

Executive Summary and Recommendations

Conflict and Coexistence in the Extractive Industries

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Clashes over the terms of mineral contracts have become a political lightning rod in many resource-rich countries. A series of bitter disputes in recent years – some ending in lengthy litigation, project cancellation or even expropriation – has unsettled investors and global markets. These disputes call attention to the fragile and complex relationship between companies and their host governments that characterizes the extractives sector.

The economic significance of the sector to producer countries is well known, as is its role in influencing the fate of political leaders. Consequently, it is often subject to intense global scrutiny – whether over revenue transparency or its environmental legacy. Its impact on the national economy or local communities also remains an area of contested rights, responsibilities and benefits.

A decade of high prices and fast-growing global demand has triggered a new generation of mineral mega-investments. Many of these ventures are located in countries with long-established extractive industries, such as Australia, Chile and Canada. But ‘emerging producers’ – such as Mozambique and Mongolia – are also attracting interest from extractive companies, whether private corporations or state-owned enterprises (SOEs).

Today, public anticipation of the benefits of extractives projects is again rising in many countries, with producer governments asserting greater control over their mineral endowments. But these expectations come at a time when the operational and political context for mineral investments is shifting across the world, raising questions about the long-term future of the extractives sector, especially in developing countries.

Mineral and hydrocarbons production increasingly takes place in geologically, ecologically and politically challenging regions, as opportunities for more accessible reserves dwindle. Water scarcity and the increasing frequency of extreme weather events are raising new risks for investors and producers. Heightened concerns over resource security, environmental degradation and climate change will bring further scrutiny and tensions. Other uncertainties also cloud the market outlook. Talk of the end of the commodities super-cycle is prompting some companies to slash investment, undermining the prospects for resource-led development.

The relationship between host country and company in the extractives sector will remain contentious. In many parts of the world conflicts are set to escalate. Future disputes have significant ramifications not only for the economic and political stability of the countries concerned but also for companies’ assets and reputations.

Key findings

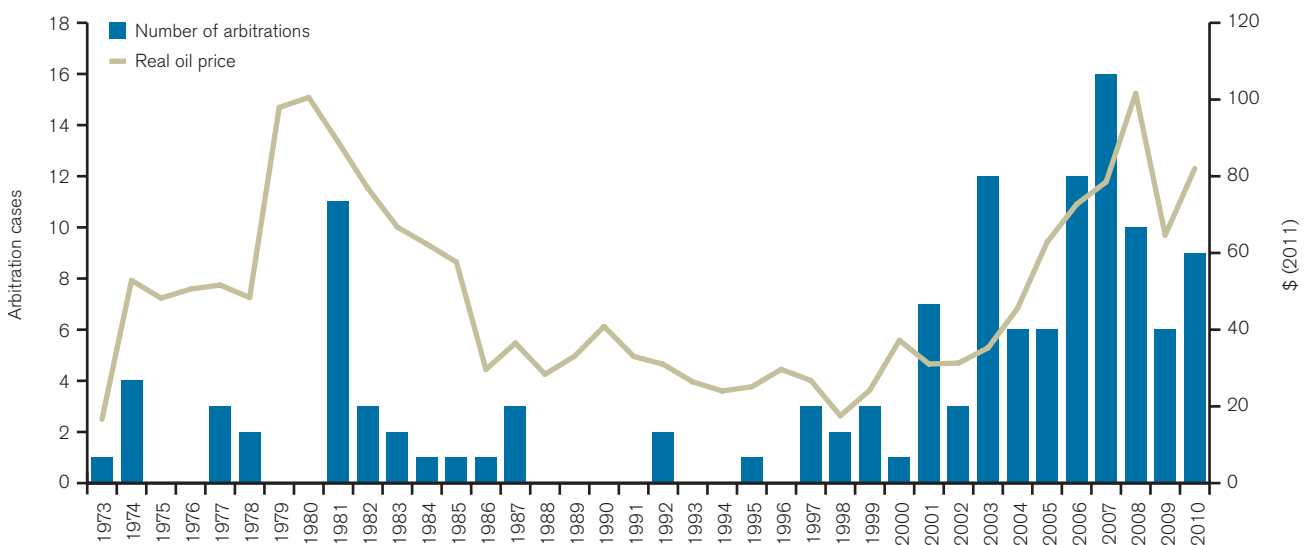
The number of disputes is on the rise.

Over the last decade, more disputes in the extractives sector have resulted in international arbitration than ever before. Between 2001 and 2010, arbitration cases for oil and gas increased more than tenfold compared with the previous decade, while those for mining increased nearly fourfold. This dramatic increase reflects escalating

tensions among stakeholders involved in the sector, culminating in disputes that have been difficult to resolve in a cooperative manner.

Companies and governments are always competitors when it comes to the distribution of mineral and hydrocarbon revenues and profits, despite their mutual drive to unlock potential wealth. Not so long ago, experts suggested that the worst types of commercial dispute would become a thing of the past. But experience has proved otherwise: three recent expropriations (affecting Repsol in Argentina, Rio Tinto in Guinea and First Quantum Minerals in the Democratic Republic of the Congo) have cost investors some \$13 billion.

Figure A: Real oil prices and international arbitration cases in the extractives sector, 1973–2010



Source: Chatham House Arbitration Database (CHAD).

The higher incidence of arbitrations correlates strongly with the commodity price boom. No country or type of company is immune to such disputes, although they tend to play out in different ways depending on the level of sophistication of the host country's legal and political system. They range from fights over changing legislation and project revisions to wrangling over liability for environmental damages.

Community-level conflicts, for example, remain frequent in countries with weak environmental protection frameworks, high economic and social inequality, and insecure water rights and land tenure. Reliable statistics on community conflicts and their impact are generally unavailable, but incidental evidence suggests that the number of such conflicts is increasing in many parts of the world. One assessment identified 126 active local conflicts in Peru related to the extractives sector as of mid-2013.

Poorer countries are not necessarily more prone to conflict. Even in long-established producer states, resource governance frameworks are susceptible to political pressures, as shown in the 2010 Australian super-profit tax debate and BP's ongoing legal battles in the United States over the Gulf of Mexico blowout and oil spill. At the same time, companies from emerging economies confront similar investment risks to those of their Western counterparts. The multi-billion-dollar loss that Vale, the state-backed Brazilian company, faces in Argentina and Guinea is a case in point.

Tensions between foreign investors and host governments are often attributed to resource nationalism. But many analysts fail to distinguish incendiary rhetoric from policies that legitimately address societal concerns. The extreme positions taken by Argentina and Zimbabwe are likely to remain exceptions rather than the rule. Most producer governments remain wary of deterring foreign investment. Where governments have announced new ownership requirements or taxation regimes – in Peru, Mozambique, Mongolia, Zambia or Guinea, for example – these proposals are often watered down or reversed under industry pressure.

The contract between government and extractive companies is inherently vulnerable.

At the heart of the problem is the absence of a practical formula or a benchmark to determine an equitable distribution of revenues between the state and companies in extractive ventures. Model contracts of the 1990s have by and large failed to weather the commodities price boom. According to the World Bank, more than 30 countries have revised petroleum contracts or entire fiscal regimes between 1999 and 2010. In mining, at least 25 governments (including most major mining countries) announced or implemented tax or royalty increases in 2010 and 2011 alone.

Revenue-sharing is often the frontline of company–government disputes. How to ensure a ‘fair share’ for each party remains an overriding challenge, and perceptions of fairness or equity are heavily shaped not only by the changing domestic and international context, but also by historical experience. Questions of who is in control and who benefits from the resource extraction remain relevant to a company’s presence and operations in a country long after the ink on the contract is dry.

In theory, governments should focus on capturing resource rents in excess of normal profits. In practice, distinguishing objectively between rents and profits is extremely difficult. Revenue-sharing agreements are therefore typically reached after protracted bargaining, while original contracts may be amended or renegotiated several times over many decades. Outcomes in these negotiations depend on the relative bargaining power of each party, including their control of information, market sentiment and prevailing views regarding the role of the state in the sector.

Throughout the lifetime of a project, three sets of structural pressures tend to challenge the contract between parties. First, commodity price cycles can undermine existing contracts and challenge their legitimacy. Second, ideological shifts and transitions of power, especially from dictatorship to democracy, often trigger demands to renegotiate deals. Third, the changing distribution of bargaining power over the project cycle may embolden action by one or other party. For example, companies often hold more bargaining power at the outset of a project, given their access to finance and technical know-how. After the investment costs are sunk, however, the balance of power can shift.

Extractive industries are in a period of flux.

The rules by which extractive companies operate in producing countries will be subject to changes, sometimes radical, as markets remain volatile and many resource-rich countries lack a broad national consensus on how their domestic resources should be managed. In several states, particularly in sub-Saharan Africa, generational change will bring new demands on the sector.

Global pressures and new obligations for companies to disclose information concerning their overseas investments are also accelerating. For the extractive industries, greater use of legal measures and penalties relating to transparency and corrupt practices will have ramifications for the ways in which companies operate abroad.

The increasing level of scrutiny from multinational NGOs, and the speed and reach of global communication mean that the spread of ideas and access to information about how projects should be conducted will influence local and national demands. The more varied nature of joint ventures globally, involving combinations of multinational companies, SOEs and smaller independent partners, is likely to increase the complexity of potential conflicts.

Meanwhile, a ‘capital strike’ by major investors – triggered by growing uncertainty about future prices and demand – is now a serious risk for some countries whose budgets rely on a continuing boom in resource investments and exports. This could lead companies to scale back, delay or even cancel flagship projects. Governments may demand that companies adhere to their ambitious development schedules, and companies risk being confronted with ‘use-it-or-lose-it’ arguments.

Going forward: recommendations

Even with a strong body of knowledge, lessons learnt and expertise on regulation, tax regimes and good governance, for example, best practices in each of these areas have been unevenly implemented. Despite initiatives such as the Extractive Industries Transparency Initiative, Intergovernmental Forum on Metals, Mining and Sustainable Development or the United Nations Guiding Principles on Business and Human Rights (also known as the Ruggie Framework), relations in the extractives sector worldwide continue to be strained.

Caution is essential for new producers moving into extractives-led development. While economic and political pressure to develop resources quickly will be high, in some countries the best option may be to 'go slow'. The emphasis should be on building the capacity to regulate companies, generate employment opportunities and manage revenues in tandem with the resource sector. Delaying development could be a preferred option for Afghanistan and Somalia, for example, given the combination of political instability, conflict and environmental stress they are currently facing.

With a greater number of mega projects and the range of new actors involved, it is imperative for stakeholders to persist in their efforts to tackle these governance challenges and invest in processes to enhance dialogue and to defuse future tensions. Recommendations include:

Improving the terms of engagement

- Companies and governments should opt for more flexible contractual arrangements with built-in response mechanisms to changing market conditions such as sliding royalty scales, rather than focusing on rigid, 'watertight' agreements.
- Governments should simplify tax and regulatory frameworks for investors – including clearer, more concise mining and petroleum laws that standardize licensing frameworks – to reduce the burden of negotiation for individual licences or contracts.
- Companies should conduct regular, open dialogues with civil society, organized labour and the media as well as opposition parties on issues such as the impact of operations; and they should stretch their engagement beyond governments, regulators and affected communities.

Raising standards of governance

- Companies should align due diligence, environmental practices and transparency standards with international best practice to ensure their long-term 'social licence to operate' and to insulate themselves from risks arising from unanticipated regulatory and political changes.
- Producer countries should make full use of governance-related initiatives (e.g. with respect to revenue transparency, or assistance in training local journalists and community leaders to enhance public understanding of extractives-sector development) to strengthen accountability through capacity development and checks and balances, with the support of donor agencies.
- Governments should clarify and update the risk assessment and liability regimes in accordance with international best practice and stress-test them against a range of scenarios, especially for 'frontier' and 'unconventional' projects.

Planning together and defusing tensions

- Governments should undertake a public assessment of national and local capacity to capture development benefits, prior to taking strategic decisions on exploration or development of major deposits. Companies should set out in concrete terms how they can contribute to filling capacity gaps to help manage local expectations.
- Multilateral institutions and donor agencies could support the development of integrated infrastructure plans in developing producer economies to meet not only the needs of the specific projects but also the broader development objectives.
- Public–private partnerships should be established to channel targeted investment in local capacity, including small and medium-sized enterprises, to strengthen forward and backward linkages from the extractives sector to the rest of the economy. Blunt approaches such as unrealistically high local content requirements should be avoided.
- Donor agencies could support the appointment of an independent, high-level ombudsman for the extractives sector, especially in emerging producer countries, to help defuse company–government tensions at an early stage, and to conduct public investigations into allegations of legal breaches.

