments below it. In a properly ordered legal hierarchy, a country would not agree to terms in a contract that conflict with rules established in regulation, legislation or the constitution. Also, laws and policy are supposed to have more authority than a contract—take precedence, in legal speak. In practice, however, contracts can also be written to explicitly override the laws and regulations.

Constitution. A constitution establishes the basic structure of government and the rights and responsibilities of citizens. It reigns supreme over all other legal instruments in a country. As foundational documents, constitutions are purposefully difficult to modify, with changes frequently requiring some sort of super-majority approval in the legislature or popular referendum.

Many constitutions include information relevant to natural resources, such as the structure of political institutions, checks and balances within the political system, rights to land ownership, environmental protection, civil legal process, and labor standards. Fundamental values concerning natural resource governance, including national ownership of subsoil resources and a commitment by the state to manage these resources in the public interest, are included in some constitutions in resource-rich countries. Most constitutions do not establish specific rules governing the sector. A few countries have included specific provisions on key policy issues, including formulas for resource revenue-sharing (e.g., Nigeria, South Sudan); requirements that parliament approve contracts (Kuwait, Ghana, Tunisia) or that all contracts be made public (Mexico, Niger).

Policy and legislation. National policies and laws should provide a coherent set of strategies and rules to govern behavior in the sector. Many countries draft formal petroleum or mineral sector *policies* to define a core set of principles and goals that will underpin all other rules and activities. Some policies are approved by a national legislature, while others are promulgated by the executive alone. The best-designed policies are developed through a process of broad-based consultation that incorporates stakeholder feedback and provides a clear explanation of public strategy.

Legislation is the legally binding set of rules that govern the vision established in a policy. Most resource-rich countries have laws that focus on elements of the oil and/or mining sector (e.g., mining code, petroleum exploration and production act, among others). In addition, more general laws often represent a major component of the rules for the industry, including environmental laws, labor laws, tax laws, and land management laws. In democracies, legislation is usually created by a process requiring action by the legislative and the executive branches of government, which means that changing the rules embodied in legislation also requires legislative approval.

Regulations and model contracts. *Regulations* are usually the implementing rules created by an executive body of government to make legislation practical. They are most often tied to a law but provide significantly more detail. For example, a law may require that the executive awards petroleum licenses by competitive tender and spell out the general parameters governing the tender process. The regulation implementing this legislation may then describe how, when and where interested companies must register their interest and the specific forms they must submit. Often the legislation will give some guidelines about what the regulations should cover. The method of passing regulations varies from one country to another, but in many instances a branch of the executive (such as a ministry, or the cabinet acting as a whole) has the power to create regulations without seeking legislative approval.

A *model contract* provides a template for agreements between the government and extractive companies. Some countries have very detailed model contracts, with one or several sections left blank to account for the results of a tender process, or to be completed during negotiation. In other cases, the model contract serves as a starting point and more substantial variation is allowed as a part of individual negotiations. By using model contracts, states can reduce the need for lengthy negotiations and increase their leverage by fixing some of the parameters that would otherwise be up for negotiation. Some governments have formalized their use of a model contract by establishing it as a regulation or appending it to legislation. In other countries, the model is more of a guiding document created by the government or state-owned enterprise(s) responsible for licensing or contract negotiation.

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International standards and laws

Many contracts require companies to comply with “good industry practice.” How this phrase is interpreted can vary from country to country, but often includes consideration of the many voluntary standards or semi-voluntary agreements that exist between governments, multi-stakeholder bodies, and industry. The International Council on Mining and Metals (ICMM), for example, is a group of mineral extraction companies that have agreed to measure their performance against a set of ten principles of sustainable development. Because of the influence of the companies involved, some of these principles may become industry standards. In a similar vein, many international financial institutions have tried to influence industry standards through compliance requirements for their loans. To obtain a loan from the International Finance Corporation (IFC), for example, companies must comply with a strict set of social and environmental performance standards. The Extractive Industries Transparency Initiative (EITI) is a multi-stakeholder initiative that promotes transparency and accountability. While it is implemented on a country-by-country basis, it aims to influence the level of transparency throughout the industry.

In addition to these voluntary standards, there is also a body of international law that governs the actions of states. This international law is formed through agreements between countries about how governments should operate. Human rights law, for example, describes how governments should respect and protects the rights of people within their borders. This law includes a responsibility to protect people from violations of rights by third parties, such as corporations. In some situations, people impacted by extraction operations have appealed to these international laws when they felt their rights were violated during the process of extraction.

Contracts: Contracts are agreements between two or more parties. While laws apply to an entire territory, a contract only applies to a specific location and to the actors that are party to it. There are myriad contracts that govern individual mining or petroleum projects, but the ones that receive the most attention are the contracts in which the state grants the right to explore or extract natural resources. These are often referred to as *host government agreements* or *state-investor agreements*. They can take several forms including concessions, production sharing contracts, and service agreements.

A contract lays out those role and responsibilities that are not specified by the law. Contracts often include terms bearing on operational, financial, social, environmental and production obligations. (See more below on the relationship between laws and contracts.) Because the contract is limited in scope by geography and parties, a different contract must usually be negotiated and signed for each extraction site. A contract can be changed when both parties agree.

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Primary types of contracts

Through a **concession agreement**, a government licenses a company (or, a lead company and its joint venture partners) to develop resources in a given geographic area. The rights to the resource (either minerals or petroleum) are legally held by the commercial operator. This concession holder finances all the costs of exploration, development, and production. The government typically receives a royalty, fees for acreage, and taxes paid by the joint venture, as well as bonuses and social taxes. If the government is a partner in the joint venture, it also receives a share of the production corresponding to the share it owns.

In a **production sharing contract (PSC)**, the government owns the resource, even though it agrees by contract to compensate the company for developing the field through in-kind oil payments. (PSCs are rare in the gas sector and are not utilized in the mining sector). Specifically, under a production sharing contract the company or contractor provides all the funding and recovers its costs in the oil it produces. After recovering all costs, the contractor shares the profit, in oil, with the government according to an agreed formula.

Under **technical service agreements**, the government retains control of the resources and enters into an agreement for a company to provide technical services in the form of exploration work, construction, and managing the development process. The government keeps the resource that is produced and then pays the company in either cash or commodity (e.g., oil). Under this type of agreement, remuneration is not based on production but on activities (e.g., man-hours rendered by the contractor). These forms of contracts are rare and generally used in some OPEC countries like Iran, Kuwait, and Saudi Arabia.

HOW IT ALL FITS TOGETHER

Some countries have constitutions, laws, and regulations that are very specific about the rules governing extractive industries. As a result, there may be less information in contracts and less for governments and companies to negotiate about for each deal. In the image below, Country A has more detailed laws and regulations, so the government needs to cover fewer terms in the contract. Country B, on the other hand, has less detail established elsewhere in the legal hierarchy, and thus leaves more detail to be fixed by each contract. Some governments have even agreed to terms in individual contracts that actively contravene the provisions of the law or regulation. Lawyers drafting the contracts will often make references to the different laws and regulations, meaning that those who seek to understand the terms must have all relevant laws and documents to hand.

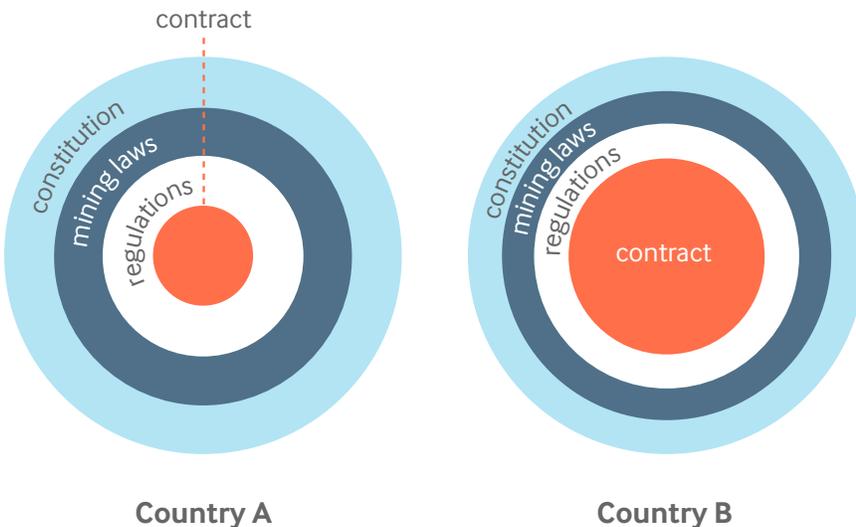


Figure 2. The scope of a contract can vary

Source: Mining Contracts - How to read and understand them

Experts increasingly suggest that the model with more detailed laws and regulations (that of Country A), creates a stronger foundation upon which a country can manage its extractive industries according to national priorities. In addition to helping investors to feel like they are being treated equally across deals, consistent terms across projects can streamline monitoring for government institutions. A robust legislative framework may also result in greater public input because the public can more easily participate in the legislative process than in individual contract negotiations.

There are two kinds of *clauses*, or sections, in natural resource contracts that have a special impact on the relationship between laws, regulations and contracts. A *stabilization clause* mandates that changes in legislation or regulation enacted after a contract is signed or enters into force will not apply to the parties' implementation of the project covered by the contract. In effect, it freezes the laws and regulations based on the day the contract is signed or becomes relevant. The clauses often serve to limit the government's ability to change the rules governing the project through national laws without the company's consent. In order to prevent stabilization clauses from totally stopping public policy progress while still giving companies a confidence in the security of their investments, many countries now draft clauses that restrict stabilization for a fixed number of years or limit the reach of stabilization to fiscal provisions rather than the broader set of rules, such as environmental or human rights protections.

Stabilization clauses can interact closely with *international arbitration clauses*, which exist because some companies have concerns about the stability of the legal framework of those countries where they are investing. Because foreign investors often lack confidence that a domestic court system will provide a neutral forum to adjudicate a dispute, contracts often stipulate that any disputes (or a particular sort of dispute) that cannot be resolved amicably will be settled by an international panel of experts in arbitration. Bilateral or multi-lateral investment treaties between resource-rich countries and the home countries of investing companies sometimes contain similar clauses. Many investors and economic analysts reason that arbitration provisions facilitate investment by providing security to ensure fair treatment and respect of applicable rules, even where domestic judicial systems are weak or biased. Such clauses have been controversial, however, because they serve to limit states' practical ability to exercise their sovereignty.

“A legal framework with comprehensive laws and regulations, and less detail up for negotiation in individual contracts, provides a stronger foundation upon which a country can manage its extractive industries according to national priorities.”

QUESTIONS TO ASK

- How is the legal architecture organized in my country?
- Do I have access to all the relevant documents?
- What is the balance in my country between what is covered by legislation and regulation versus what is negotiated in the contract?

ADDITIONAL RESOURCES

Further reading

Oil Contracts: How to read and understand them (OpenOil 2012) available at: <http://openoil.net/contracts-booksprint/>

Mining Contracts: How to read and understand them (2014), available at: <http://www.resourcecontracts.org/blog/guides-to-contract-terminology.html>

Smith, Erin and Peter Rosenblum, Enforcing the Rules (NRGI 2011) , available at: <http://www.resourcegovernance.org/publications/enforcing-rules>

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