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8 July 2024
English only

Agenda item 10
Consideration, with a view to adoption, of the draft regulations on exploitation of mineral resources in the Area.

Note on the proposed system of annual fee payments in the Draft Exploitation Regulations

Note by the Secretariat

I. Introduction

1. The purpose of this note is to provide the Council with the Secretariat's observations on the proposed system of fees to be paid by contractors, with a view to contributing to the discussions on the draft exploitation regulations on the financial terms of contracts. Where appropriate, reference will be made to the relevant and analogous provisions of the exploration regime and the Council's related decisions.

2. By way of context, a brief discussion on this matter took place on 19 March 2024 and 20 March 2024 in the meeting of the Open-ended Working Group in Respect of the Development and Negotiation of the Financial Terms of a Contract, where the Secretary-General highlighted certain budgetary implications of the present articulation of the relevant draft regulations in the President's Consolidated Text (ISBA/29/C/CRP.1, referred to hereunder as the "draft Exploitation Regulations"). This note aims to facilitate further consideration of this issue during the remainder of the twenty-ninth session of the Council.

3. The Annex of this note also includes a possible alternative wording for Regulation 85 governing the payment of annual fixed fees, for the consideration of the Council, based on the considerations of the Secretariat outlined in this note in respect of the current wording of Regulation 85 in the draft Exploitation Regulations.

II. Categories of annual fee payments in the draft Exploitation Regulations

4. To recall, in the latest iteration of the draft Exploitation Regulations, the following draft regulations in Part VII govern the envisaged payment of fees from contractors to the Authority:

a. Draft Regulation 86 on the "*application fee*";
b. Draft Regulation 84 on the "*annual reporting fee*"; and
c. Draft Regulation 85 on the "*annual fixed fee*".

5. Payments from contractors to the Authority on other legal bases (such as in the context of royalty payments or compensation payments) are not subject to this note).

6. The imposition of the application fee and the annual fixed fee are dictated by the provisions of the Convention, while annual reporting fees are, strictly speaking, not (and appears to have been inspired by the practice of the Authority in connection with exploration contracts, as discussed below).

III. The legal basis and the purpose of the application fee

7. Pursuant to Article 13(2) of Annex III of the 1994 Agreement, application fees are to be paid by applicants in order to cover "*the administrative cost of processing an application*". Consistent with this requirement, all three exploration regulations incorporate detailed provisions on application fees[1], the current amount of which is fixed at USD 500,000.[2] It has been recognised, already in the early phases of the development of the draft regulations on financial terms, that the application fees in the context of exploitation regulations will inevitably have to be of

[1] Regulation 19 of the PMN Regulations; Regulation 21 of the PMS Regulations; Regulation 21 of the CFC Regulations.
[2] Initially the PMN and PMS Regulations both allowed contractors a choice of alternative payment mechanisms in their respective Regulations 19 and 21. These have ceased to be available by virtue of Council Decision No. ISBA/19/C/17.

a significantly higher magnitude than the application fees under the exploration regime.[3] This is the logical consequence of the regulatory requirements on applicants under the exploitation regime being significantly more onerous, as is the resultant workload of the Authority in screening the applications consistent with the detailed rules now set out in draft Exploitation Regulations 12 to 16 (and the relevant Standards to supplement these Regulations in due course).

8. The key consideration here is to ensure that the Authority will have sufficient resources to be able to ensure full compliance with Draft Regulations 12 to 16. Draft Regulation 86(1) provides that the amount of the application fees should be determined by the Council upon the recommendation of the Finance Committee. In previous iterations of the Draft Regulations (presented to the Council in 2019, and not yet taking into account the global inflation since 2019) an amount of USD 1 million was envisaged on this count.[4] Deferring the determination of this amount to the Finance Committee's recommendation preserves flexibility in the system, so that the Council remains able to adjust the required fee levels in the light of market conditions, the Authority's budget and the actual costs involved in processing an application for approval of a plan of work for exploitation.

IV. The legal basis and the purpose of the annual fixed fee

9. The purpose of the "*annual fixed fee*" is different, and is not related to the administration of applications for the approval of plans of work. Draft Regulation 85, governing annual fixed fees, also finds its foundations in the Convention and the 1994 Agreement. Pursuant to Section 8(1)(d) of the 1994 Agreement, "*[a]n annual fixed fee shall be payable from the date of commencement of commercial production*".

10. Since the 1994 Agreement is the to be applied together with the Convention as a "*single instrument*" (as per its Article 2), Section 8(1)(d) has to be construed together with Annex III, Article 17(g) of the Convention, which in turn stipulates that "[*c*]*ommercial production shall be deemed to have begun if an operator engages in sustained large-scale recovery operations which yield a quantity of materials sufficient to indicate clearly that the principal purpose is large-scale production rather than production intended for information gathering, analysis or the testing of equipment or plant*". This definition indicates that any commercial recovery operations which lead to recovery other than with the purpose of information gathering, analysis or testing will qualify as commercial production and, accordingly, trigger the contractors' duty to pay an annual fixed fee. Importantly, the definition under Article 17(g) does not apply (at least on its face) the distinction between the concepts of exploration and exploitation on its face, which was subsequently developed in greater detail.[5] In substance, however, Article 17(g) indicates that activities falling within the scope of exploration contracts (i.e., information gathering, analysis or testing) is not subject to an annual fee – whereas actual exercise of exploitation rights should be.

11. Draft Regulation 85, as it is presently drafted, includes two alternative wordings. One would require contractors to pay the annual fixed fee upon the commencement of "*Commercial Production*" (capitalised, as this term is now dealt with elsewhere in the Draft Regulations, as opposed to its appearance in the Convention); while the alternative wording would require contractors to pay an annual fee upon the "*effective date*" of the Exploitation Contract (as opposed to the date of the commencement of "*Commercial Production*"). There are several practical and legal reasons one may consider in support of the alternative approach shifting the focus to the "*effective date*":

a. While the defined term "*Commercial Production*" in the Draft Regulations[6] is consistent with the language of Article 17(g) of Annex III, Regulation 27 of the Draft Regulations arguably goes beyond Article 17(g) of Annex III and defers the precise thresholds of Commercial Production to be ascertained in Standards. Based on the discussions in the Council during Part III of the twenty-eight session and Part I of the twenty-ninth session, it appears that certain Members consider that there may be a need to designate a "ramp up" period between the factual commencement of the recovery of resources, on the one hand, and the point in time when the volume of resources reach a sufficient threshold, as per the applicable Standard, to qualify as "*Commercial Production*". The consequence of this distinction would be that not all levels of recovery (let alone all commercial activities under an exploitation contract preceding any actual recovery) would trigger the obligation for annual fixed fee payments. On one view, this approach attributes a meaning to "*Commercial Production*" which was not intended under Article 17(g) of Annex III with the consequence that certain categories of exploitation contractors would be immune from annual fixed fee payments as long as they do not ramp up their production to whatever thresholds Standards would eventually set. As explained above, Article 17(g) strongly suggests that any and all activities

[3] Developing a Regulatory Framework for Deep Sea Mineral Exploitation in the Area – Draft framework, High level issues and Action plan, Version II 15 July 2015 (Reviewed and revised for Stakeholder responses to the Report to Members of the Authority and all stakeholders issued 23 March 2015), p. 18.

[4] ISBA/28/FC/2, page 5 and the references there.

[5] Albeit it appears for example in Article 151(8) of the Convention.

[6] President's Consolidated Text, Schedule, definition of "Commercial Production".

beyond exploration, strictly speaking, were in fact intended to be subject to an annual fixed fee. It is therefore arguable that this rationale is given effect only if the annual fixed fee payment is triggered by the effective date of exploitation contracts, i.e., from the moment exploitation rights are held by contractors, as opposed to a subsequent moment of sufficiently ramped up production.

b. This rationale is also understandable from a practical perspective. The administration of contracts and the supervision of contracts is continuous, even in circumstances where actual recovery is not yet conducted. As a result, the Authority will incur significant administrative costs immediately upon the approval of applications for plan of work and the effective date of contracts, i.e., already at a phase when contractors are merely conducting preparations for exploitation activities or are in the process of ramping up production. For example, Draft Regulations 25 and 26 impose obligations on contractors to furnish to the Authority a substantial amount of documentation (on the Feasibility Study and the Environmental Performance Guarantee), following the approval of their application for a plan of work but prior to the commencement of "*Commercial Production*". At this point in time, neither the application fee nor the annual reporting fee is suitable to cover the costs of the Authority incurred in reviewing this documentation and supervising the contractors, while annual fixed fees would not yet be payable insofar as those payments were tied to a narrowly understood concept of "*Commercial Production*", as discussed above. This creates a lacuna in the regime on fees to be paid by contractors, and exposes the Authority to a situation where it would have to incur substantial costs for administrating contracts without a corresponding fee due from contractors. One may also entertain a scenario where a contractor eventually never commences "*Commercial Production*" and the Authority will have wasted its time and resources on administering such a contract.

c. Article 13 of Annex III of the Convention provides that the financial terms of contracts should incentivise investment and ensure optimum revenues to the Authority. Against this backdrop, it appears counterintuitive to allow contractors to 'sit on contracts', without any commercial production and hence without paying any "consideration" for holding such contracts and the corresponding exclusivity privileges. This is a further circumstance militating in favour of imposing a fee payment obligation on contractors from the moment of their acquisition of exploitation rights.

12. Based on the above considerations, the Annex to this note includes a possible revised wording of Draft Regulation 85, governing the payment of the annual fixed fee, for the consideration of the Council. The revisions therein have been drafted on the basis that the obligation to pay the annual fixed fee would arise upon the effective date of the exploitation contract (i.e., on the same day when, pursuant to Draft Regulation 84, the obligation to pay the annual reporting fee would arise).

V. The function of the annual fixed fee in comparison with the function of the annual reporting fee

13. If exploitation contractors were not subject to an annual fixed fee payment, the paradoxical situation would arise where exploration contractors are required to pay such a fee (in the form of the so-called "*annual overhead charge*"), while exploitation contractors are not. While, as discussed above, the Convention and the 1994 Agreement did not necessarily dictate the introduction of such annual charges for exploration activities, on 25 July 2013 the Assembly adopted a Decision concerning overhead charges for the administration and supervision of exploration contract (ISBA/19/A/12). As a result, a fixed overhead charge is due to be paid by contractors on an annual basis "*to cover the costs of the administration and supervision of the contract and of reviewing its annual report provided in accordance with the contract*". This was designed to meet a specific concern that the activities of contractors should not be subsidised by the assessed contributions of member States. Corresponding amendments were subsequently made to the exploration contracts. The amount of this fixed overhead charge is now at USD 80,000[7] (effective since 1 January 2022). The precedent of introducing the annual overhead charge for exploration contracts also illustrates that even if a narrow reading of the term "*Commercial Production*" was adopted, so that not all exploitation contractors would be required to pay an annual fee under Article 17(3) of Annex III, it is still squarely within the Council's and the Assembly's prerogative to extend the annual fee payment obligation to all exploitation contractors, even to those who are not yet engaged in actual commercial conduct, to determine its amount as dictated by the budgetary needs of the Authority and to avoid subsidising the activities of contractors. This open-ended prerogative of the Council is also recognised in Draft Regulation 87.

14. Draft Regulation 84 draws on the practice of annual overhead charges in introducing the annual reporting fee, but only in part. As the Assembly held, the function of the "*annual overhead charge*" is not merely to cover the costs associated with the annual report, but also to cover all costs of the administration and supervision of the contracts. It appears that the annual reporting fee envisaged under Draft Regulation 84, to accompany the

[7] As per Council Decision No. ISBA/26/C/28, para. 1.

submission of annual reports, is not intended to cover this latter aspect, which reinforces the importance of accounting for all of the Authority's remaining costs incurred in relation to the administration of exploitation contracts immediately upon their "effective date".

Annex

Regulation 85

Annual fixed fee

1. A Contractor shall pay to the Authority, from the effective date of an Exploitation Contract and for the term of the Exploitation Contract and any renewal thereof an annual fixed fee. The amount of the fee shall be established by the Council as required under paragraph (1) (d) of Section 8 of the Annex to the Agreement on the advice of the Finance Committee, and with the aim to cover the likely costs associated with the Authority's management of the contract, including staffing the Secretariat and conducting inspection and enforcement activities.

2. The annual fixed fee is due and payable to the Authority within 30 Days of the commencement of each Calendar Year.

3. Where the effective date is part way through a Calendar Year, the first payment shall be pro-rated and made within 30 Days after the effective date of an Exploitation Contract.

3. bis Where an annual fixed fee remains unpaid after the date it becomes due and payable:

(a) This constitutes a violation of the fundamental terms of the contract for the purposes of Regulation 103; and

(b) A Contractor shall, in addition to the amount due and payable, pay interest on the amount outstanding, beginning on the date the amount became due and payable, at an annual rate calculated by adding 5 per cent to the special drawing rights interest rate prevailing on the date the amount became due and payable.

[4. In any Calendar Year, the annual fixed fee may be credited against any royalty or other amount payable under Part VII of these Regulations.]