

Sub- contract agreements vs the letting of mining rights

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It is the ordinary course of business for South African mining right holders ("MRH") to contract with third party service providers to carry out some, or all, of the physical mining operations for and on behalf of the mining company.

Sub-contract agreements are entered into as between the MRH and the relevant sub-contractor and the mining right remains vested in the MRH.

It is not considered necessary for the MRH to apply for ministerial approval in terms of Section 11 when sub-contract agreements are concluded. Section 101 of the Mineral and Petroleum Resources Development Act, 28 of 2002 ("MPRDA") allows for this.

The MPRDA makes provision for *inter alia* the **letting** of both a prospecting right and a mining right, with prior consent of the Minister under Section 11 of the MPRDA.

Section 11 sets out the scope and requirements for the Minister's approval when entering into a lease arrangement, with one such requirement being that the lessee is capable of carrying out and complying with the obligations and the terms and conditions of the mining right in question.

The *essentialia* of a subcontract agreement requires that there must be a rendering of services by the contractor in favour of the employer, for remuneration and subject to a relationship of subordination between the employer and the contractor.

This must be distinguished from a contract of lease in respect of which the *essentialia* requires that the lessor and lessee must agree that the lessee is to use and enjoy the lessor's property, for a specific period and at a specific price.

In the recent case of *Optimum Coal Terminal (Pty) Limited and Others v Richards Bay Coal Terminal (Pty) Limited and Others* (D531/2023) [2023] ZAKZDHC 30 (31 May 2023) ("**Optimum Case**"), however, Hiralall AJ agreed with the respondents in that matter that the real economic benefit of concluding the "mini-pit contracts" ("**the contracts**") accrued to the contractors and not to Optimum Coal Mine ("**OCM**").

Hiralall AJ decided that the Optimum Mine was not mining and producing coal (albeit by way of contractors and subcontractors), rather that by entering into the contracts, on a proper analyses, it was really carrying on what he described as a "*lease of its mining right/business*".

This judgement once again raises the debate as to whether or not it is correct that the construct of a sub-contract does not require Section 11 approval and if not, then on what basis such arrangements should be considered exempt and what features of a lease agreement should be avoided when defining the terms of an intended sub-contract arrangement.

The Optimum Case

In the Optimum Case Hiralall AJ found that OCM is not a "Coal Exporter" for purposes of clause 1.1.14 of the Richard's Bay Coal Terminal Shareholder's Agreement ("**Shareholder's Agreement**") which entitles it to, amongst other things, export coal to the international market.

Clause 1.1.14 of the Shareholders' Agreement provides a definition of Coal Exporter "**any company which mines and produces coal in the Republic of South Africa and is lawfully entitled to export coal from the Republic of South Africa; or ...**" (own emphasis)

The aforesaid finding was based on the fact that contrary to the provisions of the Shareholder's Agreement, OCM was, itself, not mining and producing coal.

The mining and production of coal was carried out by mini-pit contractors for their sole benefit and profit with only a minimal "royalty" for use of the mine being paid to OCM.

Properly construed, its relationship with the entities that were extracting coal constituted a lease of its mining right.

The applicants did not dispute that OCM was not mining and producing coal on its own but contended that it remained a "Coal Exporter" on account of the mini-pit contractors doing so *on behalf of OCM*.

The applicant's argued that the Shareholders' Agreement did not specifically require that the company must itself mine and produce coal or that it cannot do so through contractors. They contended that OCM was entitled to contract with a third party to perform some or even all of the functions and obligations arising from 'mining and production' of coal.

The applicants asserted that the business rescue practitioners elected to utilize the risk averse rather than the risk aggressive approach. This was achieved by the business rescue practitioners agreeing with the operators that they would conduct the mining operations on behalf of OCM but entirely at their own cost and **would thereafter purchase** the coal from OCM at a fixed margin.

This entailed that there was absolutely no cost to OCM: it did not have to obtain specially trained employees or any yellow equipment; it did not have to pay the mining contractor for services; and it would be paid a fixed royalty for the coal so mined and produced which would enable it to properly manage its cash flow of income and expenditure without having to make any payment or to commit to any capital or cost outflows.

The Court considered this arrangement and disagreed that OCM retained ownership of the mined coal until it is purchased by the mini-pit contractors as suggested by the applicants.

This conclusion was evidenced in the extract below from the affidavit of the Curator:

'21.7 I highlight below the following general observations in regard to the mini-pit contracts:

21.7.1 in all but one contract which provides for a profit share, OCM is paid a fixed royalty fee. The royalty fee is reduced by an agreed amount where the contract miner has made a prepayment of the royalties to OCM. The royalty fee does not take account the prevailing and changing market conditions and save in one instance where provision is made for escalation, albeit based on CPI, there is no escalation on an annual basis;

*21.7.2 the mini-pit contracts do not, save as set out hereafter, ordinarily contemplate the adjustment of the royalty payable to OCM. **The contracts do provide for a change in the royalty payable, as a result of decrease in the coal price (in which the royalty will be reduced). There is, however, no similar provision allowing for an increase of the royalty payable to OCM in the event of an increase of the coal price;***

*21.7.3 it would have been more beneficial for OCM had the mini-pit contractors been engaged on a basis that had included a determined or determinable fee (incorporating, for instance, adjustments to provide for changes to key elements) to be paid to such contract miner for the mining of OCM's coal resource, as opposed to the current royalty structure. **In such a scenario, the contract miner would charge for its services rendered and OCM would retain ownership of the extracted coal, enabling it to sell the coal at a profit to an off taker (as opposed to OCM being made party, as is currently the case, to complex transactional arrangements in which OCM is effectively used as a conduit for other contracting parties to not only extract OCM's coal resource for an insignificant royalty payment, but also, for them to utilise and benefit from OCT's RBCT Entitlement, without any benefit accruing to either OCM or OCT for it; ...'** (My underlining.)*

In summary, the Court *inter alia* considered the following factors to come to the conclusion that the contracts and ancillary transactions resemble leases of the mining right rather than contracts for service.

The mine:

- is/was to be paid a fixed royalty fee (regardless of prevailing market conditions); and
- should have rather paid the contractor a determined or determinable fee, allowing it to retain ownership of the resources mined and sell it (for a profit) to an off-taker.

Conclusion

The Court in the Optimum Case took a substance over form approach in that although Optimum Coal Mine asserted that the contracts are, and the contracts are described as, contracts for service and not leases, on a careful analysis of the transactions the Court concluded that the contracts more closely resembled lease agreements than contracts for service.

In order to ensure that contracts of service are truly that in nature, MRH must *inter alia* ensure that any sub contract agreements they enter into –

- (i) provide at the very least for payment for services
- (ii) ensure that no royalties are payable
- (iii) ensure that the MRH retains ownership of the ore. In not doing so they run the risk of a court finding that the agreement in question falls outside the scope of Section 101 and that it in fact requires Section 11 approval from the Minister.



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