



**samda**  
South African Mining Development Association

## **SOUTH AFRICAN MINING DEVELOPMENT ASSOCIATION**

SUBMISSION TO THE DEPARTMENT OF FINANCE  
REGARDING THE PROPOSED MINING ROYALTY BILL

30 APRIL 2003

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## 1. EXECUTIVE SUMMARY

- The South African Mining Development Association (SAMDA) represents the junior mining sub sector in South Africa. This consists of smaller producing companies (those with an asset base of between R18 million and R 1 billion), contracting companies to the mining industry and associated members. BEE companies play a significant part in the association and SAMDA actively strives to promote new entrants to the mining industry. SAMDA also has strong links to small scale mining groups and associations.
- Given that the State is the custodian of mineral rights in South Africa, SAMDA agrees to the principle of a royalty tax imposed on the mining of these minerals.
- SAMDA has concerns, however, regarding the effect that the proposed royalty tax in its draft form will have on current and future mining operations.
- SAMDA has consulted its membership and wider constituency on the effect that the royalty will have on their current and future operations.
- Without exception, all companies canvassed believe that the royalty will have a negative impact on present and future operations with a resulting loss of revenue and consequent job losses.
- Of particular concern is the effect on BEE companies. The case studies in this submission show that BEE companies in joint venture agreements with established operators will be negatively affected, as will new entrants in “stand alone” projects.
- This submission shows that the international comparative basis used in the draft Bill as rationalisation for the imposition of the royalty has not been sufficiently researched and requires re-examination.
- SAMDA is concerned that there is not sufficient clarity on the definition of marginal mines.
- SAMDA proposes that a royalty based on profit would be a more appropriate method of taxation and that this royalty be phased in over a time frame so as to cause a minimal disruption to the industry.
- SAMDA believes that the State should consider incentives for the industry such as flow through shares to assist new entrants.
- SAMDA proposes that any revenue obtained from royalties be earmarked for the industry. Proposals on the use of these funds include capacity building in the BEE sector, and support of tertiary institutions involved in mining education as well as financial support to the science councils.

In addition, rural development and skills development should benefit from royalties.

## **2. PREAMBLE**

After the 1994 elections, the Government set about transforming South Africa from a racially exclusive society into one that allows full participation by all its members in all its aspects: social, political and economic.

The mining industry, long perceived to be the cornerstone of the economy, has received particular attention from the Government. Three statutes will govern transformation of the mining industry: the Minerals and Petroleum Resources Development Act, the Mining Charter, and the Minerals and Petroleum Royalties Bill. The industry has generally accepted the first two of these, but the third, the Royalties Bill, has raised a number of concerns.

The South African Mining Development Association (SAMDA) is an organization formed specifically to represent the interests of the junior mining companies, contractors and small-scale miners in South Africa. Its vision is to be the vehicle for the development of a vibrant and sustainable junior mining sector, thereby promoting equitable access to the nation's mineral and petroleum resources by all the people of South Africa, an objective of the Mineral and Petroleum Resources Development Act.

SAMDA represents companies in the junior mining sector and the thousands of small-scale miners throughout South Africa. In addition, it has established strong relationships with labour organizations in the mining industry. SAMDA is concerned that the proposed Royalty Bill, in its present form, presents a serious threat to the mining industry and to emerging black companies in particular.

These concerns, and SAMDA's proposals to alleviate them, are set out in this document.

## **3. THE STRUCTURE OF THE JUNIOR MINING SECTOR**

South Africa classifies its mining industry into three sectors: coal mines, gold mines and other mines (RSA, 2002a). Mines in the other mines category produce some 85 different minerals, ranging from high value/low volume minerals such as diamonds and platinum to low value/high volume industrial minerals such as gypsum, feldspar and limestone.

From the inception of the South African mining industry in the second half of the 19th Century, several very large mining houses dominated the gold and diamond sectors. This situation changed during the last decade of the 20th Century. As some gold mines reached the end of their economic usefulness, the mining houses sold them to operators with much smaller capital and cost structures. These smaller companies became the junior miners.

Since 1994, the rate of change in the mining industry has accelerated, and will continue to do so. The Minerals and Petroleum Resources Development Act (RSA, 2002b) will facilitate the entry of many more participants to the industry, both companies and individuals.

There are four groups of junior miners:

- “White” owned and controlled companies, examples being Metorex Limited and Durban Roodepoort Deep, Limited. These companies actively pursue affirmative action policies in the recruitment and training of previously disadvantaged South Africans, and are committed to the objectives of the Minerals and Petroleum Resources Development Bill.
- Foreign based companies, involved in exploration and operation of mines. Examples are Aquarius Platinum and Southern Era Resources.
- The newly emerged black owned empowerment mining companies, examples being Eyesizwe, Sedibeng, Sebenza and Kuyasa Mining which operate mines purchased from the large mining houses but do not generally conduct exploration activities.
- Black-owned empowerment companies and rural community trusts that operate in terms of joint venture agreements with the major mining houses. Examples of these are the Royal Bafokeng Nation, which is partnered with Anglo Platinum Limited in the Rasimone platinum mine, and Sedibeng, which is re-processing old diamond mine dumps in the Kimberley region in association with De Beers Limited.

A fifth group comprises the small-scale miners:

- Small-scale or artisanal miners are usually driven by poverty, and have little or no recourse to modern technology. However, the National Steering Committee of Service Providers to the Small Scale Mining Sector (NSC), a government-funded body, does provide technical, administrative and financial support to selected small-scale miners. Small-scale miners usually produce only one product.

The junior mining sector ranges from a few medium-sized companies to small community based trusts with virtually no capital base. They operate across the whole spectrum of minerals produced in South Africa and are all extremely sensitive to any increase in working costs.

**Table I: illustrating the various tiers in the industry.**

<b>CATEGORY</b>	<b>ACTIVITY</b>	<b>SPHERE OF OPERATION</b>	<b>GROSS ASSET VALUE (Rbn)</b>	<b>ANNUAL SALES VALUE</b>
Major	Production Exploration	Global	More than R1bn	More than R1bn
Junior	Contract mining Production Exploration	National	Less than R1bn but more than R18m	Less than R1bn but more than R30m
Small-scale (Formal)	Production	Regional	Up to R18m but more than R150 000	Up to R30m but more than R500 000
Small-scale (Informal)	Production	Local		

Source: MEPC 2002

The primary objectives of the Minerals and Petroleum Resources Development Act, and its associated Charter (RSA, 2003), are to place ownership of mineral resources in the hands of the State and to encourage historically disadvantaged persons to enter the mining industry. It will also facilitate the entry of foreign investors, many of whom are large international corporations, which have brought with them much needed capital and have provided employment opportunities for South Africans.

#### **4. IMPACTS OF THE ROYALTY BILL ON BLACK EMPOWERMENT IN THE MINING INDUSTRY: SOME CASE STUDIES**

The proposed Royalty Bill will impact severely on both junior and small-scale miners. Without doubt, there will be widespread loss of employment, both current and potential. Research conducted by Mitchell and Sakoana (MEPC Report 2002) indicate that there are at least 68 000 people employed in 181 operating companies in the junior sector alone. Research conducted by the Department of Minerals and Energy (DME) in 2002 indicates that there were 34 Black Economic Empowerment (BEE) companies operating in eight categories of mineral commodities. Given the rapid growth in this sector, however, it can be assumed that the number of BEE companies has increased since this research was conducted. Current research by the DME identifies 35 projects in the Platinum Group Metal (PGM) sub-sector and 12 projects in the gold sub-sector involving BEE companies. The Coal Forum, a body comprising 26 coal companies, includes 10 BEE companies.

#### 4.1 Durban Roodepoort Deep, Limited (DRD, 2003)/Khumo Bathong

Durban Roodepoort Deep, a member of SAMDA, is a medium-sized, low-grade gold producer. It employs more than 24 000 people at four operations; earns more than R3 billion in foreign exchange annually; and pays R271 million in direct tax. In addition, DRD is planning to develop a very large gold project, Argonaut, that will exploit the southern extensions of the Main Reef containing more than 30 million ounces of gold, providing employment to a further 30 000 people.

**In 2002 DRD entered into a partnership with a black empowerment group, Khumo Bathong Holdings (KBH), by selling KBH a 60% interest in DRD's Crown Gold Recoveries.** The partnership later acquired 100% of the East Rand Proprietary Mines Limited (ERPM). Both of these deals were commercial transactions in which the Industrial Development Corporation played a significant role. **Crown Gold Recoveries and ERPM currently pay more than R160 million in wages annually. Given the current price of gold, an imposed royalty would leave both companies with little future, resulting in the retrenchment of at least 4 000 workers.**

A 3% royalty payment on revenue from DRD's existing operations would amount to R88 million but would cause earnings per share to drop from 113.2 cents to 62 cents, and will increase the pay-limit, thereby effectively reducing the company's reserve from 235 tons of gold to 215 tons.

Foreign investors hold a large amount of DRD's share capital. The impact of a 45% reduction in earnings per share would seriously affect the company's capital structure and almost certainly halt the Argonaut project. The potential to create the 30 000 new jobs would be lost.

#### 4.2 Metorex Limited (Metorex, 2003)/Umnotho we Sizwe

Metorex Limited is a medium-sized mining company, and a member of SAMDA. It owns and operates seven mines, with a staff of approximately 3 500 people. Metorex has made its own submission on the Royalty Bill. Metorex concludes that:

- a 3% royalty payment on revenue from its marginal gold mines will decrease profits by 49%; and
- a 2% royalty payment on revenue from its marginal base metal mines will decrease profits by 32%.

Metorex considers that the introduction of a royalty payment is both untimely and detrimental to the industry. In addition to the other taxes and government levies, the introduction of a royalty levy will lead to a

further contraction of the industry. This is contrary to the objectives of the Mineral and Petroleum Resources Development Bill.

In June 2002, Umnotho we Sizwe, the black empowerment company, acquired an initial 8% interest in Metorex's coal division, Wakefield. Umnotho we Sizwe earned this 8% interest through its acquisition of the Middelburg Townlands coal reserve.

The agreement provides the opportunity for Umnotho we Sizwe to build up a meaningful 20% stake in an existing mining company through the delivery of reserves and markets. To consolidate its stake, Umnotho will have the option to raise its shareholding to 50% within a certain time frame through an equity purchase agreement. Umnotho will also have the option of converting equity in the coal company for equity in Metorex Group to gain exposure to Metorex's diversified resource base.

**Metorex mines and sells coal from Umnotho's coal deposits, and pays a royalty to both Umnotho and the Middelburg Town Council. The proposed royalty levy could damage Metorex's profit margins to the extent that the operation becomes unsustainable.**  
([www.metorexgroup.com](http://www.metorexgroup.com)).

#### **4.3 New Diamond Corporation**

The majority of shareholders in New Diamond Corporation, which was established in 1998, are historically disadvantaged South Africans, and it also has an agreement with the Schmidtsdrift community to which it pays a 5% royalty on the gross revenue received from the sale of diamonds recovered from Schmidtsdrift. The Schmidtsdrift community also owns a 20% interest in the operating company.

NDC also pays a similar royalty to the State, ie. 5% of gross revenue received from the sale of diamonds recovered from Schmidtsdrift, and a premium of 2% on its exploration loans.

**The net effect of these existing royalty payments was that NDC recorded a loss of R16 million during the year ended February 2002, and a loss of R19 million during the year ended February 2003.**

**NDC cannot sustain these losses, and the added burden of a further 3% royalty payment to the State would further exacerbate the situation.**

NDC has made its own submission to the Department of Finance, in which it fully explains its concerns.

#### 4.4 Placer Dome Incorporated (Placer Dome, 2003)

Placer Dome Incorporated is a large international mining company based in Canada. While it is not a junior mining company, it is extremely concerned about the proposed Royalty Bill, and communicated these concerns to SAMDA.

Placer Dome entered the South African mining industry in 1999 with a firm commitment to the principles and objectives of the Mineral and Petroleum Resources Development Bill, and actively promotes affirmative action employment policies. It has invested more than R4.5 billion in the acquisition and development of its 50% share in South Deep, a large gold project on the West Rand with a projected life in excess of 70 years.

Placer Dome is concerned that mineral royalties, especially when levied in conjunction with high taxation rates and other negative factors such as political risk and high working costs, will adversely affect the sustainability and longevity of the mining industry in South Africa.

Placer Dome has evaluated the attractiveness of the South African mining industry against those of other mineral-rich nations. In addition to the relatively high working costs and the cost of capital, South Africa has a number of additional burdens not present in these alternative investment options, ie:

- direct and indirect taxes, levies and STC;
- labour intensive mining methods;
- historical costs of purchasing mineral rights;
- costs associated with funding a 26% BEE participation interest;
- the cost of raising offshore capital for an effective 76% interest, because of the 26% BEE requirement;
- the cost of social development and upliftment plans, and environmental rehabilitation programmes;
- the skills development levy, currently 1% of total employment costs;
- the cost of meeting the requirements of the Mining Charter;
- taxes on expatriate labour; and
- BEE procurement subsidies.

Placer Dome completed a study that indicates South Africa returns the second-lowest rate of return to shareholders in all the countries in which it operates, a situation that the proposed royalty on gross mineral revenues will exacerbate. **Placer Dome is currently negotiating with a number of BEE companies to enter into joint venture agreements and is concerned that the proposed tax will adversely affect negotiations around these agreements.**

#### 4.5 Sedibeng Mine

The Sedibeng Mine is another example of a community-based project that the imposition of a Royalty Tax will affect. This mine came into existence when a group of small scale diamond miners in the Kimberley area, with the assistance of the Minerals and Energy Policy Centre, formed the Small-scale Miners' Forum, a group representing small-scale diamond producers in the region. After a lengthy process of negotiation, they entered into a joint venture agreement with De Beers to reprocess old mine dumps in Kimberley. **Sedibeng is paid by De Beers per ton mined as part of a rehabilitation agreement, as well as a percentage on the profits from diamonds recovered. An imposed royalty of 8% will reduce the revenue achievable by Sedibeng. This, in turn, will affect the company's ability to develop other mining projects.**

#### 4.6 Sebenza Mining

Sebenza mining is a smaller BEE company involved in the coal sector. Sebenza believes that a royalty tax, after profit, is fine in principle. **However, of particular concern is that the tax will damage the smaller operators and the company believes that some mechanism needs to be put in place that differentiates between the larger operators and the smaller players.** Sebenza believes that a phased-in approach over a 15-year period would lessen the damage on companies. A related concern is that the money raised from the royalty should be ploughed back into the mining sector (for example, into beneficiation of mineral resources) and not simply disbursed into general government expenditure.

#### 4.7 Leeuw Mining and Exploration

Leeuw Mining and Exploration Company is a small, start-up BEE company operating in the coal sector. It is currently in the planning stages of the Leeuw Vaalkrantz Mine. **According to this company, a 2% royalty on coal will severely affect the implementation of this project. During the start-up phase of the project the effect of the royalty will be an additional R0.75 million burden, whilst the first full year of operation will cost an additional R1,6 million. This translates into 10% of plant operating costs and 5% of mining costs. The company is already struggling to raise the capital for the start-up phase and this proposed tax has meant that the company is currently revising its project proposal.** The company points out that start-up capital for BEE companies is particularly expensive and this added burden would make it almost impossible for new entrants to access the market. The suggestion is that the emerging companies should be excluded from the royalty tax for a few years and that a royalty should only be imposed after profit.

## **5. THE GENERAL OPINION OF THE JUNIOR MINING SECTOR**

**The general opinion of the junior mining sector is that:**

- 5.1** the principle of a royalty based on revenue be re-examined. A fairer system would be to base it on profits after tax. South African mines already carry a considerable tax burden in addition to direct tax, and any royalty levy must consider these.
- 5.2** the application of different royalty rates for different minerals is difficult to understand. In its attempts to secure royalty payments from the major mining companies, which would perhaps be able to absorb these rates, the Department of Finance should investigate different measures to address the challenges faced by BEE companies.
- 5.3** There is, at present, **a number of agreements that allows local communities to benefit from revenue accruing from mining operations. Examples of these are:**

- **royalties received by various tribal communities from mining producers, for example the Royal Bafokeng Nation, Mpahlele etc;**

**The funding of numerous rural renewal community projects by various mining companies would be limited under the burden of a royalty levy.**

## **6. THE PRESS STATEMENT BY THE DEPARTMENT OF FINANCE**

The Department announced the consultation process for the proposed Mineral and Petroleum Royalty Bill in a Press Statement on 20<sup>th</sup> March 2003.

In this statement, the Department set out its rationale for introducing the Bill, as well as the logic by which it derived the proposed parameters and application mechanism.

**SAMDA's comments on the Press Statement are:**

### **6.1 Rationale for the Royalty Bill.**

Many countries apply royalty payments and SAMDA does not contest the fundamental principle. However, SAMDA questions the manner in which the Department proposes to impose this royalty, as well as its magnitude, at this time in the transformation of the mining industry in South Africa.

SAMDA is also concerned that the Department uses the concept of mineral rent interchangeably with the concept of mineral royalties.

The Department defines resource rents as “excess profits, over the minimum rate of return, which are required to justify an investment into a mining venture”. It then goes on to say “these rents can be taxed or shared between the government and operators without impacting negatively on the economic viability of the project”.

This is a highly subjective argument. What is the minimum rate of return? How will the Department know when the economic viability of a project is negatively impacted?

Investors use so-called hurdle rates, which are the rates they would receive from alternative investments with acceptable profiles. Hurdle rates, or minimum rates of return, consider risk profiles. A low risk/return ratio will induce investment of capital. By reducing the rate of return to the minimum, and by adding to the risk, the Department is simply increasing the risk/return ratio, and the investor will seek alternative investments.

The debate on mineral rent is more than 200 years old. As long ago as 1775, Adam Smith (1776) defined mineral rent as “that part of the annual produce of the land which pays the landlord for the use of his land”. Since then, and especially since 1931, when Hotelling (1931) published “The Economics of Exhaustible Resources”, a considerable literature on this subject has developed.

Sadly, the proposed Royalty Bill takes little or no cognisance of this literature.

Current usage of the term “rent” means a payment over and above that required to maintain current reserves of a resource (Stilwell, 1999). The Department relates rent to current costs and revenues. Mineral rent, which must take account of the cost of depleting a non-renewable resource, has nothing to do with profits, but everything to do with the need to sustain an industry that, unlike any other, consumes its asset base.

## **6.2 The *Ad-Valorem* royalty base and regime.**

The Department proposes to base its royalty levies on the gross sales value of mineral commodities, and will not allow any deductions from this gross sales value. The proposed royalty regime imposes a charge for “the extraction and transfer of South African mineral resources”, ie. transport cost from the mine is included.

This is not consistent with the practice in many other mineral producing countries, for instance:

### **6.2.1 Australia - New South Wales (NSW 2003)**

There are three methods for collecting royalty in New South Wales.

*Quantum royalty* is levied at a flat rate per unit of quantity, the rate being dependent on the mineral. Quantum royalties generally apply to low value to volume minerals such as coal, limestone and clays.

*Ad valorem royalty*, applied to high value to volume minerals, is levied on the 'ex-mine' value of a mineral. The 'ex-mine' value is the value of the mineral less allowable expenditure items. [*Note: not the Gross Sales Value.*]

*Profit-based royalties* are applied in certain special cases. Profit for royalty purposes is substantially different from corporate or taxable profit.

### **6.2.2 Canada – North West Territories (Canada 2001)**

The Canadian mining regulations require each mine to pay an annual royalty to the Crown, based on the value of the output of the mine. Value is defined as market value of the output less allowable deductions such as:

- transportation, smelting and refining costs and mill operating costs;
- exploration and development costs;
- depreciation of buildings, plant and equipment;
- amortisation of pre-production exploration and development costs;
- other exploration costs in NWT; and
- a processing allowance if the mineral is further processed in NWT.

No royalties are levied for the first three years after the start of commercial production.

Manitoba, Ontario, Quebec, Newfoundland and NWT levy a mining royalty against a mine-mouth value of the minerals produced after deduction of production costs and an allowance on the capital employed in further processing. British Columbia has a two-stage system. Stage I is a 2% levy on gross revenue less mine operating expenditures. Stage II is a tax calculated on net revenue, which is essentially the cumulative profit from the mine after taking into account both operating and capital costs. British Columbia allows deduction of all expenses.

### **6.2.3 South America (PriceWaterhouseCoopers, 2000)**

No royalties are payable in Chile or Bolivia.

## **6.3 Royalty rate structure**

The Department claims that the chosen royalty rates are “eminently reasonable, falling in the lower half of the international scale” and that the rate chosen for diamonds, 8%, is “also reasonable given the fact that South Africa’s neighbours charge a rate of up to 10%”. The Department also claims that “international best practice” justifies the use of gross sales value as a base for calculating the royalty.

An examination of the ad-valorem rates used in New South Wales (NSW 2003) reveals that they do not exceed 4% of ex-mine value, which is somewhat different from that proposed for South Africa.

In Canada (Canada, 2001) the average royalty rate in five provinces (British Columbia, Manitoba, Ontario, Quebec, and Newfoundland) is 7.3% for high profit base metal mines, 8.6% for low profit base metals mines, 5.7% for high profit gold mines and 5.8% for low profit gold mines.

Canada bases its royalty rates on profits, and not on gross revenue. Therefore, although its rates are numerically similar to those proposed for South Africa, there is a fundamental difference.

The combined Canadian royalty and tax rates are 28%, 33%, 22.4% and 25.5% for the four classes of mine, respectively. These are considerably lower than what is proposed for South Africa.

A number of other countries (Indonesia, Mexico, Peru, Surinam, USA, Venezuela, Mexico and Zimbabwe) repeat this pattern of lower tax and royalty rates. Of these, only two, Surinam and Zimbabwe, base royalty payments on gross sales value (PriceWaterhouseCoopers, 2000).

## **6.4 Exemptions and reductions**

SAMDA recognises the value to the industry of allowing royalty exemptions in cases of marginal mines. However, it does appear that the Department equates a marginal mine with a low-grade mine. Whilst it is true that the majority of marginal mines have low-grade ore reserves, it is equally true that a mine with high-grade ore reserves can be marginal. The marginality, or otherwise, of a mine relates to its ability to make a profit, and is a function of many variables, not only the quality of its ore reserves.

Furthermore, a mine can move between profitability and marginality as market conditions and other parameters change. The Department claims that the provision to exempt low-grade mines from paying a royalty will prevent their closure. The industry perceives the provisions in the proposed Bill as creating confusion throughout the industry in general, and amongst SAMDA members in particular. The guidelines on marginal mines need to be clear and unambiguous.

#### **6.5 Fiscal stabilisation provision.**

Other than to note that the concerns already addressed in this document relate to uncertainty, SAMDA has no comment on this provision.

#### **6.6 Special withholding rules for diamonds.**

Many SAMDA members operate small diamond mines. By forcing them to pay a royalty as a *voorskot*, the Department will place an intolerable strain on their cash flows. The amount so received by the Department would be a fraction of that received from the large operations, which are exempt from this provision.

SAMDA proposes that the Department seeks alternative measures to collect royalties from small operations in the industry (many of which are BEE companies).

### **7. THE EFFECT OF ROYALTY PAYMENTS ON THE TAX LIABILITY OF A GOLD MINING COMPANY.**

Gold mines in South Africa pay tax according to one of two formulae (RSA 1997):

1.  $Y = 43 - 215/X$ , or
2.  $Y = 51 - 255/X$  (if the mine has exercised an option to exempt it from secondary tax on companies).

In both these formulae, Y is the percentage of taxable income payable as tax, and X is the ratio of taxable income to income, expressed as a percentage.

Graph I describes the first of these formulae.

The blue line shows how the percentage tax payable on taxable income varies as the taxable income/income ratio varies. A mine with higher costs but the same income as a mine with lower costs will have a lower taxable income/income ratio and will therefore tend towards marginality, whereas the mine with lower costs will be more profitable. The tax formula allows mines with a taxable income/income ratio of five or less not to pay any tax.

The red line shows the locus of the differential of the tax formula, ie:

$$\frac{dy}{dx} = \frac{215}{x^2}$$

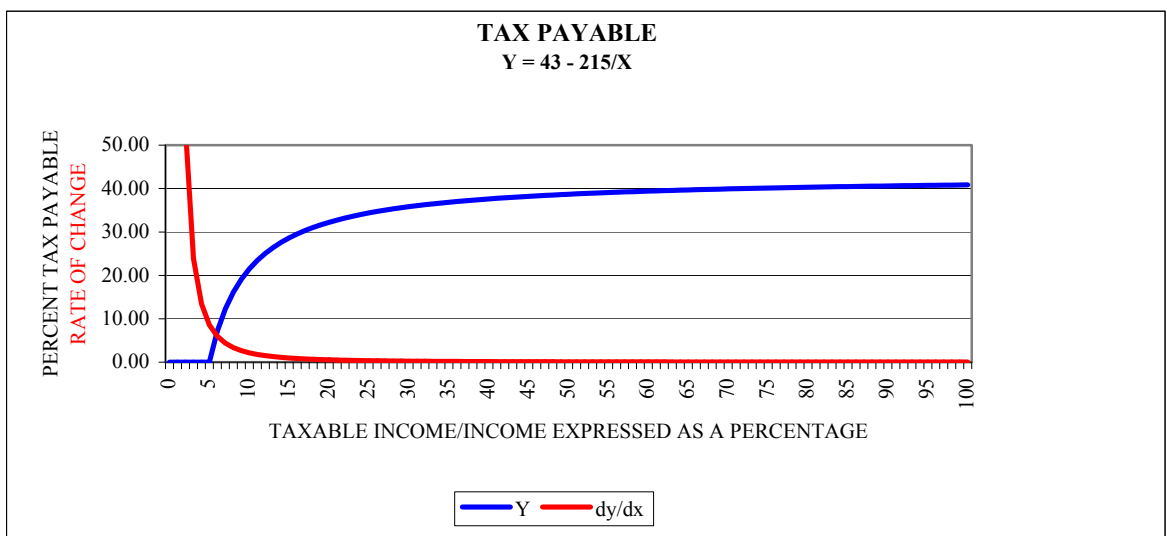
The differential is the slope of the tangent to the tax curve, and is the rate at which the tax rate increases as the taxable income/income ratio increases. The effect of an added cost in the form of a royalty payment will be to decrease taxable income, thereby decreasing the taxable income/income ratio. As the denominator, income stays constant, ie:

$$\text{If } \frac{T}{I} = A \quad \text{then } \frac{T}{I} - 1 = A' \quad \text{and } A' < A$$

Clearly, the effect on marginal mines will be far greater than that on profitable mines.

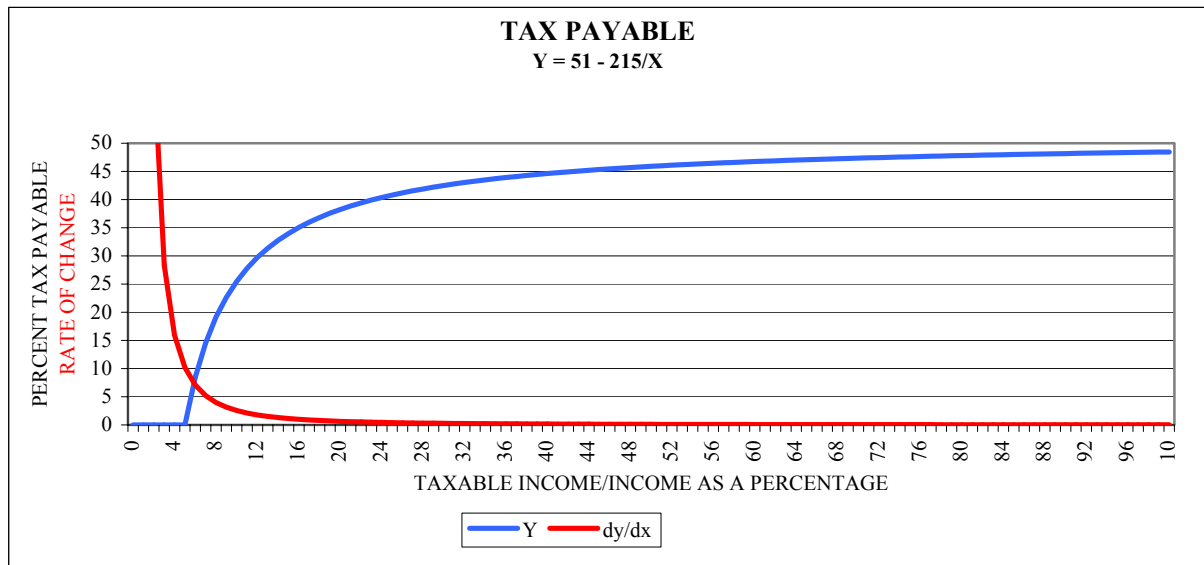
Most of the gold mines in the junior mining sector tend to the lower taxable income/income ratios. In other words, the junior mining sector – in which all the small-scale miners operate – will suffer a proportionately far higher impact on their profits through an increase in tax liability.

Graph 1



Graph 2 shows the percentage tax payable, and the rate of change as the taxable income/income varies if the second formula, that for mines electing for exemption from secondary tax, is used. The effects are the same as shown on Graph 1, but the maximum rate of tax approaches 48.45% instead of 40.85%.

Graph 2



## 8. EMPLOYMENT

Table II shows how the number of people employed in the South African mining industry has diminished since 1992. Although the average wages of mineworkers, especially those in semi-skilled and unskilled jobs have risen dramatically, the overall effect has been to reduce the flow of income through employment in the industry.

Year	Average number of employees	Percent of economically active population	Real* average wage per worker Rand	Percent of total mining revenue
1992	663303	5.0	36184	30.0
1993	619013	5.0	35805	27.4
1994	610794	4.5	35420	26.9
1995	598123	4.3	37786	28.1
1996	569069	4.1	40329	26.8
1997	553116	3.8	42199	27.9
1998	466663	3.4	48287	27.0
1999	437028	3.0	51313	26.3
2000	418294	2.6	55930	22.5
2001	407154	2.7	59979	21.2

Table II Employment and Wages in the mining industry.

Source RSA 2002a

\*Current wages deflated by CPI with 2001 as base year

A paper, presented to the Commonwealth Council in Johannesburg in 2003, estimated that every R1 million increase in output from the mining industry created seven jobs in the rest of the economy. Of these, 4.2 are in the formal sector and 2.8 in the informal sector.

A study conducted in 2002 (Mitchell, 2002) estimated that the junior sector comprised of 181 operating companies employing an estimated 68 000 employees. Of these, 20% or 13 600 were employed by BEE companies. In addition tens of thousands of small-scale operators are affiliated through SAMDA. All of these associates are at risk through the proposed legislation.

Since the implementation of the Mineral and Petroleum Resource Development Act and the Mining Charter, the presence of BEE companies has increased.

## **9 OTHER RESEARCH INTO THE ROYALTY BILL**

A paper by Mthenjane and Mashile argues that the Bill will not have the intended result of empowering previously excluded entrants into the industry. The authors argue that:

“The paper wishes to demonstrate that the payment of a royalty will impact negatively on the stated objectives of empowerment as defined in the BEE Commission Report and hence on the achievement of the pillar on Ownership and Joint Ventures... In addition, numerous arguments have been presented about increasing the ‘size of the pie’ in order to achieve significant broad-based empowerment. Consideration should be given to whether an introduction of a Royalty Bill does not reduce the size of the pie before any sharing has begun. Sharing of the pie should not exclude a sharing of investment risks. A revenue-based royalty does not account for the risks in operating or developing mining operations.” (See Appendix 1)

## **10 INCENTIVES**

SAMDA suggests that the Department of Finance should offer incentives to invest in the mining industry, in particular to newly emerging companies in the junior sector.

### **10.1 Flow through shares**

One such incentive, which has proved highly successful in developing a vibrant junior mining sector in Canada, is so-called flow through shares.

Junior mining companies obtain financing for expenditures on exploration and pre-production development by selling flow through shares to investors. The company renounces, or flows through, certain expenses to the purchaser of the share, who then offsets the expenses against his or her liability to tax. Van Blerck (2003a) discusses flow through shares in detail.

## 10.2 Royalty payments based on profits

Van Blerck (2003b) proposes that a formula, similar to that used to determine liability for tax, be used to calculate royalty from profits, ie:

$$y = a - \frac{ab}{x}$$

Where y = the royalty rate

a = the marginal royalty rate

b = the portion of royalty-free revenue

x = the ratio of taxable income to income, expressed as a percentage

The factor “a” would have different statutory values according to the mineral produced. This system has a number of advantages, which Van Blerck (2003c) explains in a paper submitted to the Department of Finance.

## 10.3 Phased introduction of royalty payments

The Mineral and Petroleum Resources Development Act allows a five-year period (RSA 2002b) for mining companies to convert “old order” mining rights to “new order” rights. The Mining Charter (RSA 2003) allows a 10-year period for mining companies to achieve a 26% level of ownership by previously disadvantaged South Africans.

In the light of these concessions, SAMDA suggests that a phased introduction of royalty payments would allow existing operators, particularly those in the small scale and junior sectors and the emerging empowerment companies, to adjust their cost structures to accommodate the royalty burden with the least possible disruption to the industry.

## 11 CONCLUSIONS

Previously disadvantaged entrants to the minerals industry in South Africa generally do not have extensive capital resources, and rely on vendor funding and various other financial instruments to finance their entry.

In summary SAMDA would propose the following:

- the payment of royalties after profit;
- royalty payments in phases;
- royalty revenue benefits the mining industry, with a focus on rural development and labour sending areas;
- royalty revenue is invested in skills development in mining;

- royalty revenue benefits the science councils, eg. Mintek, the Geosciences Council and Miningtek;
- royalty revenue stimulates BEE capacity building, with an emphasis on the junior and small scale mining sectors;
- royalty revenue is invested in the development of mining faculties in former black universities and technikons.

SAMDA re-states its support for the principle of royalty payments by the mining industry, but urges the Department of Finance to initiate a process similar to that from which the Mining Charter emerged, and which would include major stakeholders such as:

- the Department of Finance;
- the Department of Mineral and Energy;
- representatives of rural communities;
- SAMDA, representing junior and small-scale miners;
- the National Union of Mineworkers; and
- the Chamber of Mines.

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## **APPENDIX 1**

### **An Investment Perspective on the Royalty Bill – Impact on the Transformation of the Minerals Sector**

By: Mzila Mthenjane<sup>#</sup> and Dennis Mashile<sup>\*</sup>

#### **1. INTRODUCTION**

Transformation in the minerals sector has been driven by the introduction of legislation. The Minerals and Petroleum Resources Development Bill stipulated as a broad objective, a use-it-or-lose-it principle with respect to mineral rights that were not being used and to use those rights for empowerment. The Bill was then followed by a Charter, wherein all stakeholders in the industry agreed on how to embark on this process of transformation. The Charter identified pillars upon which transformation will be effected. Various transactions have been concluded in pursuit of the objectives of the Charter.

The pillars are:

- ✓ Human Resource Development;
- ✓ Employment Equity;
- ✓ Migrant Labour;
- ✓ Mine Community and Rural Development;
- ✓ Housing and Living Conditions;
- ✓ Procurement;
- ✓ Ownership and Joint Ventures; and
- ✓ Beneficiation.

Transactions concluded are: -

- ✓ Mvelaphanda Diamonds - purchase of an additional 20.5% (from 4%) stake in Trans Hex;
- ✓ IDC and Simane – Harmony Gold Mining facilitates the acquisition of 10% of the Company's shares, with financing from the IDC;
- ✓ Royal Bafokeng Nation - takes up R100m equity in SA Chrome.

The paper wishes to demonstrate that the payment of a royalty will impact negatively on the stated objectives of empowerment as defined in the BEE Commission Report and hence impact on the achievement of the pillar on Ownership and Joint Ventures;

## **Objectives of Black Economic Empowerment (BEE Commission Report – 2001)**

- ✓ To redress the imbalances of the past by seeking to substantially and equitably transfer and confer the ownership, management and control of South Africa's financial and economic resources to the majority of its citizens;
- ✓ BEE seeks to ensure broader and meaningful participation in the economy by black people to achieve sustainable development and prosperity.

In addition, numerous arguments have been presented about increasing the “size of the pie” in order to achieve significant and broad-based empowerment. Consideration should be given to whether an introduction of a Royalty Bill does not reduce the size of the pie before any sharing has begun. Sharing of the pie should not exclude a sharing of investment risk. A revenue-based royalty does not account for the risks in operating or developing mining operations.

## **2. MECHANICS TO ACHIEVING OWNERSHIP BY HDSAs**

### **a. Equity ownership mechanisms**

This mechanism is the same irrespective of whether the equity is traded on a stock exchange or privately owned. The process broadly involves:

- ✓ Sale of equity by vendor and purchase of same equity by a BEE entity;
- ✓ A third party provides financing for purchase of the equity. Security for funding will be by way of a sale of the shares on capital appreciation of the shares or a guarantee by the vendor.
- ✓ Redemption of the loan (capital and interest + margin) depends on the dividend income due to the BEE entity; The dividend is firstly applied to the loan prior to being paid as income to the BEE shareholder;
- ✓ Ownership vests in the BEE entity after repayment of outstanding finances (up to five years);
- ✓ Risk is skewed towards the financiers (unless the BEE entity has been placed on risk) and hence the rewards will flow to the financiers first. The reward is in the form of the dividend streams (where a company declares dividends);

### **Pros and Cons**

- ✓ Assumption that the dividend yield is higher than the cost of funds – biggest risk – it is usually not;
- ✓ Cheap funding is scarce;
- ✓ Loan repayments are dependent on valuation of the equity (even more difficult with unlisted companies);
- ✓ Distribution of risk skewed towards vendor and financier – BEE entity not exposed;
- ✓ BEE entity distant from cashflows;
- ✓ May take long for BEE entity to start participating in the economic benefits.

## Impact of a Royalty (level and type)

- ✓ The Royalty is charged on gross sales revenue (NSR), thus reducing the amount of revenue that can be applied to costs related to operating and growing the business. Although the Royalty can be expensed against tax, the impact still leaves a company in a negative revenue position. This reduced revenue generation will influence dividend policy (reduce dividend payment to the extent that the reduction in revenue (earnings) impacts on the growth potential of the company), which will in turn impact on the ability of HDSA's to finance potential transactions;
- ✓ The higher the level of the Royalty rate, the greater the impact on the ability to finance potential BEE transactions;
- ✓ Where the Royalty is based on the profit achieved (NPI), the impact will be less severe. The company will have accounted for expenses generated in operating and growing the company; However, the level of Royalty may still have a severe impact on earnings;
- ✓ Positive motivation to grow revenues is maintained (is it possible that Companies will increase revenues in order to remain at the same levels after deducting the Royalty);
- ✓ Example – IDC and Simane Investments transaction (timing is important)

## b. Project participation mechanisms

Where Empowerment is embarked on with a new mining development (if it goes ahead, depending on the impact of the Royalty regime), the financing structure is as follows: -

- ✓ Project owner invites a BEE entity to participate. However, the entity must seek financing to contribute to the development of the project;
- ✓ Third party financing is injected into the project on behalf of the BEE entity;
- ✓ Cashflows generated from the project are applied firstly to paying the loan (capital and interest + margin);
- ✓ Security for the funds injected on behalf of the BEE entity is either a guarantee from the incumbent or cession of rights in the project;
- ✓ Excess cashflows are then paid to the empowerment entity;
- ✓ Example: -
  - Harmony Gold Mining and African Vanguard in the Doornfontein project in Randfontein;
  - African Rainbow Minerals and Anglo Platinum in the Maandagshoek platinum mine.

## Pros and Cons

- ✓ Levels of cashflows are usually much higher than the cost of funding – therefore it is much easier/cleaner/simpler to facilitate empowerment in this manner compared to equity transactions;
- ✓ The BEE entity is much closer to cashflows and has the ability to influence policy (when ownership has vested). Project funding is much easier to facilitate;

- ✓ There is the potential to participate in the economic benefits much sooner – the relatively higher cashflows (compared to dividend income) allow for early redemption of debt;

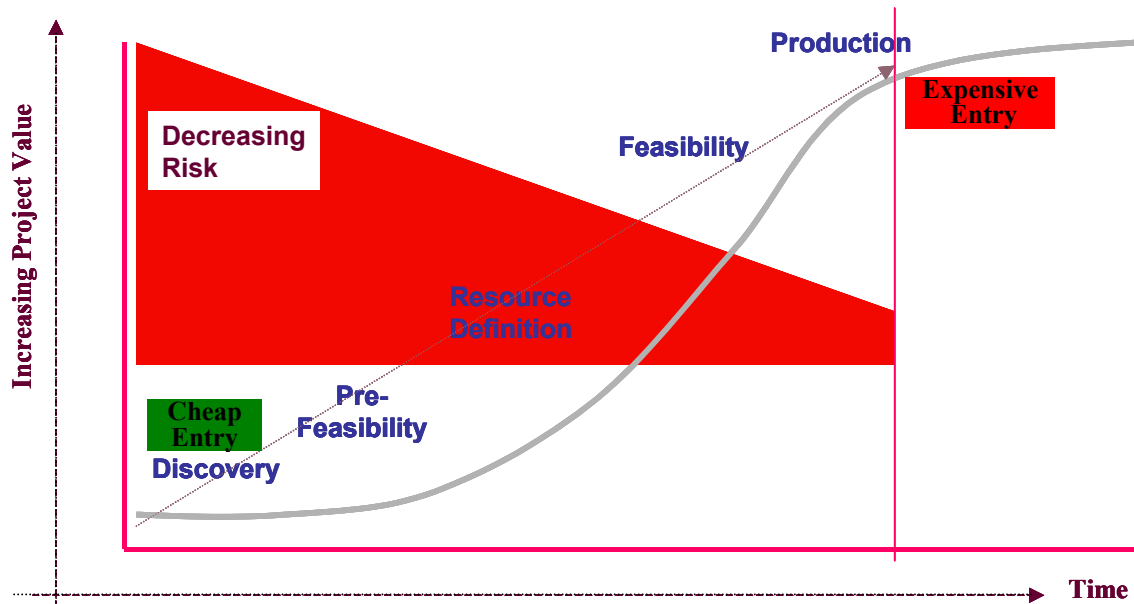
#### Impact of a Royalty (level and type)

- ✓ The type of Royalty, NSR or NPI, will have similar consequences to the equity mechanism;
- ✓ In addition to the above, the level of Royalty will impact firstly on the decision to proceed with a new mining investment. Immediately, potential participation by HDSA's is eliminated, at worst, or delayed by a few more years, at best.
- ✓ Where a project does proceed, the Royalty will have the impact of reducing expected returns from the project. A new mining development demands much higher returns as a result of the high risk being undertaken (graph 1 – changing risk profile);
- ✓ Royalty impacts on the possibility of generating cashflows in excess to the required rate of return of the project, resulting in longer periods for project paybacks;
- ✓ The impact on BEE is that its share in the economic benefits is further back-ended;

In summary, the potential impact on the transformation process is:

- ✓ Potential to dilute the objectives of the Charter;
- ✓ Potential to alleviate, if not eliminate, opportunities for HDSA's to participate in the economic development opportunities arising from the industry (which opportunities and efforts have already begun);
- ✓ Delay participation in the economic benefits of new project developments: -
  - BEE will not earn unless the project or vendors obtain a threshold return. The longer it takes to achieve this threshold return, the longer it takes for empowerment to share in the benefits;
  - Frustrate Empowerment objectives – empowerment consortium are structured in the manner that they are for specific reasons. Each constituency (women's group, professionals, community group(s), to name a few) has a specific objective it wishes to fulfil by participating in the transaction.

**Graph 1**



Source: New Africa Mining Fund

The above graph illustrates the relationship between risk and return when investing in mining projects. The risks are high initially, requiring substantial equity investment. Entry into the project (for additional investors, including BEE) is cheap. However, as the certainty of cashflows becomes confirmed when the project migrates towards production, entry into the project becomes more expensive. Expected equity returns are also increasing in order to compensate for the risks endured during the early stages of the project. In addition, timing with respect to development and entry is also important. This timing is largely a function of the market (commodity prices), which will influence the progress on the project and the likelihood of a BEE entity participating in the project.

Therefore the potential impact of the Royalty Bill on the transformation process must be considered and accounted for prior to the implementation of the Bill.

Although the Bill envisages exemption from a royalty under the circumstances where the achievement of the targets set in the Mining Charter are threatened, the application of this exemption remains uncertain:

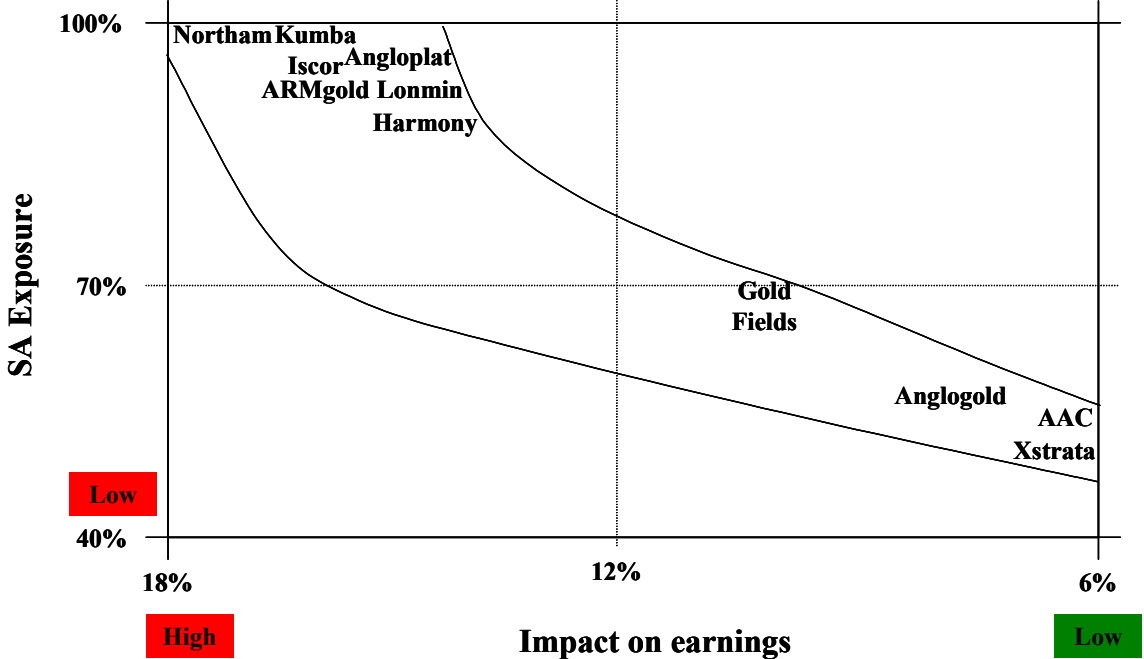
- ✓ The turnaround time for response; and
- ✓ The duration of the exemption.

### **3. RATIONALE FOR DIVERSIFICATION**

The argument for the potential impact of the Royalty Bill on the transformation process can be further demonstrated by studying the impact on earnings of mineral extractors with South African exposure. Mineral extractors with the least exposure to South Africa (ca 45 to 55% exposure) have will be impacted the least (6 – 7%) in terms of their forecast earnings in the next year or two. However, high SA exposure

(100% and pure-play) on the part of other mineral extractors could have a negative impact of up to 30% (graph 2).

**Graph 2: Case for Diversification**



Source: HSBC Securities

The above graph has implications:

- ✓ Companies that are least diversified geographically have had the least impact on their forecast earnings; geographical diversification is pursued not only to minimise technical risk, but also to minimise sovereign risk. The Royalty Bill is supporting this geographical diversification strategy, which will lead to reduced inward investment in new mineral development projects by South African mineral extractors;
- ✓ Potential inward-bound investment in new mineral projects by offshore investors is likely to be re-considered (Xstrata comes to mind following its acquisition of MIM in Australia);
- ✓ Diversification is a normal and accepted business decision, but we have to make it work for us not against us.

This potential and actual loss of investment in new projects in South Africa certainly has the ability to alleviate the progress, to date and anticipated, on transforming the ownership patterns in the mineral extraction sector.

#### 4. Conclusion

- ✓ It unlikely that the mineral sector will not have to incur Royalties. The ideal situation would be that no royalty is paid at all and this situation is strongly recommended in the context of current and future investment incentive packages compared to total tax packages – a long term perspective (impact should be considered);
- ✓ We believe that the resulting impact on the transformation process has been clearly demonstrated. Empowerment is not independent of the capital and skills hosted by the incumbent and potential investors into the mineral sector. Without this investment, we cannot expect to transform the sector to the extent that we have envisioned;
- ✓ It is important to consider the impact of the Royalty Bill in the context of the total funding requirements for impending empowerment transactions both within the mineral sector and other sectors. During this competition for funding, it is important that mining projects are attractive to potential funders. The royalty has a potential to render the mineral sector as runners up for potential investments. Being chosen as a winner is important because of the impact that mining has on the economy e.g. multiplier effect in the economy where 1 job in the industry results in four other jobs in associated industries and that 1 employed worker on the mines has an impact on ten other people in unrelated functions.

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