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Insights

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Critical Considerations for Critical Minerals: Mitigating ESG Risk and Potential Disputes in an Energy Transitioning World

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Introduction

Governments all over the world are accelerating their implementation of measures to fulfill their obligations under the United Nations Framework Convention on Climate Change ("UNFCCC") and the Paris Agreement, as well as other international legal instruments. Meeting those targets as part of the energy transition necessarily will require increased mining of critical minerals. The exploration and exploitation of these critical minerals will give rise to disputes for several reasons:

- Governments all over the world are enacting protective measures over the critical minerals within their jurisdiction, changing "the rules of the game."
- Increased scrutiny of environmental, social, and corporate governance ("ESG") factors, especially by downstream participants because of requirements under new laws or for reputational reasons.
- Supply chain constraints as upstream participants compete over limited available resources of these critical minerals and new downstream entrants seek to use these critical minerals in novel ways.

As discussed below in the Recommendations section, participants in these evolving markets need to:

- Develop their compliance programs. This is especially relevant to new entrants in the upstream market (for example, new junior mining companies) and downstream participants who recently are sourcing these minerals in their supply chains (for example, electric vehicle automakers investing in battery metals projects).
- Conduct due diligence that addresses ESG considerations to minimize lender liability risk. This is particularly relevant for lenders to critical minerals projects.
- Structure dispute resolution options carefully to account for potential disputes with governments when investing in metals projects in new markets and with upstream/downstream counterparties regarding ESG concerns.

Importance of Minerals in Energy Sector Transition

The mining sector is elemental to the energy transition. Compared with fossil fuel-based energy systems, clean energy technologies require more rare and precious metals, such as lithium, molybdenum, cobalt, copper, nickel, manganese, and zinc. The World Bank expects the transition away from fossil fuels to boost demand for minerals and metals massively.

- Production of minerals, such as graphite, lithium, and cobalt, could increase, by nearly 500% by 2050, to meet the growing demand for clean energy technologies.
- Recent estimates suggest that more than 3 billion tons of minerals and metals will be needed to meet the Paris Agreement's goals of net-zero greenhouse gas emissions by 2050.
- Clean energy transition will require an estimated $1.7 trillion in global mining investment.

A significant proportion of the essential minerals for the energy transition is located in sub-Saharan Africa and South America. Governments in these regions are implementing measures to control and to regulate these critical minerals more closely. Unresolved issues are arising regarding how public-private partnerships would operate or how governments would deal with foreign companies that have existing mining concessions to exploit these minerals.

- In Argentina, Bolivia, Chile, and Mexico, proposed measures have taken the form of nationalization or increased government involvement in the extraction and processing of lithium (in Argentina, a bill to nationalize lithium deposits is under review; upcoming elections in October could prove pivotal in a decision to nationalize lithium production).
- Argentina, Bolivia, and Chile are also considering establishing a lithium consortium for lithium-producing countries, and have sought to integrate other Latin American nations with a developing lithium industry, including Brazil and Mexico.
- In Indonesia, Namibia, and Zimbabwe, measures have taken the form of a ban on exports of unprocessed critical minerals, in favor of attracting foreign investment to develop local processing industries.

The energy transition has already resulted in a significant surge in investor-state mining arbitrations. By way of background, investor-state arbitrations are arbitrations initiated by investors (such as mining companies or lenders or sponsors of a specific mining project) against the host States in which they have made investments regarding breaches of a bilateral or multilateral investment treaty or investment contract. In 2019, an ICSID arbitral tribunal awarded USD 6 billion to a mining company that sought to explore and develop one of the world's largest undeveloped copper and gold deposits in Pakistan. The last three years alone have witnessed several high-profile mining disputes, including several matters involving the production of critical minerals as well as matters involving government programs phasing out the exploitation of fossil fuels. For example, Canada's planned phase-out of coal has triggered arbitration with mining investors. In Australia, the passing of similar legislation in 2022 makes the future of its coal mines uncertain, and the possibility of investor-state mining disputes more likely.

Race on Deep Seabed Mining in International Waters

Deep sea deposits of minerals (including polymetallic nodules, polymetallic sulphides, and cobalt-rich ferromanganese crusts, which contain key ingredients for electric vehicle batteries) have recently received greater attention due to increased demand for materials necessary to decarbonize global energy and transport. The metals extraction industry has been particularly interested in seabed mining as an alternative to critical minerals from land-based projects.

The International Seabed Authority ("ISA") is tasked with overseeing deep-sea human activities in international waters. Since its inception in 1994, the ISA has issued 31 contracts for mineral exploration to mining operations sponsored by States. The ISA Council was put under significant pressure to finalize exploitation regulations for deep-sea mining by July 2023, but the Council was not able to deliver the necessary regulations to form the Mining Code and the relevant deadline expired. This led to concerns that the ISA would have to assess the world's first commercial deep-sea mining application prematurely and potentially lead to unregulated deep-sea mining.

The applicant, a publicly traded Canadian company sponsored by three Pacific nations, acknowledged the opposition of ISA members to commercial mining being carried out in the absence of the Mining Code and declared that it now intends to submit an application in July 2024. Given the increased reliance by many industries on the critical minerals the seafloor can provide, the applicant expects to power the clean energy transition with the exploitation of nodules as early as the fourth quarter of 2025. However, the ISA indicated that in the event exploitations regulations are not completed by July 2024, it would aim to fulfil its obligation in 2025. The ISA Council has not indicated how it would handle permit applications for commercial deep seabed mining filed before the adoption of the exploitation regulations.

Under the current version of the draft regulations, parties to an exploitation contract would have to settle their disputes in accordance with the procedures set in the United Nation Convention on the Law of the Sea, which grants broad jurisdiction to the Seabed Dispute Chamber of the International Tribunal for the Law of the Sea.

- The Seabed Dispute Chamber has jurisdiction over disputes concerning (i) the interpretation or application of a relevant contract/plan of work; and (ii) acts or omissions of a party to the contract relating to activities in the exploitation area and directed to the other party or directly affecting its legitimate interests.
- While any party to a dispute described in (i) may request binding commercial arbitration, any question of interpretation of the Convention on the Law of the Sea would have to be referred to the Seabed Dispute Chamber for ruling.

Mining Treaty-Based Disputes Raising ESG Issues

Fueled by the climate crisis, market volatility, and political shifts, ESG has become a key consideration for metals and manufacturing companies. Empirical evidence shows a growing number of mining disputes with ESG issues are coming before arbitral tribunals.

Governments' commitment to various international instruments to protect human rights and local environment and the inclusion of ESG considerations in investment agreements have empowered tribunals to openly consider ESG issues and grant them a greater weight in their decision-making process. Tribunals now consider ESG issues raised as part of a State's defense of its actions, a counterclaim brought by the State against the claimant/investor, or in the potential reduction of damages owed by a State to an investor in the event of a treaty breach (contributory fault or unclean hands).

- In *South American Silver v. Bolivia*, finding that the investor's actions exacerbated the conflict with indigenous communities and caused further violence, the tribunal awarded $18.7 million in damages of the $385.7 million sought.
- In *Copper Mesa v. Ecuador*, finding that the investor contributed to 30% of its loss through its actions towards the local communities, the tribunal reduced the damages awarded by 30%.
- In *Bear Creek v. Peru*, the dissenting arbitrator found that the investor's inadequate preparation to obtain a social license contributed to the demise of the project, and as such the tribunal should have reduced the damages awarded by half.
- In *Perenco v. Ecuador*, while the tribunal granted partial damages to the investor, it also awarded $54 million to Ecuador for its counterclaim for the restoration of the ecosystems.

ESG issues in mining disputes are expected to be brought forth with increased frequency in investor-state proceedings.

Recommendations

- Compliance Programs and Due Diligence:

a. All parties in this sector need to ensure that their compliance programs address ESG concerns. This may be particularly relevant to new entrants to the critical minerals market who may have less developed programs.

b. Downstream participants manufacturing products that require critical minerals in the supply chain need to ensure they conduct due diligence to account for ESG and political risk when investing in battery metals projects or entering into supply agreements with their suppliers.

c. Lenders to critical minerals projects need to ensure their due diligence covers ESG concerns, especially when projects are located in emerging markets.

- ESG Provisions in Contracts:

  a. Substantively, keep abreast of national and international rules and guidelines on ESG. In addition to national and regional laws on ESG that might apply to commercial activity, compliance with “soft law” instruments such as the UN Guiding Principles on Business and Human Rights might become binding depending on the terms of the contract.

  b. Consider the extent to which ESG factors need to be weighed for all steps in the supply and value chains (and not just the immediate counterparty to a contract).

  c. Attention should be paid to the forum in which ESG-related disputes will be adjudicated. Forms of alternate dispute resolution, such as mediation or conciliation, may be suitable for addressing this category of disputes. Alternatively, arbitration may be preferable to litigation for a number of reasons, including confidentiality and the bilateral nature of arbitral proceedings. It may also be necessary to draft express provisions on consolidation and joinder if multiple parties will be required to resolve a dispute arising under a bilateral contract.

- Treaty Protection Against Governmental Action Over Mining Projects:

  a. When investing in the mining sector, consider routing investments through a jurisdiction that has executed a bilateral investment treaty with the target state of the investment.

  b. Not all investment treaties are equal, though. Careful attention needs to be paid to how the treaty defines a qualifying investor and a qualifying investment. The treaty may impose restrictions on the place of business or contain carve-outs (such as tax carve-outs) from the scope of the treaty’s coverage. More recently executed treaties may contain relevant provisions on ESG and/or corporate social responsibility that could be instrumental to the dispute’s outcome.

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