European Critical Minerals Supply Chains – What lies in store for Australian participants?

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The 2020 edition of its Critical Minerals Prospectus (**Australia's Prospectus**) showcased Australia's "significant capability" in critical minerals and declared the country was "open for business":

"Forecast demand growth for critical minerals presents an important economic opportunity. Australia is an important global supplier of many critical minerals and has the resource potential to scale up to meet rising global demand and drive the upstream diversification of global supply chains". This holds true for a particular sub-set of critical minerals, rare earth elements (**REE**), necessary for whole sectors of our developed economies.

In September 2020 the European Commission released its Critical Raw Materials Action Plan focussing on "the most pressing need, which is to increase EU resilience in the rare earths and permanent magnets value chains, as these are vital to most EU industrial ecosystem".

The EU is looking to establish resilient critical mineral supply chains and for them a rule of law country such as Australia with its strong resource base, technologically advanced mining industry and close economic and geo-political relationships with the EU and its allies, the U.S and the UK, is an attractive long-term partner and source of supply of critical minerals.

Australia's substantial resources of critical minerals, including REE, will provide local mining companies with significant opportunities to participate in critical minerals supply chains to the EU.

The current very strong demand for critical minerals such as REE is closely linked to the transition of developed economies from reliance on fossil fuel energy to greener sources; electric vehicles and wind turbines are powered by REE permanent magnets. Demand is occurring at a time when political commitments to achieving net zero, establishing environmental sustainability and investigating and avoiding undesirable environmental, human rights and good governance (**ESG**) impacts are in the process of being developed by the EU into legal obligations.

The EU considers itself to be "a global leader in the transition towards climate neutrality, and it is determined to help raise global ambition and to strengthen the global response to climate change, using all tools at its disposal, including climate diplomacy." Its policy centrepiece is the European Green Deal (**EGD**) (released in 2019, and substantially updated on 14 July 2021) whose "aim is to transform the EU into a modern, resource-efficient and competitive economy with no net emissions of greenhouse gases by 2050."

The mining and processing of critical minerals such as REE at prices that can compete with countries such as China will be a significant challenge in itself. Australian mining companies

Simon Salter | Solicitor, Independent Legal Advisor
Flora Pitti-Ferrandi | Competition Partner, V&A

will also need to understand and prepare for the challenges posed by the EGD and related EU legislation and policies, to which they will be subject to, or affected by, directly or indirectly when their products find their way into the EU's internal market.

Before we consider those challenges, it is appropriate to introduce some context.

EU-Australia FTA negotiations, EU Trade Policy and SDG Report

Negotiations for a Free Trade Agreement between the EU and Australia (**FTA**) are continuing. Following a vote on the Carbon Border Adjustment Mechanism in March this year, media reports indicated the FTA would not be ratified until Australia does more to reduce its emissions. The Australian Broadcasting Commission reported Kathleen van Brempt (MEP; European Parliamentary Committee on International Trade) as saying the FTA was contingent on "a clear vision" from Australia on "when and how they will become climate neutral and by when and how they will phase out of coal" and Pascal Canfin (MEP; Chairman of the European Parliamentary Environment Committee) as saying "Australia has to understand that we are really serious" and "We will not ratify a trade deal if there is no concrete additional climate change action from Australia".

This is in line with the very strict stance taken by the EU in its recent review of its trade policy, "An Open, Sustainable and Assertive Trade Policy" (**EU Trade Policy**), undertaken in February 2021, which the Commission describes as "one that will support achieving [the European Commission's] domestic and external policy objectives and promote greater sustainability in line with its commitment of fully implementing" the SDGs [the U.N.'s 17 Sustainable Development Goals], and is part of the support for the European Commission's objective to ensure that "trade is sustainable, responsible and coherent with our overall objectives and values".

Following the release of the 2021 report from the U.N.-backed Sustainable Development Solutions Network (**SDG Report**) on the progress made in achieving the U.N.'s 17 Sustainable Development Goals (**SDGs**), The Guardian reported on 1 July 2021 that "Australia received a score of just 10 out of 100 in an assessment of fossil fuel emissions, emissions associated with imports and exports, and policies for pricing carbon" under the headline "Australia ranks last for climate action among UN member countries". The Guardian also reported that the SDG Report noted "Australia had not committed to achieving net zero carbon emissions by 2050. Scott Morrison [Australia's Prime Minister] has instead signalled Australia wants to achieve carbon neutrality "as soon as possible" and "preferably" by 2050".

Whilst the processes involved in concluding and ratifying the FTA may not be directly relevant to the ability of an Australian company to successfully negotiate membership of a supply chain of critical minerals into the EU internal market, such background noise may not be helpful. The EU Trade Policy is described as" Assertive"; Australia may consider "Difficult" a more appropriate adjective.

The European Green Deal and related EU legislation and policies

The starting point in understanding the issues confronting Australian mining and processing companies looking to provide products to critical minerals supply chains into the EU is the European Green Deal and related legislative initiatives and policies including:

- *Sustainable Finance Disclosure Regulation* (EU Regulation 2019/2088) (**SFDR**) which came into force in March 2021 and imposed wide-ranging ESG disclosure requirements on EU institutional/financial markets investors requiring public disclosure of how sustainability risk is assessed in their investment decision-making processes;

- *Non-Financial Reporting Directive* (EU Directive 2014/95) (**NFRD**) requiring qualitative non-financial reporting (such as sustainability information) by so-called "public interest entities" such as listed companies, banks and insurance companies (currently totalling about 11,000 entities) which is proposed to be extended by the *Corporate Sustainability Reporting Directive* (**CSRD**) a proposal for which was released by the European Commission in April 2021 and will substantially expand the types of entities required to report to almost 50,000 and will establish more detailed sustainability reporting requirements, including mandatory reporting standards to be developed by the European Financial Reporting Advisory Group (**EFRAG**) to ensure that their business plans are consistent with limiting global warming to 1.5C;

- *Taxonomy Regulation* (EU Regulation 2020/852) which provides the framework to determine whether an economic activity qualifies as "environmentally sustainable" in the context of six environmental objectives and the *Taxonomy Climate Delegated Act* which defines the technical screening criteria (**TSC**) for qualifying as substantial contribution to the first two of these six objectives (climate change mitigation and climate change adaptation) (together, **EU Taxonomy**);

- *European Parliament Legislative Initiative Report* requiring mandatory due diligence on the environment, human rights and good governance (**ESG**) dated 10 March 2021 (**ESG DD Law**). The ESG DD Law is aimed at ensuring that undertakings under its scope (including non-EU companies operating in the EU's internal market) fulfil their duty to respect ESG and do not cause or contribute in a substantial way to potential or actual adverse impacts on ESG through their own activities or those directly linked to their operations, products or services by a business relationship or in their supply chains, and that they prevent and mitigate those adverse impacts; the Report includes a draft of the proposed Directive; and

- *Carbon Border Adjustment Mechanism* (**CBAM**) a proposed regulation by the European Commission on 14 July 2021.

(collectively **EU Regulations**).

While some of these EU Regulations, such as the SFDR or the NFRD, are already applicable to companies active in the EU, some extensions (the CSRD for the NFRD) or new pieces of regulations, such as the ESG DD Law and the CBAM, will take time to implement.

The ESG DD Law needs to be proposed by the EU Commission, adopted by the EU Parliament and Council, and then transposed in national laws by the 27 Member States, whilst the first full application of CBAM is not anticipated until 2025. As regards the CSRD, the Commission aims to have the first set of EFRAG's draft mandatory sustainability reporting standards ready by mid-2022, and for them to be legally adopted by the end of that year which will mean that companies would apply those standards for the first time to their reports published in 2024 in respect of the 2023 financial (i.e. calendar) year. Finally, TSCs for the remaining 4 objectives under the Taxonomy Regulation are expected in the first half of 2022.

The EU has established specific sustainability goals and objectives and clearly outlined how they will be achieved via a public, coordinated and consistent legislative agenda which will be a strong influence on both the EU's geo-political partners (such as the U.S. and the UK) as well as companies within and without the EU that wish to access the EU internal market. Despite the fact that it will take time for the legislative agenda to be completed, those wishing to access the internal market are now fully aware, in general terms, of what access will require of them and their supply chains in terms of disclosure and diligence and will now be planning their EU supply chains accordingly.

This article considers some of the pragmatic impacts that the EU Regulations will now have on Australian REE miners/processors.

In what circumstances will the EU Regulations relevantly impact Australian companies involved in critical mineral supply chains?

REE mined in Australia and processed there or in another country, and which in whatever form enters the EU internal market as part of a supply chain, will mean that the Australian company which mined the REE and either processed it itself or through a third party will need to understand to what extent its involvement in the supply chain for the ultimate processed form of the REE product that enters the EU will expose it to EU Regulations.

Three likely scenarios are considered:

- The importer – in this case an Australian company imports a processed REE product into the EU (such as a metal alloy developed from REE that it has mined and processed either itself or through contractor(s) on its behalf) for use in the manufacture of REE permanent magnets in an EU plant. The Australian company is the last link in the supply chain at the EU entry point and so will be directly exposed to some EU Regulations (the **Importer**);

- As an investee – in this case the Australian company has been financially supported by a direct investment by an EU entity (e.g. an EU permanent magnet manufacturer) (**EU Investor**) to enable it to develop its mining or processing operations. It is a partly-owned corporate member of an EU group that is subject to EU law, and so the Australian company will be indirectly exposed to some EU Regulations (the **Member**); and

- As a supplier in the supply chain - in this case the Australian company is contracted to supply REE in its raw or processed form to an upstream entity and is a member of a supply chain with the last link in the chain being (say) an EU permanent magnet

manufacturer that is subject to EU law. The Australian company as a member of, or link in, the supply chain will be indirectly exposed to some EU Regulations (the **Link**).

The Importer

It is proposed that the ESG DD Law will apply to large companies (employing more than 250 employees and meeting certain financial thresholds), publicly listed SMEs (employing more than 50 employees and meeting lower financial thresholds) and to SMEs operating in high-risk sectors, i.e. sectors of economic activity with a significant impact on ESG taking into account the sector of the undertaking or its type of activities, and will be identified by the Commission in its proposed directive. The ESG DD Law will apply to those categories of companies, whether established in the EU or not, as long as "they operate in the internal market selling goods or providing services".

Accordingly, a qualified Australian Importer, as seller of goods in the EU, will be subject to the due diligence requirements, sanctions and liability regimes established in the ESG DD Law as transposed into the legislation of the Member State in which it operates and so will be held accountable and liable when it harms, or contributes to harming ESG, including through the acts or omissions of suppliers in its own supply chain.

The proposed ESG DD Law is aimed at ensuring that undertakings under its scope fulfil their duty to respect ESG and do not cause or contribute to potential or actual adverse impacts on ESG through their own activities or those directly linked to their operations, products or services by a business relationship or in their supply chains, and that they prevent and mitigate those adverse impacts.

In the case of the environment, the Importer must perform due diligence on its own operations' and its supply chains' "potential or actual adverse impact on the environment". This term is defined as "any violation of internationally recognised and [EU] environmental standards" and will be described in an Annex (in the final form of the Directive) that is "consistent with the EU's objectives on "environmental protection and climate change mitigation".

Accordingly, the Importer's due diligence strategy will need to be aligned with the SDGs and EU policy objectives in the field of ESG including, in the case of the environment:

- all laws and policies of the EU then in force to achieve the objective of the European Green Deal, namely "to transform the EU into a modern, resource-efficient and competitive economy with no net emissions of greenhouse gases by 2050";

- including notably, the commitment to reduce greenhouse gas emissions by at least 55% by 2030; as well as

- EU international policy, especially the Paris Agreement and its goals to hold the increase in the global average temperature to well below 2°C above pre-industrial levels and pursue efforts to limit the temperature increase to 1.5°C above pre-industrial levels.

Compliance with the ESG DD Law will require the Importer to undertake a four-step process:

Step 1: Risk Assessment. The Australian Importer will be required to conduct a "risk-based monitoring methodology" to assess the likelihood, severity and urgency of actual or potential ESG impacts of its operations or of its supply chain.

Step 2: Due Diligence Strategy. Unless the Importer is satisfied that its operations and its supply chain pose no such risks (a situation facilitated if all suppliers in the chain perform due diligence as required by the Directive) , the Importer must establish and effectively implement a due diligence strategy.

To achieve this, the Importer will be obliged to carry out "in good faith effective, meaningful and informed discussions" with relevant stakeholders, a very broadly defined term to include persons whose rights or interests may be affected by the potential or actual adverse impacts on ESG, including indigenous peoples (this is discussed further below in the section "Indigenous peoples and Native Title").

Due diligence will require the Importer to "take all proportionate and commensurate measures and make efforts within its means" to prevent adverse ESG impacts in its operations or its supply chain, and to address such impacts when they occur. To achieve this objective, the Importer will need to establish a process to "identify, assess, prevent, mitigate, cease, monitor, communicate, account for, address and remedy the potential and/or actual adverse impacts on…… the ESG, including the contribution to climate change" in the Importer's own operations and throughout the supply chain The Importer will not be permitted to pass on its due diligence obligations to downstream suppliers.

The Importer will be required to publish its due diligence strategy and to evaluate (and if required, revise) it at least annually. The review process will again require consultation with the stakeholders with whom the initial strategy was agreed.

Step 3: Compliance with the Strategy. The Importer has the obligation to ensure the due diligence strategy is effectively carried out, including throughout the supply chain. This is an ongoing responsibility. The draft Directive provides examples of the types of legal structures or provisions that an Importer could employ in order to ensure compliance within the supply chain, such as framework agreements, contracts, codes of conduct and certified and independent audits.

Step 4: Grievance Mechanism. Finally, the Importer must put in place a mechanism which will operate both as an early-warning mechanism for risk-awareness and as a mediation system, "allowing any stakeholder to voice reasonable concerns regarding the existence of a potential or actual adverse [ESG] impact".

Each Member State must establish one or more national competent authorities (**NCA**) responsible for the supervision of the application of the ESG DD Law and to which an Importer may self-report cases of non-compliance or by which investigation for non-compliance will be conducted. The Importer may be required by the NCA to undertake remedial action but that will not prevent affected stakeholders from bringing civil proceedings against the Importer in accordance with the civil law of the relevant Member State. The draft Directive requires

Member States to have a liability regime in place under which an Importer can, in accordance with national law, be held liable and provide remediation for any harm arising out of potential or actual adverse ESG impacts that they, or undertakings under their control, have caused or contributed to by acts or omissions. In addition, the Importer will be subject to "proportionate sanctions" applicable to infringements including fines based on turnover.

The Member

In this instance, there are two scenarios in which an Australian company is a direct or indirect "investee" of an EU entity as a result of an investment, but post-investment remains managed in Australia and listed on the ASX.

The first is where the investor is an EU financial markets participant subject to the Sustainable Finance Disclosure Regulation (EU Regulation 2019/2088) (**SFDR**). The issue here is whether the Australian Member will be equipped to provide the data and information that is required to be disclosed publicly in respect to the investor's policy on the integration of sustainability risks in its investment decision-making process. A sustainability risk is "an [ESG] event or condition that, if it occurs, could cause an actual or a potential negative impact on the value of the investment".

The second is where the investor is either a large company or a listed SME. In this case, the Non-Financial Reporting Directive (**NFRD**) may apply. Following the introduction of the Corporate Sustainability Reporting Directive (**CSRD**) the NFRD obligations will apply to all large companies and listed SMEs. The CRSD will require companies to report according to mandatory EU sustainability reporting standards to be developed by EFRAG. In accordance with those standards, they will be required to report certain indicators on the extent to which their activities are sustainable as defined by the EU Taxonomy and disclose the proportion of their turnover, capital expenditure and operating expenditures that are derived or associated with economic activities that qualify as environmentally sustainable. The first indicators will be specified in 2022.

In both those scenarios, reporting will not be restricted to EU-based activities. Companies will have to report on the impact of their activities worldwide, whether those activities are based in the EU or elsewhere.

Australian companies contemplating receiving an investment from an EU investor and which already report in their Annual Report (or otherwise) on sustainability (and do so, adequately and appropriately in the context of the Australian market) will need familiarise themselves with the relevant EU policies and laws on disclosure, the terms employed in the EU Taxonomy and the applicable reporting standards to better understand the information an EU investor will require and the supporting data that will need to be available to it, in order that the EU investor is able to comply with its reporting and disclosure obligations under the CRSD.

The Link

The ESG DD Law highlights that a due diligence strategy should be aligned with the SDGs and EU policy objectives in the field of ESG including, in the case of the environment, the European Green Deal; and contemplates due diligence on any violation of internationally recognised and

EU environmental standards that is inconsistent with the EU's objectives on "environmental protection and climate change mitigation".

Accordingly, Australian companies contemplating joining a supply chain into the EU and which already report in their Annual Report (or otherwise) on environmental issues (and do so adequately and appropriately in the context of the Australian market) will need to familiarise themselves with the relevant EU policies and laws to better understand the information the Importer will require and the supporting data that will need to be available, in order that it is able to comply with its obligations under the proposed ESG DD Law.

Whilst the prospective Link will be involved in the ESG due diligence on its own activities, the Importer alone will have the responsibility for the due diligence, the development of the due diligence strategy and the ongoing compliance with that strategy within the supply chain.

Specific issues relating to an Australian-based REE supply chain

Indigenous peoples and Native Title

The establishment and effective implementation of a due diligence strategy requires an Importer to carry out "in good faith effective, meaningful and informed discussions" with "stakeholders" being "individuals, and groups of individuals whose rights or interests may be affected by the potential or actual adverse impacts on human rights, the environment and good governance posed by an undertaking or its business relationships [i.e. the supply chain], as well as organisations whose statutory purpose is the defence of human rights, including social and labour rights, the environment and good governance".

The list of stakeholders includes indigenous people.

In the same way that environmental issues will be identified in an Annex to the final form of the Directive so will "human rights" (the "S" in ESG): "potential or actual adverse impact on human rights' means any potential or actual adverse impact that may impair the full enjoyment of human rights by individuals or groups of individuals in relation to human rights, including social, worker and trade union rights, as set out in Annex xx to this Directive. That Annex shall be reviewed on a regular basis and be consistent with the Union's objectives on human rights."

Australia's Prospectus identifies a large number of critical minerals projects that are at an "advanced" stage meaning that the project has gone through extensive exploration activities, a scoping study and a pre-feasibility study. These activities and studies will have a history and that history will touch and concern human rights, the environment and good governance, each to a greater or lesser extent. Prospective Australian Importers, Members and Links will be linked to that history (whether or not events happened "on their watch") and an understanding of that history as well as an awareness of what will be required to develop the project through to production will be required to begin the process of establishing a due diligence strategy. That history will need to be shared with the prospective Importer as part of its own due diligence into the Member/Link and the project which will be directed by the anticipated requirements of the ESG DD Law.

In the Australian context, indigenous peoples are potentially amongst the most numerous "stakeholders" with whom consultation over a due diligence strategy will be required. The rights or interests of indigenous peoples are a significant issue in the development of most, if not all, resource projects in Australia. The Native Title Act 1993 (**NTA**) recognises the rights and interests of Aboriginal and Torres Strait Islander people in land and waters according to their traditional laws and customs and compliance with its processes is an important role in the identification of indigenous peoples with rights and interests in the affected land and the co-existence (or otherwise) of those rights and interests with the development of the mining project and the terms and conditions of such co-existence.

Regardless of the status of any relevant process provided for in the Native Title Act in relation to a project, the mandatory consultation process with indigenous peoples required under the ESG DD Law on the due diligence strategy will have to take its own course; the proposed EU law provides that all stakeholders are entitled to effective, meaningful and informed discussions on potential or actual adverse human right impacts that are relevant to them.

Discussions in the context of the ESG DD Law may go beyond the ambit of the NTA. How the interaction of the NTA with the ESG DD Law consultation process with indigenous peoples will play out will be interesting. Will indigenous peoples and their representatives consider the ESG DD Law consultation process as offering another means by which their rights or interests can be further advanced?

The ESG DD Law does not address how differences that will inevitably arise during the consultation process will be resolved. The period for discussion is open-ended. The status of a strategy agreed by some but not every stakeholder is uncertain; on the face of it, it would appear as if every stakeholder is required to agree to the strategy. The manner in which "effective, meaningful and informed discussions" should be carried out is not explained. Does each meeting require an invitation to each stakeholder regardless of his/her/its particular interest or concern? Do all stakeholders need to be informed of the interests or positions of each other stakeholder on all points? Hopefully these matters will be addressed in the national laws and that the NCA will be given powers to referee disputes.

Shareholders – Australian corporate law

Another issue that may give rise to some difficulties in undertaking the consultation process in an Australian context, is the inclusion of "the undertaking's (i.e. Importer's) shareholders" in the list of stakeholders. Australian corporate law does not contemplate a company engaging in "effective, meaningful and informed discussions" with shareholders on operational matters such as an ESG due diligence strategy. The only forum for any "live" interaction between the company and its shareholders is a general meeting, when matters are referred to shareholders for their vote following debate and discussion on the resolution in accordance with the law of meetings and the company's constitution. But that formal process is clearly inappropriate when it comes to a discussion aimed at arriving at a consensus on an operational strategy. Extending a mandate to shareholders of publicly listed companies to entitle them to discussions with the company may encourage greenmailing.

Clearly, there is potential for the process for agreeing a compliant due diligence strategy in respect to Australian mined and processed REE, to be a difficult and time-consuming business.

How far "off the pace" are Australian companies when it comes to sustainable reporting?

KPMG's "Towards net zero" report of November 2020, reported on how the world's largest companies (the G250 as defined by the Fortune Global 500 ranking for 2019) reported on climate risk and net zero transition. KPMG's Australian supplement on climate risk reporting in the ASX100 concluded that climate risk reporting by the ASX100 "has improved significantly over the last three years".

It is instructive to look at the data and information provided in these reports to get a sense of how corporate Australia fairs in comparison to overseas companies in sustainable reporting as that may indicate the scale of the job ahead of them to become part of a supply chain into the EU whether as an Importer, Member or Link.

KPMG's report covered 4 aspects of reporting on climate-risk and net zero transition (governance of climate-related risks; identification of climate-related risks; impacts of climate-related risks; and reporting on net zero transition). Specific reports on the performance of companies from Europe (France and Germany), the U.S. and Asia (China and Japan) are included.

In summary, the key findings ae:

- on the issue of governance of climate-related risks, 78% of the ASX100 (including all of the 13 mining companies in the list) clearly acknowledged climate change is a risk to the business in their reports, compared to 56% of the G250 (including 94% of the 18 French companies);

- only 32% of the ASX100 and 31% of the G250 (but 78% of the 18 French companies) identified climate-related risks in their reports or published a stand-alone climate risk/TCFD report;

- only 20% of the ASX100 and 22% of the G250 (but 39% of the 18 French and 29% of the 17 German companies) included a scenario analysis of climate related risks in their reporting; and

- on the reporting on net zero transition, 17% of the ASX100 (including only 1 of the 13 mining companies) and 27% of the G250 (but 28% of the 18 French companies) reported a science-based target.

An analysis of Australia's Prospectus shows that 14 of the 24 listed critical minerals are the subject of multiple (3 or more) "advanced" projects. Of the 141 such projects only 3 involve an ASX100 company.

This illustrates that the development of the critical minerals sector in Australia may be very substantially in the hands of ASX listed companies outside of the ASX100 some of whom may lack the financial and human resources of companies in the ASX100. Yet it is these smaller

companies that are likely to make up the majority of Australian Importers, Members and Links in EU REE supply chains in the short to medium term and on whom the EU sustainability reporting and ESG DD Law obligations will lie.

Conclusion

Whilst the timetables for the full implementation of EU sustainability reporting and the ESG DD Law suggest that Australian Importers, Members and Links will have time to prepare and adapt, the demands of the EU market for critical minerals (and, in particular, the EU's "most pressing need", REE) to meet the need for products such as permanent magnets to power electric vehicles and wind turbines, will mean that supply chains will be developed independently of the implementation of the suite of EU's rules and policies to achieve the goals of the European Green Deal. These goals and how they access the internal market are fully aware of what is ahead of them and would be well advised to develop their EU supply chains accordingly, despite the lack of "black letter" laws in most areas.

It is unlikely that the final form of the ESG DD Law will make allowances for the impact of local laws that affect the rights and interests of stakeholders, such as indigenous peoples. Perhaps the appropriate way to accommodate laws, such as the NTA, is in the Trade and Sustainable Development chapters of the FTA with the country concerned. If so, the ratification of an Australian - EU FTA may well be an important step in the development of Australian - EU critical mineral supply chains.

Simon Salter,
Solicitor,
Independent Legal Advisor

Flora Pitti-Ferrandi,
Competition Partner,
Vivien & Associés, Paris