

Reshaping contracts for quality natural resource investments

Investment contracts are agreements between an investor and a host state that set the terms of an investment project. Examples include concessions for agricultural or extractive industry projects. Together with applicable national and international law, these contracts define the way risks, costs and benefits are distributed. Who can participate in contract development greatly influences the extent to which third parties can have their voices heard. So getting the contracts right is a key part of maximising the investment's contribution to sustainable development. This goes beyond concerns about public revenues, to include transparency and public participation in the contracting process, and proper integration of social and environmental considerations throughout the contract.

Policy pointers

- **Initiatives to strengthen the** capacity of governments to negotiate good contracts can make a difference — but they need to be complemented by efforts to increase transparency and public participation in the contracting process.
- **For sustainable** development, a good economic deal is not enough — social and environmental considerations must be addressed, not just in specifically devoted clauses, but also throughout the contract and the contracting process.
- **Capacity support for** 'investment preparedness' on contracts and contracting processes (for example, to improve safeguards, expertise, partnerships or model contracts), can help ensure contracts deliver quality investment.

Why contracts matter for quality investment

In recent years, economic liberalisation, improved transport and communications, and global demand for energy, minerals and agricultural commodities have fostered foreign investment in natural resource projects in many poorer countries. And in many lower-income countries, the natural resource sector accounts for a large share of investment inflows.

Natural resource investments can help promote economic growth, generate public revenues, develop infrastructure and create employment. But they may also fail to create enough positive links with the local economy, and may crowd out local producers. Foreign investment can bring cleaner technologies and better management practices, but large natural resource projects may also degrade the environment. Natural resource investments can create new livelihoods that help reduce poverty, but may also dispossess poor people of their land and natural resources.

These positive and negative social, environmental and economic outcomes depend on many factors, including policy, institutional and socioeconomic contexts. But the 'quality' of the contract between investor and host state

is critical in determining how far an investment promotes — or undermines — sustainable development goals like poverty reduction and environmental sustainability.

Investment contracts include, for example, petroleum, mining and agricultural concessions, and production sharing agreements for oil and gas projects. Although there is huge diversity in contractual practice, these agreements usually allocate resource rights, set the terms for resource development activities, define how returns will be shared between investor and state, and determine social and environmental safeguards. Quality is shaped by these core terms of the investment far more than by corporate philanthropy at the fringes.

Governments seeking to promote quality investment need to give serious thought to contractual provisions, and to how they are negotiated and administered. In the longer term, a fair contract is important for the investor too: for example, an unbalanced tax deal would expose the investor to the risk of renegotiation; and poor social and environmental safeguards expose the project to local contestation and conflict.

Capacity to negotiate a fair deal

Lower-income countries do not always get the best possible deal. For example, an IIED analysis¹ of sample

Transparency in contracting is crucial but not enough

contracts for agricultural investments in Africa has raised concerns about how far some contracts reviewed provided a fair economic deal, or effectively addressed social and environmental considerations.

The problem has many causes, including imbalances in negotiating power, information asymmetries (for example about geological or agribusiness potential), time pressures and corruption. Asymmetries in the capacity to negotiate (for example legal expertise, financial modelling or negotiating skills) are often an important challenge.²

Capacity support can help government negotiators make a difference to negotiation outcomes. In Liberia, political leadership and world-class legal assistance with renegotiating mining and agricultural concessions led to improvements in contractual practice.³

There is growing debate about establishing international mechanisms to strengthen government capacity for contract negotiation. Some recent initiatives already provide such support, especially on the legal side. The African Legal Support Facility,⁴ hosted by the African Development Bank, facilitates access to legal expertise for African governments grappling with major legal issues, including negotiations for large natural resource contracts. Similarly, the International Senior Lawyers Project has provided pro-bono legal advice to governments negotiating investment contracts for natural resource projects.⁵ The United Nations has also provided capacity support Africa and Asia.⁶

Efforts to improve an investment contract can only maximise its sustainable development potential if they address the contracting process, not just contractual provisions; and if they tackle not just the tax deal, but a full range of social, environmental and economic issues.

Opening up the contracting process

The 1992 Rio Declaration on Environment and Development places people at the centre of sustainable development, and calls for public participation in decision making. So features of contracting — that is, the process to develop and administer investment contracts — are crucial to sustainable development. Whether people affected by an investment have a voice in the contracting process, and how easily the public at large can hold governments and investors to account, are both key to promoting quality investments that respond to local people's needs and aspirations.

Transparency in contracting is a crucial precondition both for meaningful local deliberation and for public scrutiny of governments and investors. Requirements for, and commitment to, transparency in the contracting process would also send a signal that attracts 'quality' investors, and add pressure for fair terms. Although

the vast majority of contracts for natural resource investments are negotiated behind closed doors, and contract terms are rarely disclosed, there is mounting pressure for greater public scrutiny.

Several international 'good practice' guidelines support disclosure of contract terms unless compelling reasons require otherwise (for example, the recently revised International Finance Corporation's performance standards, and the UN Principles on Responsible Contracts^{7,8}). A new Open Contracting initiative promotes transparency in public contracting, including extractives and agriculture.⁹ Some governments have disclosed their extractive industry contracts, and in Liberia disclosure is a legal requirement. Legislation in the investors' home countries can help too. In the United States, the Dodd-Frank Act of 2010 requires disclosure of payments to governments made by extractive industry companies listed on US stock exchanges.

But disclosure alone is unlikely to be enough. An investment contract comes after a decision-making and negotiation process. It is critically important to increase transparency and public consultation before the deal is made. This requires effective community engagement in the early stages of project design. International best practice points to the principle of free, prior and informed consent, and there is growing experience on how to make this work.

Also, disclosure can only improve accountability if those who are affected by decisions, and the public at large, can get organised and use the information disclosed. Non-governmental or local producer organisations, parliamentarians and the media play a particularly important role in promoting public scrutiny. Much depends on political space, and capacity support may be needed when scrutinising often complex contractual issues.

Finally, a good contract achieves little without proper implementation. Host governments need the capacity not only to do the deal, but also to monitor and enforce compliance throughout a project's life. Strengthening the non-governmental 'checks and balances' can also improve monitoring and enforcement of contracts.

In many lower-income countries, civil society organisations are doing important work to scrutinise contracts, empower local groups, and hold governments and investors to account.¹⁰ These efforts need to be supported and scaled up.

Taking social and environmental considerations seriously

Even a deal that is economically beneficial to the country as a whole is bad news if social and environmental considerations are not properly factored

in. Large natural resource investments can bring significant environmental impacts. They can also raise major social issues such as managing land acquisitions, ensuring continued local food security, promoting broad-based participation in project benefits, regulating the conduct of security forces and establishing effective grievance mechanisms.

Managing these issues requires, first and foremost, well drafted and enforced national legislation to regulate impact assessments and operating standards, provide for government inspection powers, and establish legal liabilities and remediation — among other things. For example, land acquisition often proves a major bone of contention, because it can devastate local livelihoods and sociocultural identity. In many countries, national law confers only weak land rights on local groups. Strengthening local rights and voices may require rethinking important aspects of national law, and better implementation of existing laws.

But although getting the legal frameworks right is key, investment contracts can themselves provide ‘quality’ on social and environmental issues. For example, where the national law regulating land acquisitions falls short, contracts can refer to international standards like those developed by the International Finance Corporation — though commitments must be properly resourced and governments equipped to enforce them.

Over the past two decades, contractual practice in some sectors has paid greater and growing attention to social and environmental standards. For example, a study reviewing clauses regulating environmental issues in 41 oil and gas contracts signed in 1994–2008¹¹ found that most required compliance with both national law and international standards. This marked significant progress compared with the early 1990s, when environmental standards were much less prominent in petroleum contracts, although the study also documented shortcomings in the approaches used (for instance, unclear international standards).

It is also important that investment contracts require the investor to pass obligations on social and environmental standards through to subcontractors and suppliers, since many project activities will not be implemented directly by the investor.

But while contractual clauses on social and environmental standards have tended to improve, social, environmental and economic considerations are closely linked, and must not be viewed in isolation. Balancing these considerations is at the very heart of sustainable development. Taking social and environmental considerations seriously requires reflecting those considerations throughout the contract, not just through the clauses specifically devoted to defining applicable standards.

For example, in large agricultural investments, the contract may define rigorous standards for managing resettlement and compensation. But a quality contract may also structure the agribusiness venture to minimise land acquisition in the first place — by limiting the scale of new plantations, focusing the investment on agroprocessing, and sourcing from local farmers where this responds to local aspirations and leads to more inclusive outcomes.

Equally, social and environmental aspects need careful thought when agreeing economic provisions such as ‘stabilisation’ clauses aimed at protecting the investment from arbitrary regulatory changes that may adversely affect the project. Given that contracts are frequently long term, it may later become necessary to tighten up social and environmental standards, particularly as social needs and sensitivities change, new hazards are discovered, or new technologies are developed that can more effectively mitigate social and environmental risks. But if raising social and environmental standards increases project costs or delays project implementation, it may adversely affect the economic balance of the deal, potentially triggering stabilisation clauses aimed at protecting that balance. Where public finances are strained, an obligation to restore the economic balance or compensate the investor can make it more difficult for governments to take the action needed to protect people or the environment.

Quality contracts should use stabilisation clauses only if and when they are genuinely needed to protect investment against arbitrary interference. For example, because stabilisation clauses are often required for project bankability, it may be possible to limit stabilisation to the loan period, which may be significantly shorter than contract duration. More flexible types of clause offer opportunities to restore the economic balance through good-faith negotiation, rather than freezing the regulatory framework. Where used, stabilisation clauses should be clearly defined to ensure that non-discriminatory, good faith action in social and environmental matters is not restricted.

Negotiating quality contracts requires expertise to tackle not just tax and commercial matters, but also a wider range of social, environmental and economic considerations.

Making it happen

For all the aspects discussed above (that is, capacity to negotiate, more ‘open’ contracting processes, and an integrated approach to social, environmental and economic considerations), preparedness is the key to better investment contracts. For example, developing a shared vision for sectoral development, and for the types of investment to promote; tightening up rules and procedures in anticipation of investments, including to enable transparency and effective

community engagement; creating partnerships with international centres of excellence; strengthening capacity at both local and international levels; or developing model contracts as a basis for future negotiations, can all help ensure strategic issues are addressed systematically before time pressures become intense during individual negotiations.

Where there is local demand for it, capacity support

at these stages may reap clear benefits, and can help make investment contracts an important lever to promote quality investment.

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This briefing draws on IIED's advisory work for the Government of Lao PDR, carried out as part of a capacity support project led by the UNDP-UNEP Poverty Environment Initiative, and also on nearly a decade of extensive research by IIED and partners. The following studies in particular offer useful resources:

- Cotula, L., Tienhaara, K. 2012. Reconfiguring investment contracts to promote sustainable development. In: Sauvart, K. P. *Yearbook on International Investment Law & Policy*. Oxford University Press, USA. This detailed legal analysis discusses selected contractual issues from a sustainable development perspective. See: <http://pubs.iied.org/G03528>
- Ahmadov, I. et al. 2012. *How to scrutinise a production sharing agreement*. IIED, London. See: <http://pubs.iied.org/16031IIED>. A guide to a particular type of oil and gas contract, based on experience from Kazakhstan.
- Cotula, L. 2011. *Land deals in Africa. What is in the contracts?* IIED, London. See: <http://pubs.iied.org/12568IIED>. Drawing on legal analysis of twelve land deals from across Africa, this report discusses the contractual issues most needing public scrutiny.
- Cotula, L. 2010. *Investment contracts and sustainable development — how to make contracts for fairer and more sustainable natural resource investments*. IIED, London. See: <http://pubs.iied.org/17507IIED>. Drawing on trainings held in Ghana and Central Asia, and targeting host governments and civil society, this guide discusses how to structure investment contracts for maximum contribution to sustainable development.
- Cotula, L. 2010. Pushing the boundaries vs. striking a balance: the scope and interpretation of stabilization clauses in light of the Duke v. Peru award. *Journal of World Investment and Trade* 11(1) 25–43. This journal article comments on stabilisation provisions in light of recent international rulings.
- Cotula, L. 2008. *Regulatory takings, stabilization clauses and sustainable development*. Paper prepared for the OECD Global Forum on International Investment VII, March 2008. See: <http://www.oecd.org/investment/globalforum/40311122.pdf>. This paper discusses ways to reconcile stabilisation clauses with evolution in social and environmental standards.
- Ayine, D. et al. 2006. *Lifting the lid on foreign investment contracts: the real deal for sustainable development*. IIED, London. See: <http://pubs.iied.org/16007IIED>. This report investigates a diverse group of investment contracts: how contracts are negotiated, the terms of the deals, and their wider implications for sustainable development.

Notes

- ¹ Cotula, L. 2011. *Land deals in Africa – what is in the contracts?* IIED, London. See: <http://pubs.iied.org/12568IIED>
- ² Vale Columbia Center on Sustainable International Investment and the Humboldt-Viadrina School of Governance. 2012. *Support for developing country governments in the negotiation of complex contracts*. Background paper. See: www.vcc.columbia.edu/files/vale/content/Background_Paper_for_July_18-19_Negotiation_Assistance_Workshop.pdf
- ³ Kaul, R., Heuty, A., Norman, A. 2009. *Getting a better deal from the extractive sector – concession negotiation in Liberia, 2006-2008*. Revenue Watch Institute, Washington DC. See: www.caspianrevenuewatch.org/news/publications/getting-a-better-deal.php
- ⁴ www.afdb.org/en/topics-and-sectors/initiatives-partnerships/african-legal-support-facility
- ⁵ www.islp.org
- ⁶ See for example, UNDP and UNEP. 2013. *Stories of change from the Joint UNDP-UNEP Poverty-Environment Initiative*. United Nations Environment Programme, Nairobi, p. 11.
- ⁷ IFC. 2012. *Performance Standards on Environmental and Social Sustainability*. International Finance Corporation. See: www1.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/ifc+sustainability/publications/publications_handbook_pps.
- ⁸ Ruggie, J. *Principles for responsible contracts: Integrating the management of human rights risks into State-investor contract negotiations. Guidance for negotiators*. UN. See: www.ohchr.org/Documents/Issues/Business/A.HRC.17.31.Add.3.pdf
- ⁹ www.open-contracting.org
- ¹⁰ For example, contracts scrutiny work by the Centre for Environment and Development in Cameroon. See: www.cedcameroun.org.
- ¹¹ Tienhaara, K. 2011. Foreign investment contracts in the oil and gas sector: a survey of environmentally relevant clauses. *Sustainable Development Law and Policy* 11(3) 15–20. See: <http://digitalcommons.wcl.american.edu/sdlp/>

About the series

A commercial investment's 'quality' determines whether it promotes or undermines inclusive sustainable development in low-income countries. This briefing is part of an IIED series that investigates the notion of quality investment across different sectors and themes. Individual briefings do not start from a specific definition of quality investment. Rather, a final briefing will review the series and discuss implications for such a definition.

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