

Deep-Sea Minerals

Briefing, October 2020

Draft Standard and Guidelines on the Form and Calculation of an Environmental Performance Guarantee

Introduction

The International Seabed Authority (ISA) is currently developing Exploitation Regulations¹ for Deep-Seabed Mining (DSM) in the Area². Draft Regulation 26 of the Exploitation Regulations mandates that a Contractor must lodge an Environmental Performance Guarantee (EPG) with the ISA and that further details of the EPG will be outlined in guidelines. The Legal and Technical Commission (LTC) of the ISA has now published the 'Draft standard and guidelines on the form and calculation of an Environmental Performance Guarantee' (Guidelines) for consultation with ISA members and observers.

This Briefing Note reviews these Guidelines. It proceeds by: summarising the Guidelines, reviewing the different types of financial instruments that

could be used for the EPG, reviewing evidence from case studies of land-based mining, offering comments on the Guidelines for the consideration of Commonwealth Member countries, and discussing the implications of the Guidelines for sponsoring states.

Submissions to the ISA are due by the 20th of October 2020, and should use this template (<http://bit.ly/temp-sg-rev>) and be sent to: ola@isa.org.jm. If Commonwealth Member countries would like to discuss further any aspects of this Briefing Note, or would like assistance in putting together a tailored submission to the ISA, they should contact d.wilde@commonwealth.int.

For more information on any of the issues raised in this advisory note, or other deep-sea mineral matters, please contact Alison Swaddling at a.swaddling@commonwealth.int

This is Issue 6 in the Commonwealth Deep Sea Minerals Briefing series. Previous issues can be found here: <http://thecommonwealth.org/oceans-and-natural-resources>

Summary of the Guidelines

Draft Regulation 26 of the Exploitation Regulations requires a contractor to lodge an EPG in favour of³ the ISA. The EPG must be lodged no later than the commencement date of commercial mining, and should reflect the likely costs required for:

- a. the premature closure of exploitation activities;
- b. the decommissioning and final closure of exploitation activities, including the removal of any installations and equipment; and
- c. the post-closure monitoring and management of residual environmental effects.

The Guidelines, and this Briefing Note, refer to these three cost elements as the EPG Scope.

When drafting the Guidelines the LTC was guided by two main considerations: first, that the EPG does not hinder the ability of contractors to participate in the Area; and second, ensuring that the ISA has necessary funds to cover the costs of the EPG Scope.

The Contractor submits details of its EPG as part of its Plan of Work, which is then considered by the LTC and Council. The Contractor, to satisfy the LTC that it has met Draft Regulation 26, should submit details of the proposed EPG, which must include:

- a. adopting an endorsed method, and using an accepted calculation tool, for calculating EPG Scope costs, with costs calculated on a third-party basis (e.g. that the works are not carried out by the Contractor). These costs should be calculated on a 'greatest reasonably credible costs on a worst case scenario' basis;
- b. producing a validation statement prepared and signed by an independent validator confirming that the calculation of the EPG Scope costs is accurate; and
- c. submitting EPG Guarantee and EPG Confirmation forms in the prescribed format.

The EPG is required to cover unexpected EPG Scope costs that the Contractor is unable to meet. That is, if the Contractor is unable to meet unexpected costs related to decommissioning and environmental monitoring, the ISA can 'cash' the guarantee and use it to meet those costs. The ISA will release/refund the EPG when the Contractor has met all requirements of the Closure Plan that include likely EPG Scope costs and the LTC has approved the final performance assessment. The EPG is also released when there is an approved transfer of rights (with the transferee submitting a new EPG) and when there is a change of control (and the Contractor has lodged a new EPG).

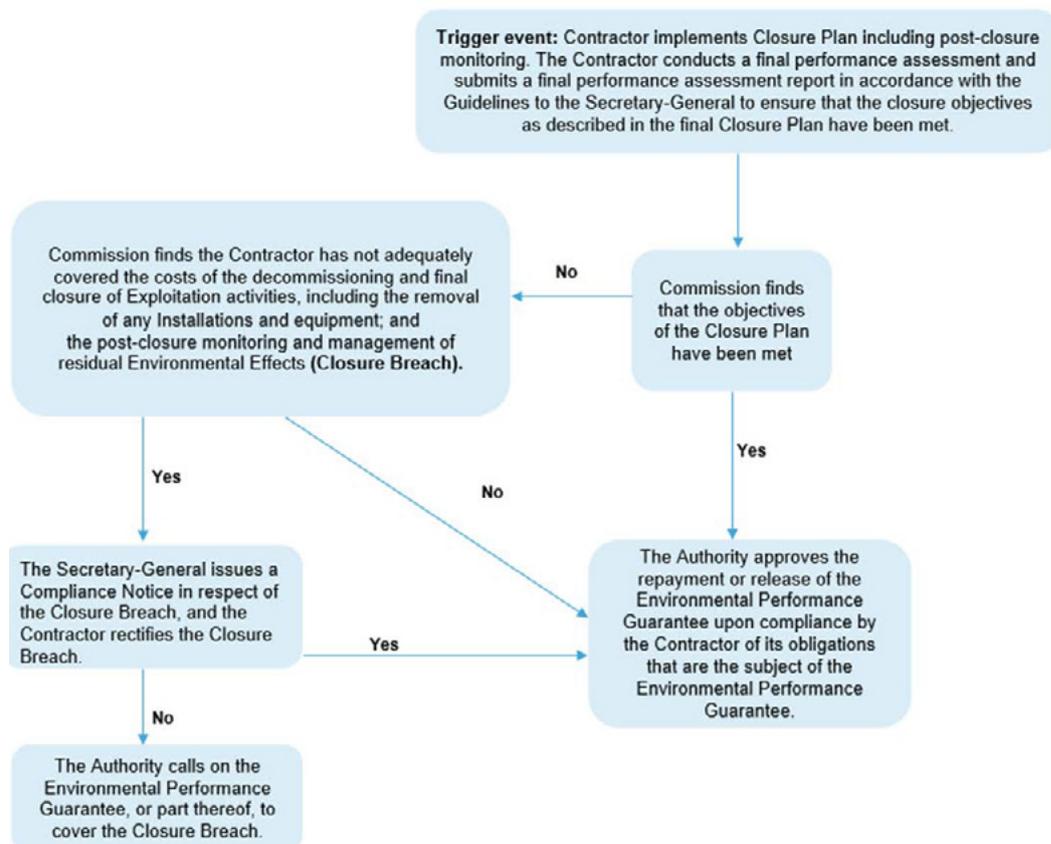
Figure 1, which is replicated from the Guidelines, demonstrates the EPG release/refund process.

Review of the Different Types of Financial Instrument that could be used for the EPG

The Guidelines do not prescribe the financial instrument used for EPG. Rather annex two of the Guidelines states 'the following **non-exhaustive** forms of guarantees may be proposed by an Applicant or Contractor [...] self-guarantee or

company guarantee, insurance policy or scheme, letter of credit/bank guarantee, insurance guarantees, cash deposits and sinking fund. Table 1 summarises and comments on these financial instruments.

Figure 1: EPG Release/Refund Process



Review of Evidence from Case Studies

The World Bank (2009)⁴ has provided a detailed overview of case studies of financial guarantees for mine closure from land-based mining. The jurisdictions studied are: Ontario, Nevada, Queensland, Victoria, Botswana, Ghana, Papua New Guinea, South Africa, Sweden and the European Union. The following points from these case studies are relevant to our discussion of the Guidelines:

- the most common financial instrument is the letter of credit. Surety bonds, cash and trust funds are also used fairly regularly, while only Ontario and Nevada accepted self-guarantees;
- on balance, the case studies demonstrate that self-guarantees do not provide sufficient protection;
- in some jurisdictions the level of detail for costs is left up to the miner, but in other jurisdictions, such as Queensland, the regulator provides considerable guidance on cost components and the costing method;
- all the jurisdictions studied, apart from Ontario, provide for costs to be reviewed, and the amount of the financial instrument to be amended, on a regular basis. The timing of such reviews varies from annual (South Africa) to every ten years (Queensland); and
- three of the case studies showed that when mines closed due to economic difficulties the financial instrument had not been sufficient to cover closure costs. Examples of insufficient funds being available for closure are provided for Australia, Canada and the UK. This finding speaks to the need for a vigorous process for reviewing individual situations, and if need be, increasing a miner's estimate of rehabilitation costs.

Table 1: Review of Financial Instruments for the EPG

Financial Instrument	Description	Advantages	Disadvantages
Self-Guarantee /Company Guarantee	Contractor guarantees its own EPG Scope costs itself, ideally based on a detailed financial evaluation of the Contractor.	<ul style="list-style-type: none"> • Advantageous for contractors as it does not tie up capital. 	<ul style="list-style-type: none"> • Public perception that a Contractor guaranteeing themselves is a contradiction in terms. • Some contractors have limited experience mining and are relatively new companies, and thus may not be well suited to guaranteeing EPG Scope costs themselves. • Many land-based mining jurisdictions no longer accept company guarantees. • Unlikely to provide access to funding in the event that the Contractor dissolves or goes insolvent – which is exactly the type of circumstance in which the ISA may in fact need to draw down upon the EPG.
Letter of Credit	This is an agreement between a Bank and the Contractor, whereby the Bank guarantees payment to the ISA under certain conditions. The letter of credit includes details of the terms and conditions of the agreement between the Contractor and Bank concerning EPG Scope costs.	<ul style="list-style-type: none"> • Relatively cost effective for contractors. Costs depend on a contractor's credit ratings but are generally not prohibitive. 	<ul style="list-style-type: none"> • Banks can themselves fail. ISA could mitigate this risk by only accepting a letter of credit from a Bank with a high credit rating.
Surety Bond	Agreement between insurance company and Contractor to provide funds to the ISA in the event that the Contractor cannot meet EPG Scope costs. The surety bond will include the terms and conditions of the agreement between the Contractor and insurance company with reference to the EPG Scope costs.	<ul style="list-style-type: none"> • From the perspective of the Contractor, low costs and no tied up capital. 	<ul style="list-style-type: none"> • There is a risk that the insurance company issuing the surety bond will itself fail. • Credit rating of the Contractor will affect the price of the surety bond. Smaller companies with poor credit ratings will face higher surety bond costs.
Insurance Policy	Contractor purchases insurance policy, insurance company pays EPG Scope costs if, subject to certain conditions, the Contractor is unable to meet such costs.	<ul style="list-style-type: none"> • For the contractor, this results in a modest cash outflow and does not tie up capital. 	<ul style="list-style-type: none"> • It remains to be seen whether an insurance market for EPG Scope costs will develop. • Given the nascent state of the DSM industry, insurance costs may be significant.
Cash Deposits	Contractor pays cash, perhaps annually up to an agreed-upon value, into an escrow account or account held by the ISA prior to the commencement of commercial mining. Cash is repaid to the Contractor when it completes all of its obligations under the EPG or alternatively cash is used to reimburse the contractor for EPG Scope costs. Cash is available to ISA in the event that the Contractor cannot meet EPG Scope costs.	<ul style="list-style-type: none"> • Cash is available if Contractor cannot meet EPG scope costs. • Highly visible and high stakeholder acceptance. • Provides additional assurance that only companies of strong financial standing are engaged in DSM. 	<ul style="list-style-type: none"> • Ultimately, significant capital is tied up for entirety of the mine life, making investment in DSM less attractive.

Points for the Consideration of Commonwealth Member Countries

Commonwealth Member countries may wish to consider:

1. whether the name 'Environmental Performance Guarantee' is a misnomer. The EPG is designed to cover unexpected costs that the Contractor is unable to meet for the EPG Scope (effectively decommissioning and post mining environmental monitoring). The draft EPG scope currently only covers post mining activities, and does not incentivise compliance with environmental obligations during mining, nor provide access to funds for environmental harm or other emergency incidents that may occur during the mining operation. A more accurate name for the 'Environmental Performance Guarantee' as currently formulated might be 'Decommissioning Guarantee';
2. whether it is appropriate for Contractors (including state parties) to be able to guarantee their own ability to meet EPG Scope costs. This is a new and untested industry, bearing high environmental risks. As such, regulatory mechanisms at the more cautious end of the spectrum should be applied. Even large companies can fail, and the financial health of a company may deteriorate during the life of a mine. There may also be contractors that have limited experience in commercial mining and limited financial resources. In the event that self-guarantees are accepted by the ISA, then further work is required to specify the criteria, method and data required for contractors to demonstrate that they are financially strong enough to self-guarantee;
3. whether it is appropriate for the Guidelines to give contractors such broad scope in choosing the financial instrument underpinning the EPG. Given the importance of ensuring decommissioning and post mining environmental monitoring, a strong argument could be made that the Guidelines should prescribe a choice of valid financial instruments likely to assure success. Commonly accepted financial instruments in land-based mining jurisdictions include letters of credit and surety bonds;
4. whether the Guidelines should allow, as is currently the case, financial instruments that rely on financial institutions without specifying the acceptance criteria for those institutions. For example, the security provided by a letter of credit is dependent on the financial soundness of the bank providing the letter; while the security provided by a surety bond is dependent on the financial soundness of the insurance company underwriting the bond. Thus, Commonwealth Member countries may wish to request that the ISA provides further guidance on the criteria for acceptable banks and insurance companies for letters of credit and surety bonds respectively;
5. whether an EPG Scope costs fund (or 'decommissioning fund') should be considered. The Fund could be held by the ISA or as an escrow account. The Contractor would make payments into the Fund equal to the amount of the forecasted EPG Scope costs. Payments into the Fund can be made up-front or over the life of the mine. One problem with the ISA receiving payments over the life of the mine is that this may lead to insufficient funding being available to cover EPG Scope costs in the event that mining ceases before the end of the exploitation contract. Once the Contractor has met its EPG Scope obligations the amount of the fund is released back to the Contractor. In the event that the Contractor cannot meet EPG Scope costs then the ISA can use the Fund to meet such costs. Such funds are highly visible and can ameliorate public concerns concerning the financing of decommissioning;
6. whether the Guidelines should be amended so that the EPG covers all EPG Scope costs that the Contractor is unable to meet. As currently drafted, the Guidelines restrict the EPG to only covering unexpected EPG Scope costs that the Contractor is unable to meet. This is an important distinction, as there may be occasions, due to say bankruptcy, where a Contractor cannot meet expected EPG Scope costs and, it could be argued, such expected costs should be covered by the EPG;

7. whether it would be useful for the ISA to develop clear criteria against which the LTC can evaluate contractors' EPG Scope costs and to include these in the Guidelines;
8. welcoming the use of an independent validator to review the EPG scope costing, while also considering whether the ISA should have to approve any independent validator selected by a Contractor; or alternatively, whether the ISA should be the responsible party to appoint validators;
9. whether it is appropriate for the LTC to place significant weight on the EPG not hindering the ability of contractors to participate in the Area. It could be argued that the principal motivation for the EPG should be guaranteeing funds for decommissioning and post mining environmental monitoring, regardless of the impact on contractor profits. Protecting the marine environment and monitoring the impacts of activities under their jurisdiction are absolute legal obligations placed upon the ISA and States, which cannot be subjugated to other interests. Moreover, only if DSM is economically marginal and the Contractor is of weak financial standing would the costs of a letter of credit or surety bond significantly affect the commercial viability of the mine;
10. whether the ISA and LTC should clarify which, if any, parts of the Guidelines are intended to be legally binding. The Draft Exploitation Regulations refer to 'Standards' which are legally binding on the ISA and Contractors, and 'Guidelines' which are advisory only. Draft Regulation 26 on the EPG refers to 'Guidelines' only and makes no mention of 'Standards'. The Guidelines, however, refer to Appendix 1 as a 'Draft Standard' and Appendix 2 as 'Draft Guidelines'. This raises the following questions:
 - a. do the ISA and LTC intend Appendix 1 of the Guidelines to be legally binding on Contractors, but Appendix 2 to be advisory only; and
 - b. can Appendix 1 be a legally binding Standard when Regulation 26 refers to Guidelines only.

Given the potentially long-lasting consequences of decommissioning and post mining environmental monitoring, it could be argued that the details of the EPG should be legally binding on Contractors and that this requires that Draft Regulation 26 is redrafted to refer to 'Standards';
11. whether transparency to Council members and observers could be further improved. In order for informed decision-making by Council, and informed discussion by Assembly, all information provided by applicants in determining their EPG quantum and mode, should be shared with Council and made available to members and observers. Additionally, the LTC will need to make transparent the details of how its evaluations and recommendations were made; i.e. how each applicant fared under (as-yet unspecified) ISA assessment criteria.

Implications for Sponsoring States

Sponsoring States should be aware that their "responsibility to ensure" that their sponsored Contractor complies with UNCLOS is quite broad and that the outer limits of that responsibility remain unclear. Damage resulting at any stage of a mining operation (including decommissioning and closure) may trigger Sponsoring State liability if the damage is shown to have resulted from the Sponsoring State's failure to fulfil its due diligence obligation. The provision of an adequate EPG may contribute to preventing or reducing the potential liability of a Sponsoring State since funds may thereby be available to the ISA to carry out activities that reduce or mitigate damage to the environment. It would therefore be in the interest of Sponsoring States that an appropriate and adequate EPG is secured from a Contractor.

The Exploitation Regulations and Guidelines give the ISA the sole power to determine the amount of the EPG to be deposited by a Contractor and to review that amount periodically. Given Sponsoring States' interest in the EPG, it would be in their interest that the Guidelines explicitly allow for consultations with the relevant Sponsoring State whenever the ISA is considering a proposed EPG.

Endnotes

- 1 Formally: 'Draft regulations on exploitation of mineral resources in the Area'.
- 2 Formally: 'The Area beyond national jurisdiction'.
- 3 In this sentence, the term 'in favour of' means that the ISA would receive the amount included in the EPG in the event that the Contractor was unable to meet unexpected ESG Scope costs.
- 4 World Bank (2009) 'Financial surety: guidelines for the implementation of financial surety for mine closure.' (2009). Available at: <http://documents1.worldbank.org/curated/en/915061468163480537/pdf/499690NWPOExtr10Box341980B01PUBLIC1.pdf>



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Author: Trade, Oceans and Natural Resources Directorate,
Commonwealth Secretariat, London, UK.

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Commonwealth Secretariat
Marlborough House, Pall Mall, London SW1Y 5HX, United Kingdom
Tel: **+44 (0)20 7747 6500**
www.thecommonwealth.org