

## **Outcomes of the Intersessional Working Group on a mechanism to develop Equalization Measures for the OEWG on Financial Terms of Contracts**

### **Introduction**

Australia facilitated further intersessional discussions on possible mechanisms for Equalization Measures from the 15-17 August 2023. The meetings were in hybrid format, with the in-person meetings generously hosted by the Commonwealth Secretariat at its London premises.

Representatives from sponsoring and non-sponsoring States<sup>1</sup> and contractors<sup>2</sup> participated in the discussions, with expert input from Professor Richard Roth of MIT, Ms Alexandra Readhead of IGF, and Dr Daniel Wilde of the Commonwealth Secretariat.

The group recalled the provisions of the Convention and the Implementation Agreement relevant to Equalization Measures. Section 8 of the Annex to the Implementation Agreement sets out the following principles:

- ‘The system of payments to the Authority shall be fair both to the contractor and to the Authority and shall provide adequate means of determining compliance by the contractor with such system;’<sup>3</sup>
- ‘The rates of payments under the system shall be within the range of those prevailing in respect of land-based mining of the same or similar minerals in order to avoid giving deep seabed miners an artificial competitive advantage or imposing on them a competitive disadvantage;’<sup>4</sup>
- ‘The system should not be complicated and should not impose major administrative costs on the Authority or on a contractor. Consideration should be given to the adoption of a royalty system or a combination of a royalty and profit-sharing system. If alternative systems are decided upon, the contractor has the right to choose the system applicable to its contract. Any subsequent change in choice between alternative systems, however, shall be made by agreement between the Authority and the contractor’.<sup>5</sup>

Article 13 of Annex III to the Convention sets out the following guiding objectives for the Authority:

- ‘to ensure optimum revenues for the Authority from the proceeds of commercial production,’<sup>6</sup>
- ‘to attract investments and technology to the exploration and exploitation of the Area,’<sup>7</sup> and

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<sup>1</sup> Australia, Brazil, Canada, Chile, Cook Islands, Ghana, Jamaica, Japan, Mexico, Morocco, Nauru, Singapore, South Africa, Tonga and the United Kingdom.

<sup>2</sup> The contractor participants included representatives from those with exploration contracts with the Authority and associated companies: Beijing Pioneer High-Tech Company (BPC), China Minmetals Corporation (CMC), Deep Ocean Resources Company Ltd (DORD), Dredging, Environmental and Marine Engineering NV (DEME), Global Sea Mineral Resources NV (GSR), Loke Marine Minerals and The Metals Company.

<sup>3</sup> Paragraph 1(a), Section 8 of the Annex to the Implementation Agreement

<sup>4</sup> Paragraph 1(b), Section 8 of the Annex to the Implementation Agreement

<sup>5</sup> Paragraphs 1(c), Section 8 of the Annex to the Implementation Agreement

<sup>6</sup> Convention, Annex III, Article 13.1(a).

<sup>7</sup> Convention, Annex III, Article 13.1(b).

- ‘to ensure equality of financial treatment and comparable financial obligations for contractors’.<sup>8</sup>

The group considered further the three models that had been proposed during its intersessional meetings in May 2023:

- An **additional fixed rate royalty**, as proposed in the African Group’s submission of 22 August 2022 on the Payment Regime for Deep Seabed Mining in the Area;
- A **cash flow additional profit-share**, outlined in the report<sup>9</sup> and presentations from the IGF; and
- A **top-up profit-share** based on the OECD’s Global Anti-Base Erosion (GloBE) Model Rules, outlined in the presentations by a group of commercial contractors.

All three proposed equalization measures aim to ensure that:

- when a contractor (or all related entities under the top-up profit share) pays less than 25% of its profits in taxes and royalty payments to the sponsoring State (or all States under the top-up profit share) it pays more to the Authority; and
- when a contractor (or all related entities under the top-up profit share) pays 25% or more of its profits in taxes and royalties to the sponsoring State (or all States under the top-up profit share) it does not pay anything to the Authority under the equalization measure.

Further information on each of these proposed measures, including their pros and cons, are outlined in the Briefing Note circulated ahead of the August meeting (attached), and in the Summary Report, papers and presentations from the May 2023 meetings of the Intersessional Working Group published on the Authority’s Website. The Briefing Note also includes preliminary draft text for each measure.

In response to questions raised by one participant about the need for an equalization measure by way of additional payments to the Authority, the experts modelled the possibility of using a **higher base rate royalty** as an equalization measure. This modelling demonstrated that if the Authority does not implement a separate equalization measure then the Authority could either:

- set low royalty rates, potentially forgoing significant resource rents, and accept that any contractors that have negotiated tax exemptions will face a lower effective tax rate than land-based miners; or
- set high royalty rates, potentially stymieing investment, and accept that contractors that have not negotiated tax exemptions will face a higher effective tax rate than land-based miners.

Partly based on this analysis, all but one participant concluded that an equalization measure was needed.

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<sup>8</sup> Convention, Annex III, Article 13.1(c).

<sup>9</sup> IGF, 2023, Report on the Proposed Payment Regimes for Deep Sea Mining: sponsoring states taxes and the taxation of capital gains [https://www.isa.org.im/wp-content/uploads/2023/05/IGF\\_Draft\\_Report\\_Deep\\_Sea\\_Mining\\_Payment\\_Regime.pdf](https://www.isa.org.im/wp-content/uploads/2023/05/IGF_Draft_Report_Deep_Sea_Mining_Payment_Regime.pdf)

## Outcomes

### *Model for an Equalization Measure*

Although there was no consensus on a preferred equalization measure, the group narrowed down the number of possible measures for further consideration by the OEWG on the Financial Terms of Contracts.

The group developed a **hybrid model**, which combines aspects of the additional fixed rate royalty and the top-up profit share.

Under the hybrid model, a contractor will pay an additional royalty to the Authority, unless an independent auditor confirms that:

- (a) the contractor does not have any exemptions from sponsoring State corporate income tax or any other sponsoring State tax; and
- (b) the contractor does not receive any subsidy from the sponsoring State or any other State.

Under the hybrid model a contractor would pay a top-up profit share if it does not pay the additional royalty. The top-up profit share would be equal to 25% of the profits of the contractor and related entities from mining, but tax payments to States will be creditable against this profit share. Thus, a contractor and its related entities that were paying at least 25% of their profits in taxes to States would not have to pay anything additional to the Authority. This top-up profit share would, to the greatest extent practicable, use existing GloBe definitions of profits/income, related entities and tax payments, which would simplify the drafting, administration and audit of this profit share.

This hybrid model:

- demotivates tax avoidance by contractors, and motivates contractors to pay sponsoring State taxes (which was not the case for the initial top up profit share),
- is better at equalizing and fairer to both the contractor and the Authority than an additional royalty only,
- is better at demotivating profit shifting between jurisdictions than the cash flow additional profit share model, and
- builds on existing definitions of taxes, profits and related entities under the GloBe Rules.

However, there are some weaknesses with this model:

- there is still some uncertainty around the implementation of the GloBe Rules, the potential for subsidies in a non-sponsoring State and unknown potential work arounds to avoid the GloBe Rules,
- further work will be needed to define and implement the concept of the 'mining perimeter', that is, those activities which can reasonably be regarded as part of a deep-seabed mining operation and those which cannot, and
- under the top-up profit share component of the hybrid model, there continues to be a risk of transfer mispricing between entities inside and outside of the mining perimeter. For example, if a related entity (e.g., a sister company to the contractor) is processing nodules

outside of the mining perimeter then the contractor could sell the nodules to that related entity at below market prices, which would shift profits away from the contractor and to the nodule processor. The GloBe rules and a strong audit function may reduce, but not eliminate, this transfer mispricing risk.

**Draft text for this hybrid model** is Annexed to this report. The group requests the Secretariat to include this draft text in the next draft of the Exploitation Regulations to be considered during Part III of the 28<sup>th</sup> session of the Council from 30 October to 8 November 2023. The draft text for the hybrid model is submitted for the purposes of furthering the OEWG's discussions and is done so without prejudice to the position of any participant in this intersessional group as to its support or otherwise for the hybrid model.

The group also discussed the desirability of provisions in the Exploitation Regulations being kept relatively simple, with supplementary details provided in a Standard. Among the matters that should be included in a Standard are:

- definitions of relevant activities/the mining perimeter, subsidies and tax exemptions,
- definitions of related entities, income and covered tax payments that will be based to the greatest extent possible on the GloBe rules,
- further details for the audit of the contractor for the purpose of this equalization measure,
- provisions for the administration of the top-up profit share (such as a profit share return and penalties for non-compliance), and
- how the equalization measure will apply to the Enterprise, including any deductions allowed for the transfer of technology from joint venture partners to the Enterprise.

#### *Effective Tax Rate*

The group also discussed the effective tax rate to be used for modelling the Authority's royalty rates in the payment regime. The effective tax rate is equal to the taxes and royalties paid by a contractor divided by its profits over the project life (that is, the life of the mine). The higher the target effective tax rate, the higher, all else being equal, will be the recommended royalty rate in the Authority's financial model of the payment regime.

The African Group's submission argued an effective tax rate of 46% should be used. This effective tax rate was based on a published, peer reviewed analysis of tax rates in the ten land-based mining jurisdictions that are the largest producers of cobalt, copper, manganese and nickel.<sup>10</sup>

The group of commercial contractors argued for an effective tax rate of 39% based on the median rate of fourteen land-based mining jurisdictions producing nickel, cobalt, copper and manganese from a dataset by the International Monetary Fund.<sup>11</sup>

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<sup>10</sup> That analysis is available here: [An Evaluation of the Payment Regime for Deep Seabed Polymetallic Nodule Mining in the Area | SpringerLink](#)

<sup>11</sup> The IMF dataset is available here: Figure 8 on page 26 of [March 2022 IMF Report No 82/22](#). Contractor analysis using IMF dataset was presented during January and May intersessional meetings.

The group agreed to use **42.6% as the effective tax rate**, as this was the average of the two effective tax rates proposed.

**TEMPLATE FOR SUBMISSION OF TEXTUAL PROPOSALS DURING THE 28<sup>TH</sup> SESSION:  
COUNCIL - PART III**

Please fill out one form for each textual proposal which your delegation(s) wish(es) to amend, add or delete and send to [council@isa.org.jm](mailto:council@isa.org.jm).

**1. Name of Working Group:**

Open-ended Working Group on the Financial Terms of Contracts

**2. Name(s) of Delegation(s) making the proposal:**

Australia on behalf of the inter-sessional working group on Equalization Measures.

**3. Please indicate the relevant provision to which the textual proposal refers.**

This textual proposal includes four new Draft Regulations: 64Bis, 64Ter, 64Qua and 64Qui

**4. Kindly provide the proposed amendments to the regulation or standard or guideline in the text box below, using the “track changes” function in Microsoft Word. Please only reproduce the parts of the text that are being amended or deleted.**

***Draft Regulation 64Bis, Determination of the Applicable Equalization Measure***

1. A Contractor is liable for the Additional Royalty unless its most recent annual Equalization Measure Audit confirms that:
  - (a) the Contractor does not have any Tax Exemptions from the sponsoring State(s);  
and
  - (b) the Contractor does not receive any Subsidies from the sponsoring State(s).
2. A Contractor that is not liable for the Additional Royalty payment in a given fiscal year is liable for the Top-up Profit Share payment in that year.
3. A Contractor will pay for an Equalization Measure Audit, undertaken by an Independent Auditor in accordance with the relevant Standard and applicable Guidelines.

4. An Equalization Measure Audit shall be carried out prior to the first year of commercial production and periodically thereafter as determined by the Authority.
5. The Contractor and sponsoring State(s) shall fully assist an Independent Auditor undertaking an Equalization Measure Audit and shall provide the Independent Auditor with all relevant documentation, including but not limited to: the Contractor's audited accounts, the sponsorship agreement, any contract, and any other documents that provide the Contractor with a Tax Exemption or Subsidy.

***Draft Regulation 64Ter Additional Royalty***

1. The Additional Royalty payable under Draft Regulation 64Bis is in addition to the royalty provided for in Draft Regulation 64.
2. The Contractor from the fifth anniversary after the first day of commercial production shall be liable for an Additional Royalty in respect of mineral-bearing ore sold or removed without sale from the Contract Area as provided for in Appendix IV to these regulations.
3. In accordance with the relevant Standard and applicable Guidelines, the Additional Royalty payment for a fiscal year is equal to zero when  $X - Y$  is less than or equal to zero, and is equal to  $X - Y$  when  $X - Y$  is greater than zero, where:
  - (a) X is the Gross Additional Royalty Liability for that year, which is equal to [8%] multiplied by the Aggregate Relevant Metal Value for that year; and
  - (b) Y is any amount of Allowable Sponsoring State Tax that has not been credited in previous years against either the Additional Royalty payment or the Top-up Profit Share Payment.
4. A payment from the Contractor to the sponsoring State(s) is an Allowable Sponsoring State Tax, where:
  - (a) the payment is an actual cash payment by a Contractor to its Sponsoring State(s) of taxes and royalties accruing from seabed mining under the Exploitation Contract;
  - (b) there is a signed letter from the Sponsoring State's tax authority stating the actual cash amount paid by the Contractor to the Sponsoring State(s) for taxes and royalties accruing from seabed mining under the Exploitation Contract; and
  - (c) where there is a signed letter from an Independent Auditor confirming the actual cash amount paid by the Contractor to the Sponsoring State(s) for taxes and royalties accruing from seabed mining under the Exploitation Contract.

5. The Contractor shall pay for the audit referred to in Draft Regulation 64Ter.4(c).
6. Draft Regulations 27, 66, 67, 68, 69, 70, 71, 72, 73, 74, 75, 76, 77, 78, 79, 80, 81, 82 and 89 shall apply to the Additional Royalty as they apply to the royalty.
7. Enclosure II Appendix IV definitions apply to the Additional Royalty as they apply to the royalty.
8. Enclosure III Draft Standard sections 1 to 4 apply to the Additional Royalty as they apply to the royalty.

***Draft Regulation 64Qua, the Top-up Profit Share Payment***

1. In accordance with the relevant Standard and applicable Guidelines, the Top-up Profit Share Payment for a fiscal year is zero when A minus B is less than or equal to zero, and is equal to A minus B when A minus B is greater than zero, where:
  - (a) A is 25% multiplied by Profits for that year; and
  - (b) B is Total Eligible Payments for that year.
2. Profits for the year are equal to C plus D plus E where:
  - (a) C is the sum of the Income for that year from Relevant Activities from all Related Entities that have not met the Inclusion Criteria;
  - (b) D is the sum of the Income for that year from all activities from all Related Entities that have met the Inclusion Criteria; and
  - (c) E is the Income of the Contractor for that year.
3. Total Eligible Payments for a year are equal to Eligible Royalty payments to the Sponsoring State(s) for that year plus Eligible Tax Payments for that year.
4. Eligible Royalty Payments are royalties payable to the Sponsoring State(s) by the Contractor accruing from seabed mining under the Exploitation Contract.
5. Eligible Tax Payments equal F plus G, where:
  - (a) F is the sum of Covered Tax Payments from any Related Entity to any state arising due to Income that has been included in the calculation of Profits provided for by Draft Regulation 64Qua.2 for that year. Any payment made to any state due to Income not included in the definition of Profits in Draft Regulation 64Qua.2 is not an Eligible Tax Payment; and



- (b) G is Covered Tax Payments from the Contractor to the sponsoring State for that year.
6. The Contractor shall submit a Top-Up Profit Share Return to the Authority ninety calendar days after the end of the fiscal year that shall include:
- (a) the Top-up Profit Share Payment due, Profits, Income, Income included in Profits, Total Eligible Payments, Eligible Royalty Payments, and Eligible Tax Payments for that year;
  - (b) for each Related Entity its Income, Income from Relevant Activities, whether it meets the Inclusion Criteria, Total Eligible Payments, Eligible Royalty Payments, and Eligible Tax Payments;
  - (c) audited accounts for the Contractor and every Related Entity;
  - (d) for every Related Entity that does not meet the Inclusion Criteria audited segmented accounts for each of those Related Entities showing the Income, Eligible Tax Payments and Covered Tax payments from Relevant Activities, and separately from Non-Relevant Activities; and
  - (e) any other information, document or anything required under the Standards or reasonably requested by the Authority for the administration of the Top Up Profit Share.
7. A Profit Share Audit shall be carried out by an Independent Auditor employed by and reporting to the Authority and in accordance with the relevant Standard and applicable Guidelines, and paid for by the Contractor.

#### **Draft Regulation 64Qui**

1. The Authority shall publish Standards providing for the effective operation of the Equalization Measure, Additional Royalty and Top-up Profit Share including but not limited to:
- (a) definitions of Inclusion Criteria, Subsidies, Relevant Activities, and Tax Exemptions;
  - (b) definitions of Related Entities, Income and Covered Taxes Payments that will be based to the greatest extent practical on the Pillar 2 Global Anti-Base Erosion Model Rules, or alternatively, may directly reference the relevant articles of the Pillar 2 Global Anti-Base Erosion Model Rules;

- (c) the criteria an auditor must meet to be an Independent Auditor;
- (d) the criteria for the Equalization Measure Audit and Profit Share Independent Audit;
- (e) the fees for the Equalization Measure Audit and Profit Share Independent Audit;
- (f) the format and required content of the Profit Share Return;
- (g) the penalties, fees, and interest that the Authority shall levy on the Contractor due to non-cooperation with an Independent Auditor, late submission of a Top-up Profit Share Return, failure to submit a Top-up Profit Share Return, submission of an incomplete Top-up Profit Share Return, late payment of the Top-up Profit Share and non-payment of a Profit Share; and
- (h) any other provisions as required.

**5. Please indicate the rationale for the proposal. [150-word limit]**

An equalization measure is needed to ensure that contractors face similar rates of payment to land-based miners.

The intersessional working group proposes text for inclusion in the draft Regulations of a hybrid royalty and top up profit share equalization measure.

Under this measure, the contractor pays the additional royalty if it receives tax exemptions or subsidies (an indicative figure of 8% for the additional royalty is included square brackets in DR64ter, paragraph 3(a), but further modelling from MIT on the rate to be used will be required), and it pays the top-up profit share if it does not. The equalization measure is designed so that a contractor and its related entities paying at least 25% of their profits in taxes and royalties to sponsoring and other states pay nothing additional under the equalization measure.

The hybrid equalization measure demotivates tax avoidance by contractors and is better at equalization than the additional royalty only. The hybrid measure builds on definitions of income and taxes provided by the GloBe Rules, which simplifies administration and audit.

Standards and Guidelines will be needed to define terms and aspects of the implementation of the hybrid measure by the Authority. For example, an Equalization Measure Audit (DR 64Bis) will determine whether the contractor is liable to pay the Additional Royalty or the Top-Up Profit Share. The initial audit should be conducted prior to the commencement of commercial production to provide certainty to the contractor and the Authority. However, after the initial Equalization Measure Audit, further such audits may not need to be conducted annually and may be initiated only if the Authority believes that new tax exemptions or subsidies have been provided to the contractor since the last audit.

By way of another example, 'Inclusion Criteria' (DR 64Qua) will need to be defined to make it clear what activities of entities related to the contractor, or percentage of revenues of the related activities, are counted as falling within the 'mining perimeter'. This will avoid all related entities of a contractor being required to submit accounts to the Authority.