

Granting Rights to Natural Resources

Determining Who Takes Natural Resources Out of the Ground

KEY MESSAGES

- Countries should put in place a reliable and consistent mechanism for keeping track of who has rights to extract minerals and access land.
- Governments can give rights to companies to extract minerals through bilateral negotiations or competitive tenders.
- Transparency is fundamental. When going through the process of awarding contracts and licenses, all bidders should have access to the same information.
- Information about the companies themselves must also be as transparent as possible, including information about who ultimately owns them.
- When companies are given rights to land, they must fairly and transparently compensate landowners.

“The government should encourage efficient exploration and production operations, and allocate rights transparently.”

– Natural Resource Charter,
Precept 3

THE GOALS OF ALLOCATING RIGHTS

In most countries, the law or constitution makes it clear that the state is the owner of all minerals under the ground. Countries often give companies the rights to explore and exploit mineral resources so that the state can benefit from the capital, technical expertise and experience of private extractive companies. When the companies invest in exploration for minerals, countries also benefit by avoiding the financial risk associated with the initial exploration process. This reader describes the processes by which governments decide which companies can have the rights to extract minerals, oil, and gas, and on what terms.

Licenses and *contracts* are the legal documents that govern the rights and responsibilities of the government and companies during extractive projects. A *license* (synonym: permit) is a standard-form legal document that the state uses to grant exploration or extraction rights according to a generally applicable set of terms, with limited variation from one project to another. As discussed in the reader on legal frameworks, the general terms of a license are usually set forth in laws or regulations. A *contract* (synonym: agreement) is a negotiated accord in which both parties agree to a set of obligations to each other. Contracts are often created from standard templates, but in contrast to licenses many resource-rich countries negotiate contracts that deviate substantially from potentially applicable rules in the laws, regulations, or model contracts.

This reader is intended for use in conjunction with Precept 3 of the Natural Resource Charter.

How governments decide which companies will have the right to extract and on what terms is referred to as *licensing* or *allocating rights*. A government often has several goals when entering into a licensing process:

- **Pick the right company.** Mineral and oil extraction is a long-term process and it is in the country's interest to have a good partner. Some companies are more effective and efficient in extracting minerals. Others purchase extraction rights to speculate on their value. If a company purchases rights, but does not efficiently extract the resources, the country might not fully benefit.
- **Get the best terms for the state.** The government wants the best deal possible, but it is often very difficult to determine what the best deal is because of large numbers of terms and inherent uncertainty in extractive industries. The ideal licensing process will make it clear to the government what the best terms are for a particular project.
- **Limit or eliminate corruption.** Licensing processes can be rife with corruption that takes benefits away from the country and puts them in the hands of an elite few. A strong licensing process brings transparency and makes it more likely that rights are allocated based on merit.
- **Reflect broader sector goals.** If the government already has a national policy for its goals for mineral or oil extraction, officials must ensure that any new extractive project is in line with those goals. They must also ensure that the project terms do not undermine future deals.

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While most licensing takes place at the national level, some countries with highly decentralized or federal forms of government involve states and provinces in the allocation of rights.

THE PROCESS

There are two common processes for allocating rights: bilateral negotiations and competitive tenders.

In *bilateral negotiations* (also called *open door processes*), two parties, usually a government and a corporate bidder, come together without an open competition. Initially, government officials determine whether the company has the minimum technical and financial capabilities to take on the project. They also assess whether the terms proposed by the company warrant granting the company the right to explore and/or exploit. If these thresholds are satisfied, government representatives proceed to negotiate the terms of an agreement with the company.

In *competitive tenders* (including *auctions*), the government makes a public call for companies to submit bids, opening the opportunity to bid to more than one party. Often the government sets out criteria that bidders need to meet in order to be allowed to participate. The process of deciding whether companies meet the criteria to bid is called *pre-qualification*. When bidders need to be pre-qualified, the bid is *restricted*. Restricted bids are common in the petroleum industry due to the high level of technical skill required to execute a project.

Open door vs. auctions

The quality of geological information can often impact which process of allocating rights is most beneficial to the government.

When significant geological data is available and investor interest is high, a competitive auction is generally considered the best option. In auctions, investors compete against one another, leaving the government in a stronger negotiating position. When there is enough information, auctions result in terms that are often a better indicator of the actual value of the deposit than what the government could calculate internally. Competitive tenders also can include built-in transparency provisions that increase the likelihood that awards will be based on objective criteria rather than political patronage.

In contrast, when geological information is limited or not immediately encouraging, governments may decide to adopt an open-door, first-come, first-served licensing procedure, or to engage in direct negotiation with a limited number of companies. The lack of information increases the risk for the companies and often makes it less likely that there would be enough bidders to foster strong competition. Though the typically scant information available in the mining sector has made it particularly oriented around bilateral negotiations, recent improvements in technology have allowed more mineral-rich countries, like Peru and Afghanistan, to try auctions for mineral projects.

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The steps in a typical restricted bid are depicted in the graphic below. To begin, government officials must decide what *blocks*, or segments of land or ocean floor, are going to be available and what terms are going to be open for negotiation. The government will then promote the bidding and ask parties to express interest. Next, during the pre-qualification stage, governments will determine whether the interested parties meet the relevant criteria. The government will then invite qualified parties to bid. After receiving the bids and comparing the benefits, the government will issue a license and/or sign a contract with the winner. Many governments aim to include all *variable terms*, or terms that are not fixed by law, in the bidding process to eliminate the need for post-bid-negotiation. In some countries, however, the government and the companies conduct negotiations after the bid is accepted to finalize all the terms.

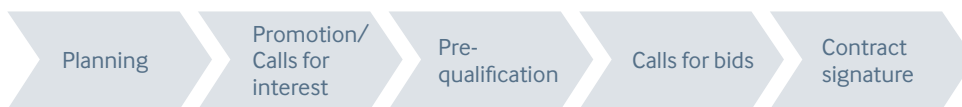


Figure 1. Steps in a typical restricted bidding process

TERMS OF AGREEMENT

In countries that use contracts (as opposed to licenses), the goal of both open door and competitive licensing processes is a contract that is in the best interest of the people while ensuring a sufficient return to the investor. What is included in that agreement, or the *terms*, may vary from project to project but generally includes information about the timetables and processes for project implementation; fiscal terms for sharing revenues between the company and the state; requirements for local economic development or infrastructure; health and safety standards for labor, social and environmental responsibilities; and the process for oversight of obligations by the government.

In auctions, the bidding terms may vary. Some terms may be *fixed*, which means they are prescribed either by law or the terms of the auction. Other terms are *variable*, and the

bidding companies are required to submit their offer for those terms. In some cases all of the financial terms are fixed, requiring the companies to bid simply on the amount of work and production they will undertake. It is easier for governments to make comparisons across bids when the auction rules limit the competition to a few variable terms.

TRANSPARENCY AND GOOD GOVERNANCE

A sound licensing regime is the first step toward effectively capture of economic benefits from extraction. A mineral licensing system is most effective in the context of a clear legal and regulatory framework with well-defined institutional responsibilities and procedures. By improving the selection of partners, an effective licensing system can minimize the risks of working with companies that will sit on mineral deposits, without developing them, purely for speculation.

Transparency is at the core of good practice when it comes to license/contract award procedures. The government should make license applicants—on a non-discriminatory basis—fully aware of the procedures to be followed. It should also provide them with access to all available data, whether on a free or purchase basis, and inform them of all applicable laws. Documentation should also provide assurances that areas offered for license are currently unlicensed and that proper authority exists for their licensing. With the possible exception of specific technical data, this information should be available in the public domain.

Disclosure by the government to the public of the criteria upon which licenses were awarded is a critical step to foster citizen trust and accountability. The disclosure of all license holders, including the *beneficial owners* (the individual or individuals who will actually benefit from the profits of the company) is also important for effective oversight by government authorities and citizens. Easy access to information about beneficial owners guards against the misuse of *shell companies* to allocate licenses to politically

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Case study: Competitive, open auctions in Iraq

In June 2009, the Iraqi government held a series of open, transparent and competitive bidding rounds to allocate service contracts for the right to extract oil. The agreements reached were considered a huge success in a country with a challenging operating environment. Companies bid fiercely, and ultimately settled for service contracts paying them far less per barrel of oil extracted than what they had proposed in the initial bids.

Due to the competitive nature of the process, the bidders drastically reduced the remuneration fees that the government would owe them under the contract. For example, the winning bid for the Rumaila oil field, led by China National Petroleum Corporation and BP, was 58 percent cheaper than the bid by ExxonMobil, and almost 50 percent less than BP's initial bid. Given the large difference between BP's opening bid and its winning bid, approximately \$750 million extra would accrue to Iraq per year from the Rumaila oil field. (Note: this figure is calculated using oil prices at the time of the bid.)

Though many terms were decided through the open bidding process, some were left to subsequent closed-door negotiations. In these negotiations, the government of Iraq agreed to bear much of the cost if there were OPEC quota restrictions, problems with exports, natural disasters, or war that disrupted production. In doing so, the government took on more risk than the risk level envisaged in Iraq's model contract, which shares split the costs of the risks for these events between the parties. In addition, a provision that would hold the company liable for exploiting the reservoirs too quickly or inefficiently was removed from the model contract.

exposed individuals. Countries that implement the Extractive Industries Transparency Initiative (EITI) must publish a registry that includes all license holders and the location and duration of licenses. The EITI also requires governments to publish information on licensing processes and encourages the publication of information on beneficial ownership.

Beyond transparency, it is good practice to introduce legal limits to discretionary powers of the authority in charge of awarding licenses or contracts. This helps prevent abuses and reduces room for corruption.

KEEPING TRACK OF LICENSES

A *mineral cadastre* is a public institution responsible for managing applications, granting mineral rights, maintaining the registries, and controlling the timing and validity of licenses. Cadastres are important for keeping track of who has rights to what, and for creating a well-organized and stable environment for investment. How the information is organized and the extent to which it is publicly available varies from country to country. Some countries have invested in technology that links licensing information to geospatial data. This can result in helpful maps, often available online, that show what types of licenses are available where. Some of the most sophisticated versions have an interface that allows the user to click on a license to get more information about the terms and ownership.

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Land rights

Even though the state may be the owner of underground assets, a licensing system must still take into account the owners of the land above the ground. In order for extractive companies to get the resources out of the ground, they must have access to land for excavation and distribution operations. If the government does not already own the land, it often tries to gain ownership through a process of *expropriation*, known in some countries as *eminent domain*. *Expropriation* means the government seeks to become the owner of the land so that it can use it for the public good, in this case selling natural resources. In other cases, even if the state does not expropriate the land, the government and extractive companies have mechanisms to obligate the land owners to allow for exploration or exploitation on their property. International law and most constitutions require that the government provides fair compensation to land owners. According to international law and standards, the compensation should include payment for the value of the land, payment for the value of any improvements or structures on the land, and compensation to address loss of connection to roads, livelihoods and ancestral lands. This resettlement and compensation process is usually undertaken by government and company officials. When executed poorly, it can be a source of local consternation and undermine the company's *social license to operate*. The process can be complicated when the government does not already have clear documentation of ownership.

QUESTIONS TO ASK

- How does my country keep track of licenses and contracts? Is it a reliable, accessible system?
- How are licenses usually allocated in my country: by auction or by open-door negotiation?
- When considering allocating a license, is interest high enough to warrant an auction? Or should exploratory work be done first in order to provide more geological data?
- Is the bidding process being implemented open, fair and transparent?
- What information is the government making available to bidders? Is the same information equally available to all bidders?
- What is the process for providing land rights to the extractive companies? Are those who are being resettled receiving fair compensation?

ADDITIONAL RESOURCES

Natural Resource Charter, Precept 3.

Campton, Peter, chapter 5, “How to Best Auction Oil Rights,” in *Escaping the Resource Curse* (Humphreys, M., Sachs, J.D., Stiglitz, J.E., eds., New York: Columbia University Press, 2007).

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>

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