

**FINANCING GLOBAL
MINING:**
THE COMPLETE PICTURE

EDITOR: ROD MORRISON



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SECTION 03

CHAPTER 05

BUILDING LASTING MINING AGREEMENTS WITH GOVERNMENTS

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Introduction

Given, on the one hand, the current buoyant status of the mining sector and, on the other, the apparent increasing fragility of agreements with governments for the extraction of raw materials,¹ be they mining ventures or oil and gas projects, how can developers and investors improve their chances of forging more lasting and productive relationships with governments from the beginning?

It goes without saying that natural resource projects inherently have two major drawbacks:

- ▶ Their investments tend to be sizeable, and paybacks are long-term and dependent on global commodity prices;
- ▶ They cannot be located anywhere else.

Although investors often say in their defence that they are bringing management, training, advanced technology, finance and reliable market outlets, and the government is only bringing 'the resource' to the table, at the end of the day, if there is no resource linked to a co-operative and reliable government, there is no project.

Likewise, if governments make little effort to be investor friendly, stable in their terms and competitive with other nations, then they are unlikely to be the first port of call for investors/developers, even with relatively attractive resources in the ground.

It is therefore a balancing act between the size and attractiveness of the investment opportunity and the investors' ability to assess risks and to either operate within the existing law or to negotiate an appropriate agreement with government. Due to the two inalienable points above, robust and fair bilateral agreements with governments are therefore an essential first step to be put in place before a major project can take place in the extractive industries sector.

This chapter outlines a range of important issues that both the investor and host governments should address in 2007 before initial ground activities or serious investment takes place.

Building a framework

For medium sized projects in developed countries, the established law and regulations can be sufficient to provide a developer with sufficient confidence and a working framework for investment; only for very large projects will the investor feel it necessary to go to government for special treatment/dispensation considerations.

However, in less developed economies, the law is frequently not specific enough and government support for natural resources projects is often seen to be 'up for grabs.' In addition to these uncertainties, each newly appointed minister/government administration may wish to stamp their own style of authority on the best deal possible for the government.

Prior to investment, at the very least, existing law and regulations should be reviewed in detail, key uncertainties clarified and basic guidelines established and agreed in principle. Perhaps a term sheet or draft investment agreement will be compiled, regarding anticipated government participation, tax holidays, incentives, etc., before the exploration and feasibility study (FS) stages are started and prior to any major investment. However, it is equally important that once the size and dimensions (including profitability under various scenarios) of a project are known following a full FS, then flexibility must be built into these initial agreements to ensure that both government and investor have the opportunity to refine the outline development agreement, to allow for an equitable share of the project to both sides and under most economic and political situations.

¹Shell Sakhalin and BP's agreements with the Russian Government, plus recent negative developments by governments on mining/oil and gas projects in Venezuela, Bolivia, Mongolia, etc.

General company requirements

Bilateral agreements

Before discussing specific government requirements, it is useful to review in brief the typical requirements of companies in bilateral agreements with governments – these can be summarised as follows:

- ▶ Clear title and security of tenure of rights – For mining or exploration rights that have the exclusive right in turn to be converted into a development/mining licence;
- ▶ Satisfactory fiscal regime – The definition of satisfactory will vary from country to country, but if general terms are seen as unsatisfactory they will need to be negotiated;
- ▶ Stability in the fiscal regime – This is equally as important, as companies will clearly wish to eliminate or at least minimise any future changes that will have a negative effect on the project's earning power;
- ▶ Satisfactory Health, Safety, Environment and Community (HSEC) regime – In the past, if countries had no national standards and regulations, there was a temptation to take US or World Bank 'standards' or 'guidelines' off the shelf without any institutional back-up for implementation or enforcement; this has given rise to many problems;
- ▶ Stability in HSEC management – As in point three above, unreasonable and unexpected changes in operating standards should be safeguarded against;
- ▶ Right to freely market products (nationally and internationally) – The right to physically mine and market the principal and any subsidiary products should be clearly understood and agreed by all parties;
- ▶ Freedom to commercial operation – Although this appears to go hand in hand with the first point above, the concept is very important in so much as commerciality will affect establishing cut-off grades, resource utilisation, etc;
- ▶ Right to repatriate profits – Although axiomatic for investors, governments are not always familiar with the importance of interest payments and early repayment of third party investors and banks;
- ▶ Foreign exchange retention rights – Essential to safeguard revenues and likewise it is advantageous to have the right of parallel accounting, using local currency for statutory returns and a stronger foreign currency for the purposes of depreciation, loan repayment schedules and tax calculations;
- ▶ Right to assign – Often very important if the exploration company is not the optimal development vehicle, or joint ventures need to be formed or acquisitions completed;
- ▶ Management control – Not essential, although most major mining companies prefer the right to manage their own operations, especially if the government is a partner and, in addition, wishes to have the right to select or deny incoming parties;
- ▶ Right to international arbitration – Although not guaranteed to provide a solution, as a last step to resolve major disputes, companies (and lending banks) like to see a clause covering the right to an international arbitration court, such as the London Court of International Arbitration (LCIA);
- ▶ Corporate transparency – The British Government's Department For International Development (DFID)-sponsored Extractive Industry Transparency Initiative² (EITI) has now been adopted by The World Bank and the International Monetary Fund (IMF) as a 'brand' for companies to publicly disclose their payments to government (tax, royalties, commissions, etc.) in order to combat corruption and raise credit ratings, as well as providing a more transparent operating environment for mining companies.

Project development

In addition to a robust and workable agreement with government, companies want their projects to have the potential for operating costs in the lower quartile of the global cash cost production curve, to exhibit manageable environmental issues and to have a clear definition of existing and future potential environmental liabilities – in this context, 'greenfield' sites are preferred.

A well developed infrastructure, linked to an attractive and competitive investment climate with stable political and social structures completes an initial 'wish list' for most investors.

Finally, although governments often have all the right structures, legal and fiscal frameworks in place, they also need to exhibit a culture of co-operation and desire to welcome and assist investors. As regards the relative attractiveness of countries for general investment, the Organisation for Economic Co-operation and Development (OECD) publishes an annual review of Country Risk Classification³ on a scale of 0 (very good) to 7 (very poor).

²Department For International Development (DFID) Extractive Industry Transparency Initiative (EITI) London conference 17 March 2005, International Council on Mining and Metals (ICMM)

³Organisation of Economic Co-operation and Development (OECD) – Annual Country Risk Classification

Companies' assessment of countries

Being more specific as regards mining companies assessing countries as to their attractiveness and receptiveness for investment, the Fraser Institute⁴ of Canada publishes an annual ranking survey of countries, fed by comments and views from mining company executives, against certain investment criteria.

Most of the criteria are controlled or at least influenced by government, such as: investment and development policy potential; policy/mineral potential, assuming no land use restrictions in place and assuming industry best practises; room to improve; uncertainty concerning the administration, interpretation and enforcement of existing regulations; political stability, general security situation, etc.

Environmental and social regulations have an increasingly important influence, with such criteria as: environmental regulations – application of the Equator Principles⁵; socio-economic agreements; labour regulations/employment agreements; uncertainty concerning native title claims; uncertainty concerning which areas will be protected as wilderness or parks, etc.

Supportive, fair, reasonable and stable financial and legal frameworks are essential investment criteria – for example, fiscal incentives, taxation regime; regulatory duplication and inconsistencies; level of infrastructure provided or expected, etc.

Some aspects are more inherent in terms of geological potential: outlets to markets, location to the coast; geological database; mineral potential, assuming current regulations and land use restrictions.

The survey concludes with a composite policy and mineral potential ranking. Although in many ways these criteria are similar to the requirements above, they are less specific and more general, and for the period 2005–06 produced the following results:

- ▶ Good countries to invest in – Chile, Ghana, Tanzania, Mexico, Mongolia;
- ▶ Less attractive countries/states for investment – Zimbabwe, Papua New Guinea, DRC Congo, Venezuela, the Philippines, Indonesia, Russia, Bolivia, Zambia, California.

What this implies is that, for countries with considerable and attractive mineral endowment, such as Russia, DRC Congo, and the Philippines, it is highly desirable to put in place well developed bilateral agreements that will stand the test of time.

Government requirements

The process of privatisation⁶ in the 1980s and 1990s demonstrated that, from generally inefficient and loss-making state-owned mining conglomerates to more profitable and efficient privately-owned companies, the aims, objectives and priorities of state versus private investor/operator often vary considerably.

For example, state-managed companies tend to be overstaffed by private sector standards, as government is more lenient with staff numbers in order to reduce unemployment; reinvestment is lower in state companies as cash flow is used for other government requirements until absolutely necessary (which is often by then too late); senior management may be political rather than sector professional appointees; large bureaucratic central offices in major cities rather than smaller on-site offices, etc.

⁴Fraser Institute – Annual Survey of Mining Companies 2005-2006

⁵Many companies, banks and now governments subscribe to applying the World Bank/IFC-issued HSEC Equator Principles that lay down a checklist of actions, guideline standards and policies recommended to be adhered to by mining projects

⁶Privatisation of State Mining Companies – C. A. Morgan, Minerals Industry International, July 1994

However, in recent years, government requirements of investors have become more in line with the private sector, with a view to building healthier, more dynamic and thereby more sustainable industries, for example:

- ▶ Cash up front – Becoming highly desirable, either in the form of signature bonuses or some other form – this allows the government to demonstrate an immediate return from sector investment, rather than subsequent governments reaping the benefit;
- ▶ Listed companies and especially blue chip major companies – Highly desirable, as they tend to operate to high standards and attract other investors;
- ▶ Commitment – Governments seek to develop a sustainable sector and will therefore be looking for the investor to commit to training programmes for nationals, international standards in HSEC processes and controls, and modern management techniques and technology;
- ▶ Broadening the market – Successful investors will also provide access to international markets, inject competition to domestic industries and provide the potential for a wider ownership;
- ▶ Increase benefits to government – Investors should also be able to demonstrate through modelling (economic and macro-economic) the increase in ‘total government take’⁷ from the venture being negotiated, in terms of revenues and other benefits to the government (jobs, technology, new markets, etc.);
- ▶ Use of assets in country – After mistakes in the past, governments now like to add as much value in country before raw materials are exported – i.e. converting iron ore and coal into steel, limestone and gypsum into cement, cutting and polishing gems in country, etc. In this way, a further objective will also be met, that is to reduce the national dependency on imports, and hence improve the balance of payments;
- ▶ Community enhancement – Notwithstanding the preference for major company investment, the importance of a healthy small scale mining sector should not be underestimated in terms of adding value to poor communities, creating jobs and providing new skills to often rural agricultural areas. However, to be effective, appropriate laws, regulations and managing ministries/institutions need to be put in place, as well as an active and empowered mines inspectorate.

Potential friction points between investors and government

Government difficulties in managing the mining sector

It is important to realise and to accept that government and investors have different aims and objectives. This is entirely reasonable and both sides must learn to appreciate the concepts and reasoning of the other; this process of education and acceptance may take the first weeks or even months of difficult negotiations before mutual respect is generated and real progress is made. It is important to keep a paper trail of decisions made and to remain patient while upward reporting lines are checked and feedback received. There is necessarily a difference in pace between government and private sector decision-makers – hence Head Office expectations must be managed, and slower than expected progress anticipated, within reason.

Other areas where government and company styles may differ include: definition of policy and objectives; the division of liabilities – who accepts what; the methodology/criteria for evaluations – clear definitions of a ‘viable project’ and ‘positive feasibility study’; the level of government involvement in operations and management; and projected future fiscal, legal and HSEC parameters.

Governments also tend to like to reserve the right to veto acceptable partners, markets, technology suppliers, brokers, etc., and be involved in the co-ordination of government and investor marketing efforts, as well as the timing of investments and activities versus the political window of opportunity.

If companies remain unhappy with the political risk dimension, then many resort to political risk insurance, such as offered by MIGA⁸ or OPIC⁹, which charge a percentage of the investment being made to cover against insurrection, nationalisation, etc.

Lessons learned from recent losses in difficult countries¹⁰ centre around the fact that political risk insurance is a good disincentive, and that companies must be careful of what is promised, avoid confidentiality provisions, recognise that arbitration rights have a positive effect and that they should not depend on actions beyond the companies’ control.

Table 5.1 summarises some of the important differing viewpoints between governments and investors that need to be appreciated prior to entering into negotiations.

⁷Total Government Take is the sum of benefits to the government through taxation (private and corporate) duties, levies, royalties, direct and indirect jobs through the multiplier effect, etc.

⁸Multilateral Investment Guarantee Agency (MIGA) – part of World Bank offering Political Risk insurance

⁹Overseas Private Investment Corporation (OPIC) – Political Risk insurance for US related investments

¹⁰International Political Risk Management – Moran and West, The World Bank Group

Table 5.1: Mining agreements – differing government/investor viewpoints on key components

Criteria	Government	Investor
Exploration	Preference for a thorough exploration programme – large expenditure.	Sufficient exploration to define resource – minimum expenditure.
Work programmes	Sizeable programmes and strong commitment to complete and spend minimum budgets.	Minimum expenditure as required before investment decision or withdrawal.
Resource in the ground	High resource utilisation, generally meaning a lower grade over a longer period of time.	Commercial resource utilisation linked to a dynamic cut-off grade, depending on commodity prices.
Mining	Large scale, perhaps lower grade operations creating jobs but being less dynamic to the market place.	Small, more dynamic operations, larger equipment, lower manpower, minimise costs.
Processing	Preference for highly integrated downstream activities to add maximum value and create further jobs. Market considerations regarding cost, quality, location of products often not fully evaluated.	Modern 'lean and mean' process facilities exporting raw commodities to the international market – revenues in hard currency. Additional value adding activities not always supported, due to additional capital exposure in the country and further interfaces to manage.
Infrastructure	Maximise infrastructure supported by the venture – roads, communications, possibly hospitals and schools.	Trend now is to minimise project infrastructure by fly in/fly out and let government meet requirements for social infrastructure in order to reduce the dependency culture associated with mines in the past.
Organisation & management	Governments tend to seek maximum use of nationals at all levels, qualifications may be of lower level than international staff. Training commitment of investor essential and ultimately in the interests of the investor (lower cost).	Lean, flat organisation with 'best man for the job' policy normally rules, irrespective of cost. Senior management, invariably expatriate with international experience, banks and JV partners may wish to be involved in the CEO selection.
Staff qualifications	Very often, local staff are promoted due to high level connections rather than appropriate qualifications and international experience. Sensitivity is required to manage these issues.	At senior levels, international experience is highly desirable, together with advanced foreign language skills in order to manage inter-cultural issues.
Markets	Local markets and downstream integration are preferred due to job creation and cash flow retention in country.	International markets generating hard currency income are preferred.
Laws and regulations	Legal framework should be internationally competitive but tailored to national requirements in terms of income tax, duties, royalties, etc.	Competitive but stable laws and regulations with a 'most favoured nation' clause, in order to allow for improvement in legal or fiscal framework but not deterioration.
Stability of agreements	Overall, governments tend to be fair with the fiscal arrangements when the investment is made. The problems arise when commodity prices rise unexpectedly or to a level not anticipated – a mechanism therefore needs to be put in place to ensure that additional benefits over and above expected revenues are shared on an equitable basis.	Great value is put on stability clauses in agreements by companies, in order to reduce investment risk going forward. Although not foolproof, stability clauses are a disincentive to governments to tinker with the fiscal package agreed on investment.
Signature of agreements	Very often, it is felt adequate that a minister signs agreements on behalf of government. However, ministers have a habit of coming and going, giving rise to the possibility of the new minister playing by different rules. This is clearly not satisfactory to the investor.	Companies always prefer agreements to be signed by the head of state on behalf of the government and subsequently are ratified by parliament. This gives the best possible protection to the investor, in terms of avoiding 'goal posts' being moved.
Cultural differences	Governments are always (often uneasily) aware of the number of expatriates imported to run a new mining operation in remote locations. Tensions can build up between similarly qualified local and expatriate engineers with widely different salaries; it is important in agreements, therefore, to define maximum expatriate numbers and agree to a dilution rate over time down to a minimum – this approach is normally accepted.	Incoming investors must be aware of local customs and sensitivities – much harm can be done to relationships by inexperienced and sometimes uneducated seconded foreign staff. There are currently some tensions rising in Africa and South America with Chinese staff seconded to their first overseas posting.
Share of revenue	It is often felt that disproportionate revenues from natural resource projects should accrue to government, as the raw material was a state asset. However, the informed negotiator, supported by his lenders, will make sure that a range of international agreements are presented to government to illustrate the normal framework and repayment schemes of other countries.	Notwithstanding normal royalty payments, levies, duties, etc., bi-lateral agreements must make clear that the investor needs to recoup his investment as a priority to pay banks, shareholders, etc., before additional profits are made available to government.
Excess profits tax	Governments now like to see a profits cap, defined in terms of additional tax when meeting or exceeding return on investment criteria, or the deposit of profit over and above agreed levels into a special account for when prices decline.	The investor takes the country, technical, management, commercial and financial risk, and therefore should be allowed to 'reap some benefits' if commodity prices rise substantially.

Source: Author

Conclusions

Companies looking to invest should be aware of what governments would like to see arising from the investment and listen to the points being raised in discussions with senior government staff. They should ensure that key issues are included into the agreement regarding training, advancement of local staff, statutory returns – form and frequency, technology transfer, government take, local community issues, HSEC standards, excess profits tax or equivalent provisions for sharing windfalls if they occur.

In major projects, companies should be cognisant of past lessons in terms of the 'Resource Curse' – the paradox that countries with abundant natural resources often have lower economic growth than countries without comparable natural resources. This can be due to a variety of reasons, but principally it is thought that the new wealth from developing natural resources strengthens the local currency and increases wage rates, which in turn lessens the competitive nature of exports and hence leads to additional unemployment.

To assist in avoiding this demoralising effect, the 'resource endowment initiative' has arisen from the Global Mining Initiative (GMI) and its successor the International Council of Mining and Metals (ICMM), which aims to examine mineral rich countries and probe factors that contribute or hinder social and economic development, as well as to provide practical solutions to ensure more countries manage mineral revenues to reduce poverty.

Initial findings indicate that some or all of the following may offer solutions to this problem: applying appropriate sector governance, correct levels of taxation, royalty, institutional strengthening and capacity building, poverty reduction programmes, community schemes and, most importantly, ensuring an equitable sharing of risk and reward between companies and host governments. In this context it is suggested by ICMM that windfall gains should be 'saved' in order to mitigate against future commodity price volatility.

Investing companies should aim for the highest level support to the agreement as possible – namely, ratification by parliament and hence the state directly. In this context, the companies should try and arrange that government negotiators are backed by parliamentary legal advisers and intend to seek parliamentary approval in due course. If negotiators are uneasy about promising this security, local legal research often reveals similar agreements endorsed by parliament and allows the power of precedence to be applied.

Overall, the chance of success in terms of a mutually workable and lasting agreement is increased enormously by careful selection of staff – the company's negotiator should be experienced, have some language skills, be firm but diplomatic, and the senior local manager a reliable and safe pair of hands; if good personal chemistry can be generated between these staff and government representatives, then the negotiations generally proceed well and agreements fall into place.

As in all negotiations, at the end of the process both parties need to feel reasonably satisfied with the deal – if not, then working to the agreement will be hard going and issues will always be found to disrupt operations or, at worse, demand a change in ownership.