

Corruption and the renegotiation of mining contracts

Query:

Many mining concessions in developing countries have been negotiated during periods of conflict and/or during past periods of authoritarian rule. Many new regimes must face the challenges of respecting old shadowy agreements. I am presently getting involved in a process of renegotiating mining contracts between international mining companies and the government in an African country. A suspicion is that acceptance of the original terms may have been influenced by corruption.

Questions:

- a) *If available, what does the literature say about the corruption dynamics in the negotiation of mining contracts (in Africa/developing nations)?*
- b) *Is there existing literature or examples of renegotiations/terminations of mining contracts influenced by corruption?*
- c) *If not, are there successful examples of renegotiations/terminations of contracts in other natural resource fields that may inform how to go about renegotiation/termination of a contract in the mining sector?*

Purpose:

The purpose is to build a case to renegotiate mining contracts between international mining companies and the government in an African country.

Content:

- Part 1: Corruption in the Allocation of Mining Contracts
- Part 2: Corruption in the Renegotiation of Mining Contracts
- Part 3: Examples of Good Practice and Tools Applicable to the Negotiation/Renegotiation of Mining Contracts
- Part 4 : Further Reading

Summary

Although rarely documented and by nature hard to detect, corruption in the allocation/renegotiation of mining concessions is believed to be widespread. The secretive nature of such deals, the lack of transparency and public scrutiny as well as amount of capital involved provide opportunities for abuse and corruption. Civil society has been calling for greater transparency in the allocation and implementation of mining contracts and a number of tools and approaches have been developed in recent years to address these issues.

Introduction

Although evidence of corruption in the extractive industries remains largely anecdotal, the mining sector is generally considered to be one of the business sectors particularly vulnerable to corruption, as confirmed by past editions of the TI Bribe Payers Index. Control of minerals in weak governance

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Date:

30 November 2007

settings is often associated with violence, insecurity and human rights violations. The high commercial value of natural resources makes them a coveted target for acts of corruption, misappropriation or plundering. They are usually characterised by complicated regulations and high levels of government control, require special permits for exploitation as well as export, and must be accounted for to determine taxes and royalties – all activities that provide numerous opportunities for manipulation and corrupt practices. Many resource rich countries in the developing world are also among the poorest, with only a small minority of the ruling elite benefiting from the country's natural wealth. They also typically perform very poorly in terms of governance and control of corruption, as measured by tools such as the Corruption Perceptions Index or the World Bank Governance Indicators.

Given the vast investment costs and potential profit involved in most mining deals, concession contracts provide opportunities for corruption at the various stages of the allocation and implementation process. Companies have a vested interest to maximise their profit margins, ensure a return on capital, minimise the payments they make to the host governments and mitigate the high risks involved in huge mining investments. On their side, national governments frequently fail to get full value for their resources, due to lack of knowledge and capacity, access to technical expertise or corrupt individuals operating in their own interests within weak public and institutional environment.

Part 1: Corruption in the Allocation of Mining Contracts

Specific Vulnerability of the Mining Sector to Corruption

Specific characteristics of the mining sector make it vulnerable to corruption. Mining is a risky, time-consuming and capital intensive industry that requires massive up-front investment before mining companies start making profits. Within such a context, companies operate under considerable time pressure to make their investment profitable and repay their investment loan. In addition, the mining industry is also more highly regulated by government than many other industries.

In the developing world, mining companies generally operate in countries that have very weak institutional and governance systems in place. An additional difficulty for multinationals trying to do business in a country is their lack of knowledge of the local context and rules of the game. They usually rely on a local partner or an intermediary who has the necessary contacts to “get things done in the country” and guide them through the political and bureaucratic processes of the country. Even when they are committed not to indulge in bribery, multinational mining companies may lack the necessary control and information over their local partners' behaviour, background and connections.

This combination of factors is likely to have a direct impact on levels and forms of corruption in the mining sector. For example, bribes can be demanded and paid to favour a request for a mining concession, get a permit or approval, speed up bureaucratic processes or secure favourable contract conditions. Please see: A survey of Corruption Issues in the Mining and Mineral Sector: http://www.iied.org/mmsd/mmsd_pdfs/marshall_corruption.pdf.

Opacity of Concession Allocation Processes

Auction Design and Bidding Process

Companies may believe it is less costly to bribe than pay market prices for a mining concession. Companies may also have strong incentives to avoid risks of failure in the bidding process and practices. Strategies to restrict competition include submitting unsolicited bids, bribery or strategic under-valuation of costs involved during the tendering process which may lead to unrealistic bidding. At the same time, individuals within government may also be tempted to get a share of the deal for

their own private benefit. As a result, corrupt public officials' and companies' interests are likely to be set against the public interest.

Corrupt practices observed and documented in public procurement or privatisation processes equally apply to the mining sector. It is often very difficult to establish whether companies are granted concessions because of their competitive bids or because of illegal payments made or favours promised to public officials. But suspicions can arise, for example, when the tender terms are not made public. In the case of privatisation of natural resource exploitation, Joseph Stiglitz highlights four major and often interrelated mechanisms for diversion and corruption, including reducing competition, channelling funds to favourites, providing favourites with insider information about the value of what is being sold, and enforcing the terms asymmetrically. Please see: http://www2.gsb.columbia.edu/faculty/jstiglitz/download/2006_Resource_Curse.pdf.

Negotiations of the Terms of the Contract

In most cases, very little is known about the contents of negotiations and actual terms of the agreements, due to opaque processes and reasons of confidentiality often invoked in relation to such contracts. There is a common perception that transparency and publication of contracts would weaken companies' commercial advantages or the government's position in future negotiations. Confidentiality clauses are sometimes attached to such contracts, committing stakeholders to stringent provisions of confidentiality and non disclosure. In most cases, concession allocation decisions and negotiations are made by members of the executive behind closed doors. Confidentiality leads to opacity and reduces opportunities for democratic controls through parliaments or civil society participation mechanisms.

Another challenge is the degree of complexity of mining contracts. Mining is a long term investment and contracts must establish how rents will be divided between governments and companies as well as how costs and risks will be shared. Negotiations in the mining sector are made even more complex by high levels of uncertainty and incomplete or faulty information at the time of the signing of the contract. Neither companies nor governments can anticipate the exploration costs, future levels of production or whether the mineral prices will justify these costs.

As a result, the technical nature and complexity of the negotiation process limit opportunities for public scrutiny as well as for the establishment of accountability mechanisms. In addition, negotiations often occur in remote areas where affected populations don't have a say or a voice in the process.

Political leaders sometimes intervene in the negotiation process and give orders to the signatories of the contract, as described in a Global Witness report on corruption in Katanga's mines. The role of these individuals who are close to political circles and their link to the mining deals are very difficult to establish, as they usually operate in an unofficial capacity and their name does not appear on the company or other related documentation of the agreements. Please see: http://www.globalwitness.org/media_library_detail.php/154/en/digging_in_corruption.

State Capture and Political Corruption

As already mentioned, mining is a risky business for extractive companies. In situations where there is a high political risk and no sufficiently credible investment protection, companies may be tempted to resort to non legal ways of protecting their investment through developing linkages and corrupt

networks with powerful, influential individuals.¹ The above mentioned Global Witness report highlights, for example, the pattern of personal appropriation of Katanga's minerals by senior political officials. Interviewed informants mentioned that it was impossible for a company to operate without a "political umbrella", meaning protection and support from politicians in the capital city. Companies are also tempted to pay bribes not only to secure contracts but to influence government officials as well as bend the rules and regulations applying to the mining sector in their favour. Corruption can also result from political donations made to the ruling parties in perfectly legal ways. Several examples of the interference of Kinshasa based politicians in the negotiation of mining contracts as well as unclear relationships between mining companies and politicians are documented in the above-mentioned report.

The Liberian Example

The need for transparency in the awarding of concessions is illustrated by recent developments in Liberia. In 2004, the National Transitional Government of Liberia (NTGL) mandated a review of existing timber concessions. The review committee required each company to demonstrate that it was a bona fide business entity, legally registered and that the concession contract was in force and effect. Of the 70 timber operators identified by the review committee, only 47 operators were able to bring forward agreements and permits that they claim granted them permission to operate. None of these companies were able to demonstrate that their operations in the country were legal. In many instances concessions had been granted through political patronage and favouritism, while corruption within the tax collection system allowed them to continue their operations even though they failed to meet their tax obligations.

During its two years in office, the NTGL itself granted a series of controversial concession agreements, the most controversial being the Mineral Development Agreement (MDA) that was signed for Liberia's largest iron ore. Corruption was alleged in various stages of the allocation process. Members of Parliaments were accused of receiving bribes to ratify the MDA while other legislators reported having relied on a mere summary of the agreement prepared by the executives that had negotiated the deal to make their decision. Please see: http://www.boell.de/en/05_world/5013.html. After a lengthy renegotiation process throughout 2006, the contract has finally been amended and approved by parliament in May 2007.

The Congolese Example

As one of the most recent and documented example of such issues, the ongoing debate surrounding the Democratic Republic of Congo (DRC)'s control over natural resources also illustrates the strategic importance of tackling corruption and promoting transparency in the allocation, implementation as well as renegotiation of mining contracts. DRC is one of the richest countries in the world in terms of mineral wealth and has undergone a long history of plunder and internal conflict. Many corrupt networks are still operating to exploit the country's wealth at the expense of the vast majority of the population even now that the war is formally over.

In 2005, the transitional government signed and approved three joint venture contracts between Gécamines, the DRC's main state owned mining company, and a number of foreign private companies. These contracts appear to be extremely disadvantageous to the DRC, leaving Gécamines with such a low share that the state will be unable to generate profits from the deals. Several reports and evaluations question the terms of the contracts, the manner in which they were negotiated and their possible impact in the absence of any international bidding process, all concluding to the unfairness of the allocation process (Please see: <http://www.raid->

¹ Please see the report on "Rule of Law and the Resource Industries' Cycles: Acquired Rights versus the Pressure Inherent in the Political Economy of the International Energy and Resource Industries by Thomas W. Wälde that can be obtained from the TI-S.

[uk.org/docs/DRC_contracts/Memo_PPP_DRC_MAR07_update.pdf](http://www.raid-uk.org/docs/DRC_contracts/Memo_PPP_DRC_MAR07_update.pdf)). Further reports including the findings of a parliamentary commission appointed to examine the legal validity of economic and finance agreements signed during the war- known as the Luntundula Commission- as well as a series of reports from a UN panel of experts that documented the links between business, resource management and conflict in the DRC in 2003, call for the revision of unfavourable mining contracts and further recommend the renegotiation or amendment of these contracts both for ethical and economic reasons. (Please see: http://www.raid-uk.org/docs/Lutundula/Unofficial_Translation.pdf, as well as <http://www.un.org/apps/news/story.asp?NewsID=8706&Cr=democratic&Cr1=congo>). These various pressures resulted in the Minister of Mines announcing, in April 2007, the creation of a governmental commission to review mining contracts signed between private companies and public enterprises.

Part 2: Corruption in the Renegotiation of Mining Contracts

Rationale for Renegotiation

Due to their long-term nature, mining contracts expose companies and governments to geological, commercial or political risks, as well as external events that may make the terms of the contract no longer practicable or economically viable for one of the parties. As a result, parties may wish to terminate or withdraw from the original agreement and push for the renegotiation of the contract. When the initial deals were obviously disadvantageous for the host developing country, renegotiation provides an opportunity to demand greater revenues that can be devoted to mitigate the negative social and environmental impact of mining on local communities as well as to poverty reduction programmes.

Renegotiation of contracts can also be used opportunistically by one of the parties to secure additional benefits, undermining the integrity of the process. A change in government can trigger a renegotiation of the concession agreement entered into by the previous government, although it is not per se a valid legal ground for renegotiation. But when the initial concession has been granted in a non transparent manner, allegations of corruption, favouritism, abuse and manipulation may be used by the opposition as a campaigning strategy against the government.

In many cases, the opposition has alleged corruption in mining deals concluded by the government. Once in power, the new government feels compelled to review earlier agreements and renegotiate the terms of the contracts. In the 80s for example, the first Garcia government in Peru reversed the previous government's investment policy. Occidental Petroleum successfully renegotiated the terms of the agreement and got its contract extended. Belloc Petroleum refused to make new investment commitments or pay higher taxes and was finally nationalised. <http://www.dundee.ac.uk/cepmlp/journal/html/vol5/article5-3a.html>. Although no exhaustive survey of investment disputes has been undertaken, they almost invariably have to do with a change of government.²

Corruption and the Renegotiation of Mining Agreements

Corruption in the renegotiation process of mining contracts has not been systematically documented and little evidence-whether in the mining sector or natural resources field- could be unearthed within

² Please see the report on "Rule of Law and the Resource Industries' Cycles: Acquired Rights versus the Pressure Inherent in the Political Economy of the International Energy and Resource Industries by Thomas W. Wälde that can be obtained from the TI-S

the time frame of this query. Nevertheless, it is widely known in cases of international disputes that bribing companies can survive political crisis while non bribing companies don't get their licence extended, are expropriated or end up nationalised because they refuse to pay a bribe or comply to the new rules of the game (see the Occidental Petroleum/Belloc Petroleum case above). In dispute settlements following a regime change, companies may accommodate some of the demands of the new government while protecting the economic terms of the agreement by dumping old partnerships and accepting new local partners with strong links with the new government. Many Russian oil/gas investment disputes, for example, show that the renegotiated deals involve the substitution of earlier oligarch partners with partners that are agreeable to the current government.³

Corruption as Providing Valid Ground for Renegotiation

Contracts obtained with significant corruption are of questionable legal validity. However, no evidence has been found of a case of concession or exploration license revocation resulting from corruption. Even after corruption has been exposed, the "sanctity of contract" is insisted upon and such contracts are not always cancelled, revoked or renegotiated as shown by the following Indonesian case.

After the fall of the Suharto regime in 1998, the legal surety and validity of the contracts concluded during the corruption-plagued years of President Suharto's regime were questioned by the lack of transparency and fairness of the original deals. In some cases, the original mining deals were signed under opaque circumstances during periods of uncertain political conditions giving substantial grounds to question the legitimacy of the deals. In some instances, companies' practices and controversial relationships with the state security forces, as well as impact of activities on the local communities and environment have been denounced by civil society organisations in a number of reports. Freeport McMoRan Copper and Gold inc, one of the most prominent mining companies controlling the Grasberg mine in Papua (one of the world's largest gold and copper reserves) provides an example of such controversy. The discussion is still ongoing and the Government announced last August its intention to renegotiate its contract with Freeport, although less on corruption grounds as to increase its share in the mine's outputs. Please see: <http://freewestpapua.com/files/Paying%20for%20Protection.pdf>.

Part 3: Examples of Good Practice and Tools Applicable to the Renegotiation of Mining Contracts

Despite some of the risks outlined above, some renegotiation processes have had positive outcomes, establishing a fairer balance of revenue sharing between the various stakeholders and committing companies to contribute to the economic and environmental development of the regions in which they are operating. A recent example is the settlement that is reported to have been reached by AngloGold with the Government of Tanzania last month following an outcry that the country should benefit more from its growing mining sector. The newly elected government committed to roll back some of the concessions and renegotiate all mining contracts to reach fair agreements between government and investors that benefit both parties. One of the experts consulted within the framework of this query also mentioned the Dominican Republic-Falconbridge renegotiation process in 1988 where both parties had an interest to reach an agreement. (Please see: http://www.transnational-dispute-management.com/samples/freearticles/tv1-1-article_49.htm).

The challenge of negotiation/renegotiation is to ensure open, efficient and transparent access to mining property. A few principles emerge from the experience of the past, including ensuring a truly competitive award of concessions, reducing opportunities for opportunistic renegotiations, promoting

³ Ibid.

transparency and full disclosure of contract information, creating opportunities for participation as well as involving civil society in the negotiation and implementation process. A number of tools and guidelines have been developed in recent years to introduce more transparency and integrity in such traditionally opaque processes.

Lessons Learned from Optimal Concession Design and Renegotiation

The World Bank Institute has documented more than 1,000 experiences of negotiation and renegotiation of contracts throughout the world. (Please see: <http://www.revenuewatch.org/reports/072305.pdf>). Although mainly focusing on infrastructure concessions, most of the lessons learnt from the review of these documents can be applied to the mining sector. Aside from the direct negative effects of potential misappropriated rents, contract renegotiation imposes substantial additional costs when handling renegotiation petitions and cases. The report emphasises the crucial importance of designing an optimal concession contract that carefully limits the opportunities for "opportunistic" renegotiations. Weaknesses in the original concession design can result from hurried processes, vested interests and limited resources of governments in the concession design. The report stresses:

- The importance of granting negotiation/renegotiation in the strongest possible legal grounding;
- The potential impact of financial advisors and investment banks in influencing the concession transaction that should be taken into account;
- The need to strengthen institutions and credibility of regulatory frameworks prior to the negotiation/renegotiation process to ensure appropriate regulatory oversight and enforcement;
- The growing awareness of the need to establish a separate, autonomous and effective body or regulatory institution that oversees the allocation, renegotiation and implementation of concession contracts. (This institution should be granted adequate resources and capacity, including well trained and compensated staff);
- The need to ensure that all processes, procedures and decisions are made in the most transparent and participatory manner.

Public Participation and Transparency

Most transparency initiatives, such as EITI, focus on transparency of revenues and do not cover the concession allocation process. Increasingly civil society challenges the secrecy surrounding the allocation and negotiation of mining agreements. Transparency allows for more effective public oversight that could even strengthen the government position during negotiations as the negotiator needs to cut a good deal to be ratified by the public. For example, within the framework of the World Social Forum that took place in Nairobi in January 2007, civil society organisations called governments to guarantee genuine participation of local communities at all stages of extractive projects, grant licences with the consent of local communities, allow for the renegotiation of contracts that are not in the best interests of affected communities and stop the harassment of individuals advocating against corruption, human right violations and the environmental destruction associated with natural resource exploitation. They also recommend mandatory independent monitoring of mining projects involving the full participation of civil society. Please see: <http://www.revenuewatch.org/announcements/GHANAcsostatement.pdf>).

Vulnerability Reviews

The corruption risks associated with the mining sector highly depend on the country's specific institutional and governance set up. Safeguards must be adapted and tailored to fit the local context. One must first evaluate the specific institutions involved and how they interact at the different stages of the mining development. One of the experts consulted in the framework of this query has

developed an approach for the institutional and vulnerability review of the various institutions that has just been field tested in two African countries. The idea is to assess the relevant institutions in terms of their i) leadership and authority ii) culture and incentives; iii) policies and processes; iv) organisational structure and v) resources and capacities, to get a clear understanding of the strengths, weaknesses and drivers of these institutions. On this basis, targeted programmes can be developed to address the shortcomings identified through this process.

Contract Design

Given the opportunities for corruption that exist, the considerable investment costs, huge profits involved, as well as the capital at stake in such projects, it is of crucial importance to look at the precise nature of the mining contract. An overview of the issues involved is outlined in the following article "Contracts in Natural Resources: a Primer". Please see: http://ksghome.harvard.edu/~whogan/Populism_Nat_Res/Populism_Agenda_files/HST_Intro_101007.pdf. As mining contracts are overly complex and especially vulnerable to corruption and risks of abuse, they should be fully disclosed, made public and open to scrutiny. This is currently more the exception than the rule.

Model International Agreement on Investment for Sustainable Development

Some of the principles outlined in the International Institute for Sustainable Development's (IISD) Model International Agreement for Sustainable Development can be applied to mining contracts and provide guidelines for the design of optimal contracts that promote responsible exploitation of mining resources. This initiative was launched in April 2005 as an alternative to existing bilateral investment treaties that applied in the mining sector and primarily tend to focus on protecting the foreign investors' rights. They are sometimes criticised for their flaws in a wide range of areas including in transparency, conflict of interest and clarity of substantive obligations. This model agreement attempts to address some of these issues by specifically introducing development objectives into the agreement as well as provisions related to addressing corruption and improving transparency in investment disputes. Please see: http://www.iisd.org/pdf/2005/investment_model_int_agreement.pdf.

Part 3: Further Reading

Covering Oil: A Reporter's Guide to Energy and Development

Although more specifically focused on oil and gas, this guide provides a comprehensive overview of the issues and challenges involved in promoting transparency in the extractive industries. Although originally aimed at supporting quality journalist reporting on these sensitive and technical issues, it maps out the various facets of extractive industry issues.

<http://www.revenuewatch.org/reports/072305.pdf>

Granting and Renegotiating Infrastructure Concessions: Doing it Right

This book presents the issues involved in the design and implementation of concession contracts by drawing lessons from some examples throughout the world. Although focusing on infrastructure concessions, most of the lessons learnt can be applied to the mining sector.

<http://crgp.stanford.edu/events/presentations/gcr2/Guasch3.pdf>

Renegotiation and contract adaptation in the International Investment projects: Applicable legal principles and industry practices

This study focuses on the law and practice with respect to renegotiation of long-term international investment agreements - particularly in the natural resources and energy sector. The study analyses the concept of renegotiation in the context of long-term international commercial contracts - particularly in the upstream petroleum industry.
http://www.gasandoil.com/ogel/samples/freearticles/article_49.htm

Multinational Corporations: Balancing Rights with Responsibilities

This presentation provides an overview of some of the issues at stake in the negotiation and renegotiation of mining contracts.
<http://www2.gsb.columbia.edu/faculty/jstiglitz/download/grotiusv2.ppt>

IISD Model International Agreement on Investment for Sustainable Development Negotiators' Handbook

This second edition of the agreement proposes an alternative to the current approaches to a number of investment treaty issues. Specific substantive changes dealing with anti-corruption obligations for investors, host governments and home governments (in relation to article 13) have been introduced. Paying bribes or otherwise seeking to corrupt the family members or other close associates of a government official is covered, as opposed to simply paying the official him or herself. Please see:
http://www.iisd.org/pdf/2005/investment_model_int_handbook.pdf

The Congolese Mining Sector in the Balance

In this report, Global Witness expressed its concerns regarding the process of review of Congolese mining contracts. They focus on the lack of transparency and clarity affecting most aspects of the review, pressure on the Commission to complete the review within an unrealistic time frame, inadequate safeguards to protect the independence of the commission and limited involvement of civil society. Please see:
www.globalwitness.org/media_library_get.php/498/mining_contract_review_oct07_en.pdf.

White Paper on Energy Sector Corruption in Bangladesh

This white paper on Energy Sector Corruption in Bangladesh illustrates some of the corrupt practices that are prevalent in the mining sector.
http://www.energybangla.com/article_det.asp?ald=745