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briefing paper

A Fair Deal on Seabed Wealth

The Promise and Pitfalls of Article 82 on the Outer Continental Shelf

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Summary points

- Approximately 70 of the 156 States that have ratified the 1982 UN Convention on the Law of the Sea have potential Outer Continental Shelf Claims (OCS). Those claims could cover more than 15 million square kilometres of seabed.
- Under Article 82 of the Convention, a portion of the revenue from the extraction of non-living resources on the OCS must be disbursed 'on the basis of equitable sharing criteria, taking into account the interests and needs of developing States, particularly the least developed and the land-locked among them.'
- Article 82 is a unique and complex provision that does not address many of the specifics of how this is to be accomplished.
- The Energy, Environment and Development Programme at Chatham House is working with the body charged with applying Article 82, the International Seabed Authority, to explore in greater detail some of the critical issues of implementation while the Article is still dormant.

Introduction and background

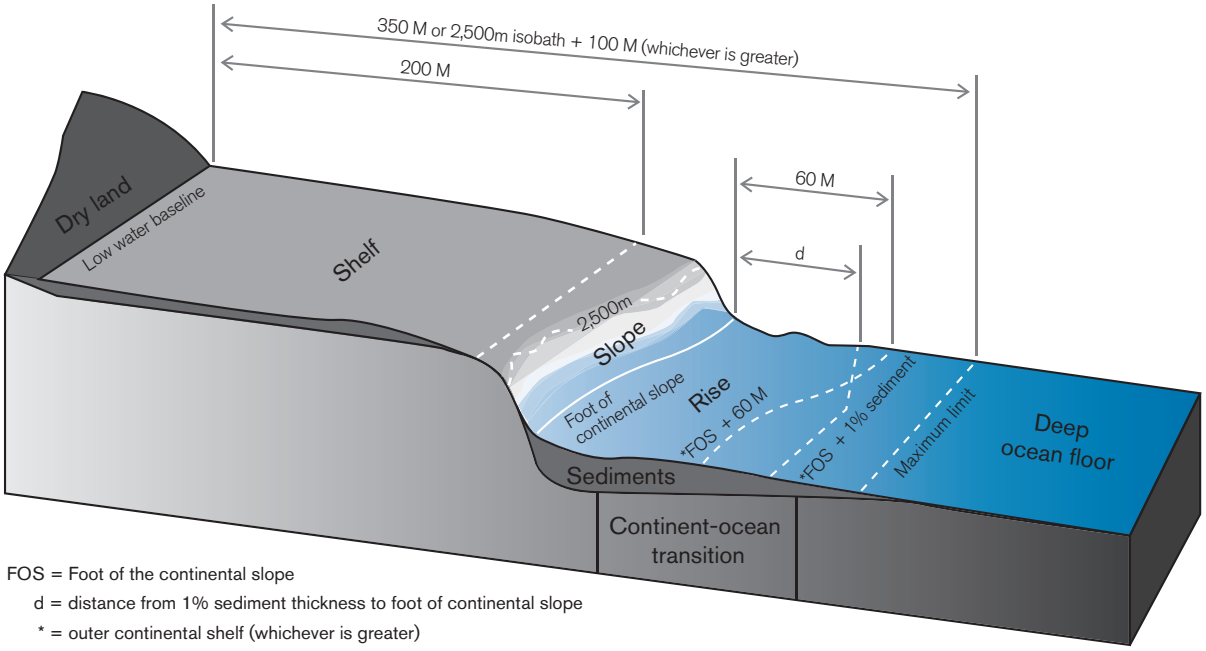
The UN Convention on the Law of the Sea (the Convention) is the most important international regime governing the oceans. It covers a wide range of issues, including navigational rights, protection of the marine environment and, relevant for this paper, jurisdiction over living and non-living marine resources. The Convention entered into force in 1994 and, as of October 2008, 156 States and the European Community were parties to the Convention. Of the major powers, only the United States has yet to accede to the Convention, though there are indications it may soon join as well.

The negotiations leading up to the adoption of the Convention were long and complex. One particularly debated topic was the extent of a coastal State's continental shelf. This was eventually set at up to 200 nautical miles from its coastline. However, through a complex assessment mechanism (see Figure 1), the continental shelf can be extended up to a total of 350 nautical miles from the coastline if the coastal State can show that *'the natural prolongation of its submerged land territory to the outer edge of its continental margin extends beyond the 200-nautical-mile distance criterion.'*

The area between the 200 nautical miles limit and the border of the total claim is called the Outer Continental Shelf (OCS). It is estimated that approximately 70 of the 156 States that have ratified the Convention have a potential OCS claim. There is a sudden interest in the OCS as States that ratified the Convention before 13 May 1999 have only until 13 May 2009 to submit that claim. For many developing nations, the added seabed could be economically critical. Land-poor countries such as Barbados, Tonga and Palau are hoping to help secure their financial future with underwater resources. Only fifteen of the States that are estimated to have a potential OCS claim do not have developing-country status.

Sections of the ocean floor that are not part of a territorial claim are called the Area. The mineral resources of the Area are considered a common heritage of mankind and, as a result, those who exploit it have to pay fees for their licences and activities in the Area. That revenue is globally apportioned, with particular emphasis on the needs of developing countries and land-locked States (since the latter have no other way to benefit from marine resources). The International Seabed Authority (the Authority), an intergovernmental organization established by the Convention, was specifically established to

Figure 1: Factors taken into account in determining a State's Outer Continental Shelf



act on behalf of mankind in the Area and is tasked with the organization and control of activities in the Area.

The potential extension of coastal States' continental shelves to 350 nautical miles erodes the size of the Area – and hence the resources available to developing and land-locked States. Article 82 of the Convention was introduced as a quid pro quo. Article 82 is a unique provision in international law. Motivated by a sense of fairness, it establishes an international 'servitude' in the form of a 'royalty' consisting of payments and contributions to be made by the coastal State to the Authority for the exploitation of the non-living resources of the OCS. There are very few, if any, similar provisions in any other legal instrument which set out a legal obligation designed to address international inequity in a practical way, not simply as a political aspiration or in vague general terms. However, Article 82 carries many ambiguities and uncertainties, in part because of its novelty, the difficult compromise behind it and unanswered questions about the mechanisms of implementation. (See box on page 8.)

Although the opportunity exists to take issue with the drafting and economic consequences of this provision, what should really guide the interpretation and implementation of this provision is the often declared international commitment to reduce global inequities. A fair and reasonable interpretation of this provision is both a legal and an ethical concern. Article 82 is a provision that requires international cooperation and good faith in its implementation.

Article 82 today

Responsibility for the implementation of Article 82 rests with the Authority and with States that exploit the non-living resources of their OCS. Payments and contributions are to be made annually by the OCS State at the rate of 1% on the value or volume of all production, commencing on the sixth year of production, increasing by 1% per year until the rate reaches 7% by the twelfth year, and thereafter remaining at 7%. Resources used in connection with exploitation are not considered part of production.

The Authority then disburses those payments and contributions to State parties 'on the basis of equitable sharing criteria, taking into account the interests and needs of developing States, particularly the least developed and the land-locked among them.'

The resources that occur on the world's continental margins may include oil, natural gas, gas hydrates, manganese nodules, sand, gravel, titanium, thorium, iron, nickel, copper, cobalt, gold and diamonds. The size and value of these deposits is unknown, but potential OCS claims cover a large section of the seabed. For comparison, OCS claims could be in excess of 15 million square kilometres, while the world's exclusive economic zones (EEZ – the water column within 200 nautical miles of the coast) are estimated at approximately 85 million square kilometres, and the Area consists of around 260 million square kilometres.

Although Article 82 has been dormant since the adoption of the Convention, there are coastal States, in particular Canada (which is a State Party to the Convention) and the US (which is not yet), that have granted prospecting and/or exploration licences or leases on their OCS. Typically, offshore petroleum and mineral development operates on a timeframe that can span decades. Today's prospecting and exploration licence may become a development and production licence within perhaps 10–20 years of initial activity. However, it is possible that Article 82 revenues will come due as soon as 2015. Either way, Article 82 will soon awaken.

However, this article is a complex provision. It is also the only provision in the Convention setting out an international royalty concerning an activity *within* national jurisdiction. It contains a rough and untested formula to determine payments or contributions. The uniqueness and complexity of Article 82 demand careful consideration of the obligation, principles and criteria for distribution of benefits, procedural aspects, the role of the Authority, the role of OCS States, and economic and temporal issues.

The Authority will need to consider a strategy for bringing this provision to the attention of Member States and to explore a practical approach for the implementation of Article 82. This is most easily, and appropriately, done while the provision is still dormant, especially as its

implementation has both international and domestic implications. At this time, the discussion and resolution are more likely to be viewed as a technical than a political exercise.

The challenge of Article 82

There are several textual ambiguities and gaps in Article 82, raising questions that require clarification. Implementation will need an elucidation of explicit stipulations and inferences of implicit requirements. As a treaty provision, Article 82 requires interpretation in the context of the international law of treaties, the overall text of the Convention (as the package deal of which it is an integral part), the negotiation history and process of the Third UN Conference on the Law of the Sea and contemporary experiences in implementation. This is a complex process that is best started by 'unpacking' Article 82 to see what challenges it contains from the point of view of the various actors involved.

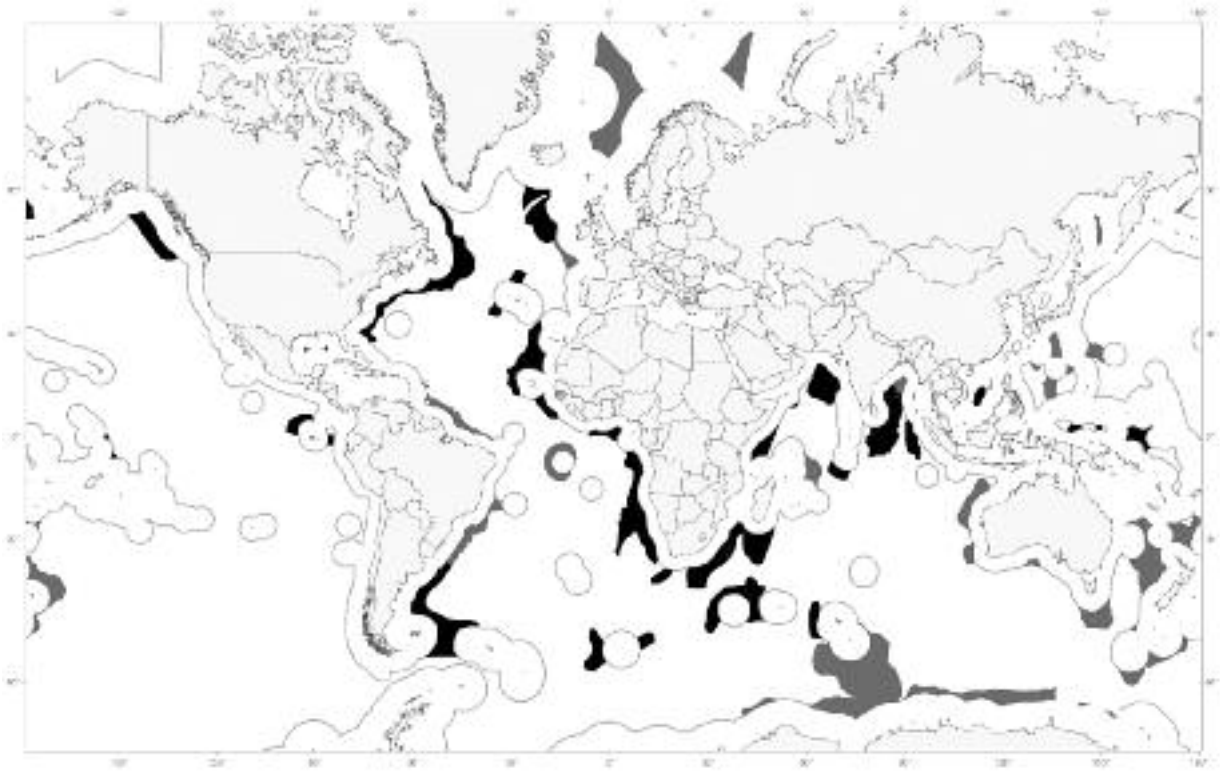
Issues for OCS States

OCS States face a range of challenges in implementing Article 82. This section highlights just some of the issues to be resolved.

Immediate Issues

Each OCS State must consider whether it will absorb the payments and contributions as a national government cost (paid from royalty and tax revenues levied on production), or whether the national government will pass the cost on to the producer in the form of additional royalty payments (although in international law the OCS State remains responsible for the discharge of the obligation).

Figure 2: Submitted and potential Outer Continental Shelf claims



Mercator projection of the world's oceans superimposed with EEZ areas (within grey lines), and the current estimated areas of continental shelf beyond 200 nautical miles (OCS), synthesized from analyses of public-domain geological and geophysical databases. Grey shows areas of OCS identified in the 16 cases already submitted to the Commission for the Limits of the Continental Shelf. Black shows areas of OCS considered to have strong potential for satisfying the requirements of Article 76 of the Law of the Sea Convention, but not yet the subject of submissions by coastal states.

Source: Map drawn by UNCLOS Group, National Oceanography Centre, Southampton University, United Kingdom.

OCS States might need to carefully consider the impact of the Article 82 obligation in a domestic context, especially where the existing domestic royalty regime may already be defining expectations for offshore investors, and where there is already a system for the sharing of domestic royalty benefits. A State party cannot justify non-compliance with a treaty on the basis of its domestic law. For example, if Article 82 were to conflict with a domestic mineral royalty regime, that conflict will not excuse a State party from fulfilling its obligation under Article 82.

Payment period

OCS States are exempted from making payments or contributions during the first five years of production. Although this grace period was intended to enable cost-recovery for the producer, it is uncertain whether this is sufficient in the modern context and cost of deep-water drilling and related operations. This is significant because the OCS royalty is applicable on the gross, not the net production, and the commercial potential of the resource could be affected.

OCS States have the option of making either payments (e.g., in monies) or contributions in kind. Article 82 appears to give them considerable latitude regarding the nature of the in-kind contribution, provided it reflects the applicable percentage of value or volume of all production. The wording of the provision seemingly means it is possible for OCS States to make payments in, say, a percentage of the sand mined. Also, a liberal interpretation of 'payments' and 'contributions in kind' may open other options, such as technology transfer or the provision of Official Development Assistance over and above what the OCS State might already be providing.

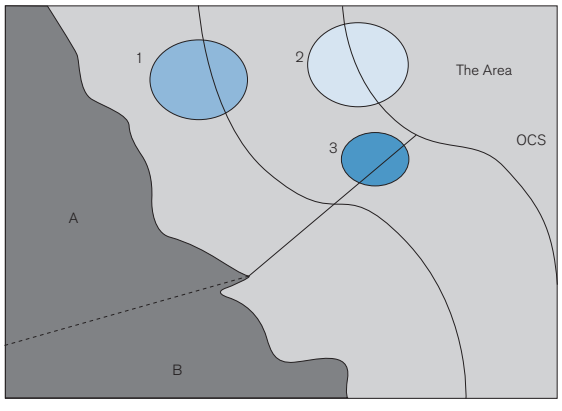
The Convention does not indicate who is tasked with the determination of the precise amount of payment or in-kind contribution, and the Authority has not been given an assessment power in this regard. It is also unclear whether the OCS State can change its choice of payments or contributions in kind after it has already begun to discharge the obligation.

The meaning of 'value' for the purposes of calculating the applicable percentage will need to be clarified for the non-living resource concerned. In the case of hydrocarbons, this could refer to the well-head value (i.e., when the product is brought to the surface, but before transportation). An additional challenge will be to determine payments due when: the OCS resource straddles the exclusive economic zone of the OCS State (Figure 3, circle 1): the OCS resource straddles the EEZ of a neighbouring State; the OCS resource straddles the Area (circle 2); the OCS resource straddles the OCS of a neighbouring OCS State (circle 3); the OCS resource straddles neighbouring States owing differing OCS payment percentages to the Authority; and the OCS resource straddles a neighbouring State and one of the neighbours is a developing State and the other is not.

Issues for the International Seabed Authority

The Convention provides little guidance to the Authority on how Article 82 might be implemented. Accordingly, one major issue for the Authority is to determine the full extent of its mandate and related powers and functions as it discharges its Article 82 responsibilities. The Council (the executive organ of the Authority comprising 36 elected States) is tasked with recommending to the Assembly (the political body of all 156 members) rules, regulations and procedures on the equitable sharing of financial and other economic benefits made by virtue of Article 82, taking into account the interests and needs of developing States and peoples who have not attained full independence.

Figure 3: Some potential overlaps complicating Article 82 accounting



The Assembly will consider the recommendations and if it does not approve them may refer them back to the Council.

For the Authority to discharge its responsibilities, it will need periodic communication with and information from the OCS State. The Authority needs to be informed of the date of commencement of production, the nature of the non-living resource exploited, the location of the resource, the form of discharge of the obligation by the OCS State (i.e., whether by payments or contributions, and if the latter, the nature of the contributions), and related matters that would enable it to receive and pass on the benefits to beneficiaries.

A potential issue is commercially sensitive information, which the OCS State might wish to protect, and which the Authority might require. The OCS State does not have an express duty to inform the Authority on any OCS matter, with the possible exception of the actual payments or contributions that are due. It might not be possible to compel an OCS State to disclose the information needed for the Authority to perform its role.

The Authority can be expected to incur expenses in discharging its Article 82 tasks. If the OCS State opts for in-kind contributions, the delivery of the contributions could pose an issue. If the contribution is in terms of a share of the resource, shipping and/or pipeline transportation and storage arrangements may need to be made and costs will be incurred. This is likely to be a difficult issue for both the OCS State and the Authority as neither is permitted to deduct costs from the payments or contributions made and received.

Given the volatility of commodity prices and hard currency value, the value of the payment or volume of the contribution might vary from year to year in response to market and other conditions. In relation to payments, the Convention does not stipulate a rule on currency. The timing of payments or contributions could potentially and significantly affect their value. It would be important for the OCS State and the Authority to agree on a regular schedule of payments and contributions, rather than leaving these to be made at any time within a twelve-month period.

The Authority is required to develop equitable criteria for the distribution of payments and contributions from the Area to State Parties. It is unclear whether those criteria, which have as yet to be developed, may be the same as for OCS revenue. The Article 82 text concerning distribution of payments and contributions suffers from ambiguity. Presumably 'taking into account' implies preferential consideration. What may be intended by 'interests and needs', and according to whom, is not clear. For example, are developing States with basic livelihood needs on a par with developing States that wish to reduce their dependence on imported energy? Drawing upon existing indices, the Authority may need to develop another composite hierarchy of needs index to rank potential beneficiary States and peoples with reference to the objects and purposes of Article 82.

However, an added complication is that there is no indication that these funds should be destined for any particular purpose or to achieve any objective. Nor is there any indication whether the utilization of the payments and contributions passed on to beneficiaries should be monitored or audited. The Authority has not been mandated with this task.

Other issues

Dispute resolution

OCS States are required by general international law and the Convention to fulfil their obligations in good faith and not to exercise their rights in a manner that amounts to an abuse of right. The Convention is silent on the consequences of lack of good faith, abuse of right or a direct violation in relation to Article 82. There is also the possibility that a State Party might question the Authority's exercise of its powers and functions with regard to Article 82.

Should there be disputes between OCS States and the Authority, or for that matter other State Parties to the Convention, the Convention's dispute settlement regime does not provide a compulsory mechanism for resolution. It is likely that the Authority may not be able to resolve such disputes through the Seabed Disputes Chamber, because Article 82 disputes do not concern activities in the

Area. Such a significant omission in the Convention may need to be addressed by agreement between the OCS State and the Authority.

Unknown technological timelines

Current estimates of size and distribution of occurrences of methane hydrates place them in both medium- and deep-water settings, making them a promising source of OCS revenue. However, the likely cost of production, from systems that have yet to be developed, can only be speculative, although it is unlikely to be less than current costs for oil and gas. This might make the grace period of five years insufficient and affect the viability of extraction.

Effect of climate change

As sea levels rise and permanently flood coastlines, the baseline from which a State's OCS is measured could retreat, rendering the State's physical reality at odds with the map on the basis of which the legal claim was made. Other States could then challenge that claim (or, for political leverage, simply threaten to challenge the claim), potentially resulting in a redrawing of the OCS claim. In the most extreme case, an entire nation could be submerged by sea-level rise, which could potentially extinguish its entire claim (and even statehood), and would certainly affect Article 82 implementation in the affected areas.

Disruption to extraction

If an OCS State is into the 7% payment period and its off-shore production facilities are destroyed (for example because of storm activity), it will continue to have to pay 7% on what can be produced even while it is trying to rebuild. This could severely affect the decision to reinvest. Similarly, if an off-shore site is leased for 100 years, produces for 20 years (putting it into the 7% period), and is then abandoned for decades before exploitation starts again, it will also restart at 7% despite incurring new start-up costs.

Conclusion

The increasing focus on OCS activities and industry's long timelines for deep-sea operations mean that immediate steps should be taken to put in place a framework to ensure the implementation of Article 82.

Given the likely long-term relationship between producing OCS States and the Authority, as well as the uncertainties identified in this paper, it is advisable for a producing OCS State and the Authority to enter into an Article 82 agreement. For this purpose, and in anticipation of the implementation of Article 82, it is desirable that the OCS States and the Authority formulate a model OCS royalty agreement within the framework of the Convention, to be applied in future Authority/OCS State-specific agreements. This would be the basis upon which the respective responsibilities in Article 82 relating to the making and handling of payments and contributions can be coordinated and administered. It is advisable for the Authority to take the lead in developing such a model agreement in close cooperation with experts from OCS States and other States Parties of the Convention.

In anticipation of its distributive assignment, the Authority should also develop equitable criteria for eligibility and distribution of the payments and contributions. It will need to adopt rules, regulations and procedures and have these approved by Member States. The development of equitable criteria will not be a simple process and, as indicated earlier, it is likely that an appropriate composite index for the ranking of beneficiaries will need to be created. The Authority will also need to determine the procedure for the distribution of benefits and set out related safeguards; it might consider developing a model agreement as a vehicle for the distribution of benefits.

Methods for accomplishing these aims will be discussed in a subsequent paper to be published by Chatham House in the coming months.

Text of Article 82 of the UN Convention on the Law of the Sea

Article 82

Payments and contributions with respect to the exploitation of the continental shelf beyond 200 nautical miles

1. The coastal State shall make payments or contributions in kind in respect of the exploitation of the non-living resources of the continental shelf beyond 200 nautical miles from the baselines from which the breadth of the territorial sea is measured.
2. The payments and contributions shall be made annually with respect to all production at a site after the first five years of production at that site. For the sixth year, the rate of payment or contribution shall be 1 per cent of the value or volume of production at the site. The rate shall increase by 1 per cent for each subsequent year until the twelfth year and shall remain at 7 per cent thereafter. Production does not include resources used in connection with exploitation.
3. A developing State which is a net importer of a mineral resource produced from its continental shelf is exempt from making such payments or contributions in respect of that mineral resource.
4. The payments or contributions shall be made through the Authority, which shall distribute them to States Parties to this Convention, on the basis of equitable sharing criteria, taking into account the interests and needs of developing States, particularly the least developed and the land-locked among them.

http://www.un.org/Depts/los/convention_agreements/texts/unclos/part6.htm

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This paper is indebted to two working papers prepared for a Chatham House seminar on 11–13 February 2009 on issues associated with the implementation of Article 82: Aldo Chircop, 'Study of issues associated with the implementation of article 82 of the Law of the Sea Convention'; Lindsay Parson, 'Technical study of issues relevant to Article 82 of the Law of the Sea Convention'.

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