HELEN SUZMAN FOUNDATION

**Submission on the Draft Broad-Based Socio-Economic Empowerment Charter for the Mining and Minerals Industry, 2018**

**24 August 2018**

## Executive Summary

The Helen Suzman Foundation believes that in order to achieve the objectives of the Draft Mining Charter, especially to broaden black ownership and employment in the mining sector, the focus needs to be redirected at making use of a company tax and profit-based royalty system so as to address government requirements and at the same time to develop an efficiently run, sensibly regulated and growing mining industry. Company tax and redefined profit-based royalties would be sufficient by themselves to yield the maximum sustainable long-term yield for the Government's fiscal and social goals, while at the same time meeting the returns required for renewed capital investment and growing investor participation.

As it stands, however, the Draft Mining Charter's approach of increasing BEE ownership requirements without regard to the financial health of the industry, will often simply worsen the sector's financial constraints. In addition, it will not only not encourage further investment, but will actively discourage it, as investors will feel they cannot rely on the predictability and reliability of the regulatory regime.

In particular, the Draft Mining Charter does not take into account the following:

- the high risk and capital-intensive nature of the mining industry, which is mostly subject to international commodity prices, coupled with exchange rate volatility, and which is not able to increase prices in order to fund BEE-requirements; and
- the fact that optimal taxation (including profit-based royalties) of the mining industry will, over the longer term, increase government revenue and the resources available for BEE entrepreneurs, workers and communities.

Whilst it is accepted that the Draft Mining Charter has been prepared with the best of intentions, it unfortunately adds to the effective cost of mining in South Africa, without providing the incentives to invest and to continue operating businesses in a sector which is not only technically difficult but which requires large investments to fund projects that take many years to complete.

A radical change of approach by the Government is needed: growth in mining needs to be supported in order to move beyond the present stagnation. Government will be able to rely on profit-based royalties and taxes which will flow in a favourable economic climate. A longer term and more strategic view therefore has to be taken, rather than the short-term approach contained in the Draft Mining Charter. The current approach has the effect of placing additional burdens on the mining sector in the bad economic times, which will not only prevent companies from making the necessary investments to blossom in the good times, but will also scare away new investors. The net effect is that the mining sector will not obtain the funding that is required not only for its growth, but for its survival.

The Government's desire to broaden black ownership and employment in the mining industry is commendable in the context of South Africa's history. The HSF supports this policy. However, the HSF disagrees with the manner in which the Draft Mining Charter attempts to implement Government policy, in a way which acts as a disincentive to an industry and its shareholders. If enacted in its present form, it will damage the prospects of mining in South Africa.

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> "A man and his wife had the good fortune to possess a goose which laid a golden egg every day. Lucky though they were, they soon began to think they were not getting rich fast enough, and, imagining the bird must be made of gold inside, they decided to kill it in order to secure the whole store of precious metal at once. But when they cut it open they found it was just like any other goose. Thus, they neither got rich all at once, as they had hoped, nor enjoyed any longer the daily addition to their wealth."
>
> - *Aesop's Fables*, a translation by Vernon Jones, 1912.

## 1. Introduction

This submission is made in response to the Draft Broad-Based Socio-Economic Empowerment Charter for the Mining and Minerals Industry, 2018 ("**the Draft Mining Charter**") which was published on 15 June 2018 for public comment.

The Helen Suzman Foundation ("**HSF**"), as a non-governmental organisation, aims to promote constitutional democracy in South Africa, with a focus on good governance, transparency and accountability. It has a long history of active participation in a variety of public interest areas in South Africa.

The HSF views the wellbeing of the mining industry and all its participants as crucial for South Africa, within a wider social, economic and political context. State regulation plays a central role in the mining industry, and for this reason, the HSF has prepared this submission in response to the Draft Mining Charter.

The Draft Mining Charter's stated objectives include the deracialising of ownership of the mining industry by redressing the imbalances of past injustices, the expansion of opportunities for black persons to enter the mining industry and the enhancement of the social and economic welfare of mine communities and major labour sending areas in order to achieve social cohesion.

We support these aims, but we argue below that the Draft Charter fails to achieve a reasonable balance between private interest and social objectives. If implemented in its current form, it will have a detrimental effect on both. It is logical that the profits of the mining industry cannot be shared if there are no profits in the first place.

This submission firstly sketches a picture of the mining industry, highlighting essential factors that may induce or deter investment in the industry. The gold mining industry is referred to in some detail, as an illustrative example of the challenges that are faced by the industry. This is followed by a discussion on global perceptions of the attractiveness of investing in mining in South Africa. BEE in mining will be considered, with reference to questions such as: what effect will the Draft Mining Charter's requirements for an increase in BEE shareholding have on the industry? Are there unintended consequences that may work to the detriment of black shareholders? How are mining communities to be affected? Will the concept of "trickle dividends" be an effective mechanism in broadening economic participation in the industry? The submission's conclusion sets out what the HSF believes is the optimal approach to achieve the Draft Mining Charter's aims in a sustainable manner.

## 2. Key features of South African mining

The South African mining industry plays a major role in the South African economy. In 2017, it constituted 6.8% of the economy, contributing R312bn to GDP. It exported R307 billion worth of produce in 2017, representing 27% of the country's exports. 464 667 persons were employed in the industry in 2017.[1] Based on the estimate that every employee supports between 5 and 10 dependants, the industry supports around 4.5 million people.[2] This underscores the significance of the mining industry in the social and economic fortune of the country.

Mining is risky, not just from a technical perspective. The financial risks are substantial and the amounts which mining projects require for development are considerable. South African mining is hugely dependent on USD-denominated commodity prices, set in international markets, and on the USD/ZAR exchange rate (there are some exceptions, such as coal companies that sell locally to ESKOM). As price takers, mining ventures are unable to increase their selling prices to address unexpected additional expenses, such as those arising from the Draft Mining Charter. The mining industry globally is vulnerable to the commodity cycle. Revenues may fluctuate substantially from year to year, and periods of substantial profit may be followed by periods of financial break-even or losses.

Large mining projects require investments of billions of Rand and take many years to reach completion - this is especially so in deep-level mining ventures in South Africa. As a result, mining companies and their shareholders need confidence that the regulatory regime will not change at short notice in a manner that affects them in an unforeseen and adverse manner. Governments which enact such changes will damage their reputations, finding it harder to attract new capital into the mining industry. Persons investing in mining companies require a return on their investment which is large enough to compensate them for the perceived risk which is inherent in the industry. Any additional regulatory risk will simply increase the returns that are required, which may lead to a decision not to invest, as the required returns are not seen as being achievable.

Many South African mining companies are currently in a loss-making situation and placing additional financial burdens on these companies will endanger their survival. It is common knowledge that approximately 60% of the platinum industry is making losses, as is the case with at least half of the gold mines in South Africa[3]. The South African mining industry has become smaller and less profitable, becoming less able to shoulder the burden of additional regulatory measures that have financial implications.

Figures 1 to 3 which are set out below, provide detail on the recent development of important aspects of the mining sector, relating to output, prices and profitability.[4]

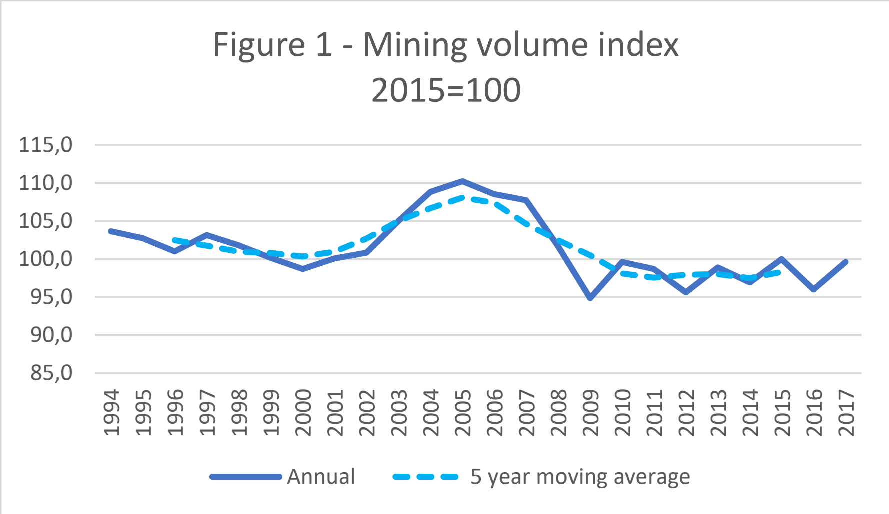
Figure 1 displays the index of the volume of mining and quarrying output between 1994 and 2017. It shows that the volume of output has decreased, after reaching a peak in 2005.

[1] Statistics taken from the *Mine SA 2017 Facts and Figures Pocketbook*, published by the Minerals Council of South Africa.

[2] *Mine SA 2016 Facts and Figures Pocketbook.*

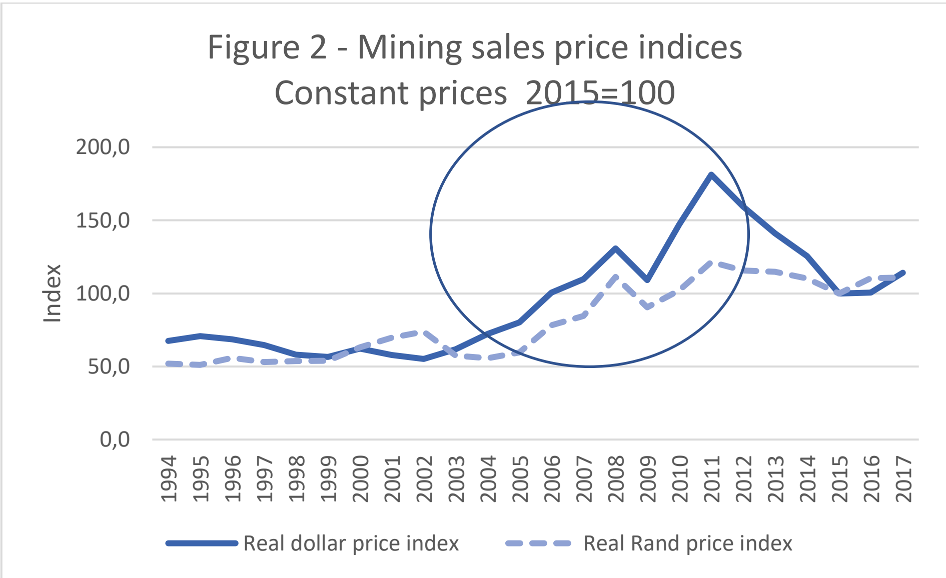
[3] https://www.businesslive.co.za/bd/companies/mining/2018-07-11-minerals-council-says-75-of-sas-gold-mines-unprofitable/

[4] All data are taken from Statistics South Africa, *Mining Production and Sales* (Statistical Release P2041) and *Quarterly Financial Statistics* (Statistical Release P0044), various years

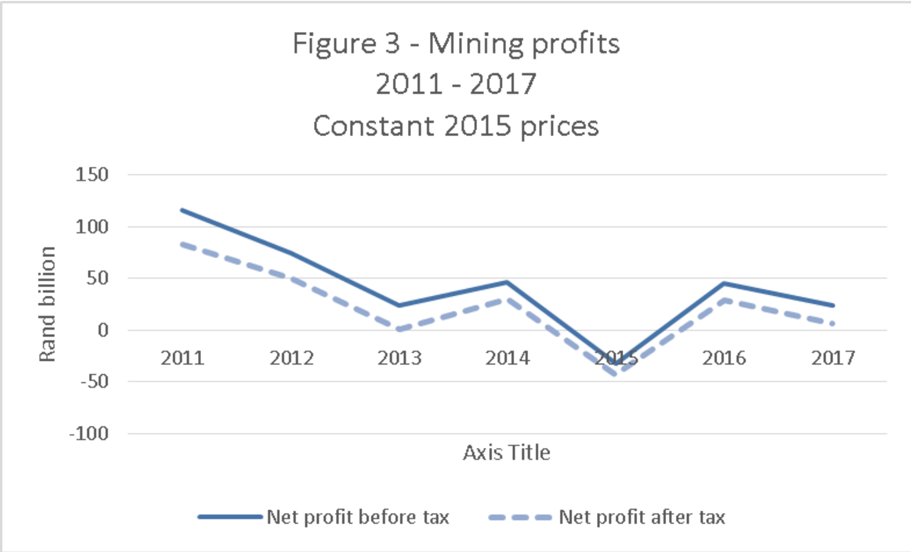



The output response to the commodity super cycle of high dollar prices between 2003 (when they started to rise), and 2011 (when the price index peaked (see Figure 2)), was relatively limited. Since 2011 the volume of production has been slightly lower on average than it was between 1994 and 2002.

The price indices of South African minerals sales in real US Dollars and real Rand are shown in Figure 2. Note that the Rand price index did not rise as far as the US Dollar price index during the commodity super cycle (ringed in Figure 2), since the Rand appreciated against the US Dollar during that period. Similarly, the effect of falling dollar prices was softened by Rand depreciation after 2011. Between 2011 and 2017, the real Rand index fell by 8.8%.



Between 2011 and 2017 (the life of the second Mining Charter), the value of aggregate income in current prices rose by 5.1% per year on average, whereas the value of aggregate expenditure rose by 8.1% per year. The result has been a squeeze on net profit before tax, as Figure 3 shows.




The most striking decrease in output was experienced in South Africa's gold industry, where production shrunk by 70% and employment by 69% during the 20-year period 1995 to 2014:[5]

| | Production (tons) | Number of Employees |
|---|---|---|
| 1995 | 524 tons | 380 086 |
| 2014 | 152 tons | 118 939 |
| | | |

The Minerals Council estimates the current employment in the South African gold industry to amount to approximately 120 000.[6] South Africa was the leading gold producer until the early 2000s, but has now slipped to 8$^{th}$ place in the world.[7]

One of the important issues relating to the South African gold industry is the fact that its costs are substantially higher than its global competitors. This is mainly due to the deep-level nature of most South African gold mines and the resulting dependence on a large work force.

[5] Statistics South Africa, *Environmental Economic Accounts Compendium*, March 2017
[6] http://www.mineralscouncil.org.za/sa-mining/gold
[7] GFMS Gold Survey 2018

The following table shows a global comparison of gold mining costs:[8]

| Gold - Global Cost of Production (USD/oz) | | | |
|---|---|---|---|
| | | 2016 | 2017 |
| North America | Total cash costs | 639 | 651 |
| | All-in sustaining costs | 804 | 843 |
| South America | Total cash costs | 588 | 618 |
| | All-in sustaining costs | 777 | 825 |
| USA | Total cash costs | 598 | 591 |
| | All-in sustaining costs | 732 | 751 |
| Australia | Total cash costs | 662 | 662 |
| | All-in sustaining costs | 840 | 857 |
| South Africa | Total cash costs | 857 | 1 010 |
| | All-in sustaining costs | 1 031 | 1 187 |
| Other | Total cash costs | 613 | 622 |
| | All-in sustaining costs | 820 | 846 |
| World | Total cash costs | 649 | 672 |
| | All-in sustaining costs | 837 | 878 |

Note: total cash costs denote operational costs, whereas all-in sustaining costs also include capital expenditure required to sustain existing production.

The gold sector has been dealt with in some detail above, in order to show what difficulties a major portion of the mining industry has had to contend with. In order to assist the mining sector, Government needs to adopt a policy that will support it in difficult times, but which will pay dividends to both Government and the sector's shareholders in better times. This presents a very relevant point of departure for this submission's comments on the Draft Mining Charter and its approach to the mining industry in general.

Against this background, our criticism of the draft Mining Charter has two main components:

A. It increases, rather than shares, the risk facing investors. Appropriations in the form of taxation and allocations to social goals are insufficiently sensitive to mining company profitability and cash flow.
B. The mining industry is currently simply not in a position to sustain all the additional requirements of the Draft Mining Charter. The consequence of this will be less interest in investing in mines or new mining projects in South Africa.

A substantial change in approach to the Draft Mining Charter is needed. We shall propose one, after pointing out the difficulties with the current draft in more detail.

## 3. The attractiveness of investing in South Africa's mining industry

It is important to consider South Africa's mining industry through the eyes of potential investors. The Fraser Institute's Survey of Mining Companies is a well-known independent research report, based on an international survey, which is often referred to in comparative analyses of the attractiveness of individual countries for mining investment. Its findings on South Africa are also

[8] GFMS Gold Survey 2018

referred to, for example, in the National Treasury's 2018 Budget Review, under the heading "Policy uncertainty hinders investment in the mining sector".[9]

The Fraser Institute's latest survey, published in February 2018, makes the following findings regarding South Africa:[10]

- In the table reflecting the attractiveness of official mining policy ("the Policy Perception Index"), South Africa is placed at position 81 out of a total of 91 countries. Out of 15 African countries in the table, only the Democratic Republic of Congo and Zimbabwe have a lower score than South Africa;
- In contrast, in the table reflecting mineral potential, assuming policies are based on "best practices", ("the Best Practices Mineral Potential Index"), South Africa appears in place 21 out of 91 countries. Only Ghana and the Democratic Republic of Congo score more highly in Africa; and
- In the resulting composite "Investment Attractiveness Index", which gives a 40% weighting to the Policy Perception Index and a 60% weighting to the Best Practices Mineral Potential Index, South Africa is at place 48 out of 91 countries. In Africa, three countries are placed higher than South Africa in this composite index: Botswana, Ghana and Mali.

The Fraser Institute's ranking effectively means that South Africa is internationally perceived to have first class mineral potential, but this potential is undermined by a very negative view of Government's mining policy. The Draft Mining Charter, with its changed goal posts, will simply confirm this perception, if enacted in its current form.

A continuing perception of this nature will have a negative effect on investment in the mining sector in South Africa. Investors want to feel that official mining policies are consistent and predictable for years to come. If they do not have this perception, they may well decide not to invest. It should be kept in mind that substantial mining projects take many years to develop and consume large amounts of capital. A typical deep-level underground shaft complex can take up to ten years to develop and cost in excess of R10 billion, with a subsequent economic pay-back of five to ten years. Shareholders who are faced with such investment decisions will be averse to invest in the presence of uncertain or unattractive mining policies and an inappropriate risk/return proposition.

As a result of the effective globalisation of many industries over the past few decades, investment decisions in general are no longer based solely on conditions in host country financial markets. This is especially true of the mining sector and in comparing potential future investments, foreign opportunities are now considered in the process as a matter of course. Mining companies and investors will decide on opportunities which are the most attractive and if national options are less attractive than foreign ones, then foreign opportunities will be favoured by foreign and domestic investors alike. If the perception continues that regulatory policies in South Africa are not investor-friendly, it will inevitably play a negative role in investment decisions where a choice between local and foreign business opportunities has to be made. The risk is therefore not just that foreign investors will choose not to invest in South Africa, but also that local capital will be moved elsewhere.

[9] http://www.treasury.gov.za/documents/national%20budget/2018/review/FullBR.pdf - on page 23.
[10] https://www.fraserinstitute.org/studies/annual-survey-of-mining-companies-2017

The increasingly global perspective of South African mining companies is illustrated by the fact that many have expanded outside of South Africa, for a variety of reasons. An example of the extent to which some traditionally major South African companies have moved their operations abroad (for whatever reasons), is illustrated by AngloGold Ashanti, which currently retains only one underground mine and two surface tailings dump-retreatment businesses in South Africa: this represents 13% of the company's total annual production from its global operations.[11]

The degree to which decisions to move elsewhere are based on South Africa's regulatory policies is difficult to gauge, as South African companies will be careful not to blame regulatory policies for their decisions, if they still retain operations in the country. Very few out-of-the-ordinary mining projects are likely to be so profitable that they are able to carry all kinds of extra financial burdens which are imposed through regulatory action. But it will be companies who are not substantially profitable or close to break-even that are going to be hardest hit by the new provisions, which will not only hurt their cash flows, but further damage the preparedness of investors to continue supporting them.

In the absence of continued investment by the private sector, the South African mining sector will continue to stagnate, with associated effects on the economy generally and in particular, on employment. If the private sector does not continue to invest in the mining industry, the State would not be able to fill the gap, given its existing fiscal constraints.

It is important to be aware of the fact that the domestic availability of mining capital is limited in South Africa. Large capital-intensive projects in the mining industry are to a large degree dependent on foreign capital. The risk/return proposition for foreign investors has to compensate them for both sovereign and operational risk. In this regard, investors are generally rational and mostly indifferent in principle to the jurisdiction in which they invest, subject to an acceptable risk/return proposition. If the risk profile of a particular jurisdiction increases, relative to others, then the attractiveness of that jurisdiction decreases and its investment return requirements would increase to make up for the increase in risk.

In order to obtain an impression of the risk/return requirements in the global mining investment market, we can refer to a recent PWC analysis of the world's 40 largest listed mining companies by market capitalisation.[12] This study finds that the return on equity in these companies amounted to 11% in 2017. It also found that the return on capital employed of 8% in 2017 is well below the 15-year average of 12 % (these returns are expressed in USD terms - in Rand terms, this percentage would increase by approximately 3%, after taking the inflation differential into account). The message that this substantial return on equity and capital employed sends is that given the risks, mining investment requires a return on this level, in order to avoid the funds being invested in sectors that are perceived to have a better risk/return relationship.

In a 2017 study on the dividend returns which shareholders have received from South African mining companies, it was found that "the average distributions to shareholders over the last 10 years as a percentage of market capitalisation and total assets have merely been 3.1% and 3.4% respectively. … These low yields can be earned on a risk-free basis by investing in government bonds with much higher returns."[13]

[11] https://www.anglogoldashanti.com/southern-africa/
[12] *Mine 2018*, PWC
[13] *SA Mine: 9th Edition* – PWC September 2017

As far as capital gains from an appreciation in the share value of South African resource companies is concerned, the JSE/FTSE Resource 20 index has gained 16% over the more than 8-year period since 1 March 2009 (which was the low point of the 2008/2009 slump following the global financial crisis). This compares to the JSE Top 40 Companies index gaining 203% over the same period, which shows that the market as a whole was relatively buoyant.

The performance of mining shares on the JSE is not out of keeping with global markets: the S&P/TSX Global Mining Index[14] shows an appreciation in share price of 15% over the same period, compared to the general S&P 500 Index[15] gaining 293%. However, the Australian mining index rose by 36% over this period.[16]

These statistics show that the stock market performance of mining shares has, in general, been muted in comparison to other sectors over the last decade. The logical deduction is that the sector has experienced difficulty in attracting capital on a worldwide basis. Especially in these circumstances, a more active stance by the South African authorities in supporting the industry would have been welcome. However, the measures envisaged in the Draft Mining Charter, in increasing financial burdens for shareholders, can only further raise the reticence of potential investors in the South African resources sector.

## 4. Moving the goal posts: increasing black ownership of existing mining rights

Existing mining right holders who are compliant with a 26% BEE shareholding, are recognised in the Draft Mining Charter as being compliant. However, the Draft Mining Charter requires them to increase the shareholding to a minimum of 30% within five years. This increase is therefore to be applied to companies who were under the impression that they had complied with the BEE requirements of the Mining Charter of 2004.

The authors of the Draft Mining Charter do not seem to appreciate the fact that investors or companies who have to make decisions on large mining projects which require considerable sums and take years to complete, take many criteria into account when they make their investment decisions. One important criterion is the certainty and attractiveness of the regulatory regime which is in place. If this regime becomes more onerous, it may affect not only the economic viability of projects under development and existing mines, but also the overall investor perception. Investor confidence will be affected not only by changes that are seen as more burdensome, but also by creating the perception that further changes may be expected on a regular basis. Key criteria for investors are the reliability and predictability of the regulatory regime. If investors do not have confidence in this respect, it is obvious that it will influence future investing decisions in a negative manner.

This is a classic example of how "moving the goalposts" can have a destructive consequence. It is not only from an outside investment perspective that this aspect is relevant, but also from an internal company perspective. Companies who thought they were compliant would now have to devote financial and other resources to addressing unexpected new requirements.

[14] This includes mining securities listed on the TSX, NYSE and NASDAQ with market capitalisation of more than USD300 million.
[15] This reflects the value of large-cap US shares.
[16] S&P/ASX 300 Metals and Mining (expressed in Australian Dollars).

For these reasons, the increase in the requisite BEE-shareholding from 26% to 30% in the case of existing mining rights should be discarded.

The Draft Mining Charter does not deal with a renewal of mining rights in the same way. It treats a renewal in the same manner as an application for new mining rights (which is dealt with in more detail below). It is not clear why a renewal of mining rights is not dealt with in the same manner as a company which is currently compliant, where the validity of its 26% BEE shareholding is recognised, described as a "continuing consequence".

## 5. BEE in relation to new mining rights

On the other hand, the objection of moving the goal posts does not apply to the requirement of a 30% BEE shareholding for new mining rights, as changes are not being made to existing rights. The issue here is rather how many applications for new mining rights there will be, given the conditions attached to them and their relative attractiveness, compared to other mining jurisdictions.

In respect of new mining rights, the Draft Mining Charter stipulates that of the requisite 30% BEE ownership, each of employees and host communities are to hold 8% (thus 16% in total), with 5% of each of these tranches to be in the form of a free carried interest (amounting to a total of 10%). This effectively means that 10% of any mining company's shareholding must be transferred, at no cost, to employees and host communities (this is tantamount to expropriation without compensation). The remainder of 14% (out of the total 30% BEE ownership) is to be held by BEE entrepreneurs[17], as it is phrased in the document. It is further not clear from the Draft Mining Charter why this latter 14% has to be held by "BEE entrepreneurs", as opposed to communities or employees.

If we analyse what is now being proposed, it effectively boils down to the following: 10% of the equity in a mining company has to be transferred for free to employees and mining communities, i.e. at the cost of the current owner/s of the company's share capital. The current owners will now own only 90% of the shares. In addition to the 10% free carry, a further 20% has to be held by a combination of BEE entrepreneurs, employees and mining communities. These categories of new share owners will often not have the funds available to purchase their shares and the mining company will therefore have to finance the acquisition of its own shares by these categories of new shareholders (through what is known as vendor-financing).

Banks no longer have the appetite to finance such transactions, as experience has shown that the interest they would charge for lending the required funds, will not be covered by the dividends received by the new share owners. In years of exceptional profit, dividends may be sufficient for this purpose, but not in general. New share owners without other assets to finance the purchase of their shares are therefore completely dependent on funding by the company or third parties. Under the circumstances, the shares which are provided for the BEE shareholding are often made available at a discount, to make their purchase *via* dividends affordable. In such circumstances, mining companies not only have to finance the sale, but also receive less money for the issuing of the shares.

[17] "BEE Entrepreneur**"** refers to Black enterprises that are at least 51% owned by black persons in which Black persons hold at least 51% of exercisable voting rights and 51% of economic interest, or an organ of State excluding mandated investments

To the extent that vendor-financing is used to fund the BEE interest, it imposes costs on the existing shareholders and therefore adds a negative element in weighing up a potential mining investment in South Africa against elsewhere in the world.

In addition, it is not clear whether another consequence of the 30% BEE ownership requirement is appreciated by the Draft Mining Charter. A rights issue may be required to supplement a company's funding in order to start a new project or to deal with the negative effects of a downturn in the commodity cycle. BEE owners will, in most cases, be unable to participate. This places the funding burden on the remaining 70% of shareholders, thereby increasing the cost of capital of these majority shareholders and reducing the attractiveness of the investment jurisdiction.

## 6. How can BEE entities be expected to invest in a company that is loss-making or has no prospects?

An underlying assumption in the Draft Charter is that, in requiring a certain level of BEE ownership, the BEE entities in question will benefit as a consequence of being shareholders.

As has already been pointed out, many South African mining companies are currently loss-making or at break-even level and, additionally, many do not have good financial prospects. This would be so especially for those producers whose costs of production are relatively high on a global comparison and who will not survive if the relevant commodity prices go down below current levels in a down-cycle. It is a normal phenomenon in a market-driven economic system that some companies thrive or at least survive, whilst others are liquidated since they are unable to generate sufficient revenue to cover their costs. The Draft Mining Charter places a blanket requirement on the sector as a whole as far as BEE shareholding is concerned, and makes no distinction in regard to profitability, which has a clear adverse effect on companies that are already struggling financially.

The question that should be asked is: how can the Draft Mining Charter expect that BEE entities will be prepared to purchase shares in companies that are in financial difficulties or have no or little prospects to become or remain financially successful? This question arises irrespective of whether BEE entities are funded by their own resources or vendor-financed, since they will end up in a position where there may be a cost for them to exit from a company that is in liquidation, together with potential legal complications.

The Draft Mining Charter therefore expects BEE entities to become shareholders even where it may be to their financial detriment. This cannot be the intention of Government and has to be reviewed, to avoid BEE entities suffering not only potentially serious financial losses, but also considerable reputational damage.

## 7. BEE requirements for prospecting rights damage the junior mining sector

The Draft Mining Charter states that it also applies to prospecting rights. The essential problem here is, once again, one of not taking into account the financial realities of prospecting companies. Mining prospecting is a very high risk activity, since the likelihood of finding an economically viable deposit is extremely low - but mining prospecting requires substantial financial outlays to fund its activities of drilling, sampling, geological modelling etc., with no foreseeable cash flow for many years. It is a typical example of the "high risk, high reward" investment type.

Given the high risk, big capital requirements and the absence of cash flow, how can it be expected that the owners of such a company should give up 30% of their company to an entity that is not able to contribute to the company's funding? It is also not clear from the wording of *Chapter 6: Applicability of the Mining Charter*, whether the 10% free carry and "trickle dividends" requirements apply to exploration rights. If they do, how can an exploration company be expected to fulfil these requirements when it has no operations and therefore no cash flow?

A better policy would be to exclude such exploration companies from BEE requirements. If the exploration reveals a resource whose exploitation does turn out to be economically viable, BEE requirements could then be met when a mining right is issued. Otherwise, there is no incentive to conduct exploration activities in South Africa (unless it is done by a large company with existing operations). The Draft Mining Charter provides that Junior Miners (a concept which is not defined) may make representations to the Minister regarding the extent to which the Mining Charter elements shall apply. However, it would be preferable to provide clarity to this part of the mining sector up front, as there is no indication as to what the Minister may find acceptable.

Against this background, it is no wonder that exploration spending is so low in South Africa. In 2017, global exploration expenditure amounted to USD7.95bn. Africa attracted 14% of this amount, with Southern Africa only 2%.[18]

> "Data produced by S&P Global Market Intelligence illustrates the extent of the decline in South Africa's exploration sector. The country's share of the African exploration budget has fallen from 35.7% in 2002 - 2003 to just 8.3% in 2017 whilst budgets set aside for exploration has fallen similarly drastically: down to R87.1m today from R404m in 2007 which broadly approximates to the apex of the commodity super-cycle."[19]

The fact that so little is spent in South Africa on mineral exploration in spite of its recognised exploration potential, needs to be countered rather than being exacerbated by the Draft Charter's proposals on exploration companies.

## 8. Greater emphasis on mining communities

Whilst it is commendable that the interests of mining communities are increasingly being put in the foreground, the question needs to be asked about the degree to which mining companies are expected to assume the obligations of local authorities and municipalities, in order to address the infrastructure and service requirements of communities. This is especially relevant as there is widespread underspending by municipalities on a national scale (R53 billion over the year to June 2017).[20] Are mining companies being expected to make up for the lack of effort or competence of local municipalities? No other sector has similar onerous social and financial responsibilities and the mining sector competes with those other sectors in the economy for capital.

[18] *World Exploration Trends*, S & P Global Market Intelligence, March 2018.
[19] http://www.miningmx.com/news/markets/33022-miller-hoping-mining-expansion-can-attract-monied-investors/ 28 May 2018
[20] https://www.businesslive.co.za/bd/national/2018-02-05-malusi-gigaba-warns-on-councils-underspent-budgets/

If we consider that an estimated R7.5 billion in royalties was collected by the State in the tax year 2017/18 in terms of the Mineral and Petroleum Resources Royalty Act of 2008,[21] should a mechanism not be devised whereby at least a portion of that amount is made available for the needs of mining communities?

A further question also needs to be raised in this context: experience has shown that the management of funding arrangements for local communities (often in the nature of a trust) has been plagued by incompetence, corruption and internal conflict, often resulting in greater conflict not only between the community and the mine, but also with other communities.

A mechanism to ensure a greater degree of transparency and control needs to be considered and a continued role in such a mechanism for local mining companies may be appropriate. Attention also needs to be focused on how representatives of local communities are chosen, to ensure that they are regarded as properly mandated representatives.

We submit that it better serves the interests of communities, the mining industry and democracy in the wider sense, for local municipalities to meet their constitutional responsibility to provide infrastructure and services to people within their jurisdictions, as determined in Section 152 of the Constitution. Rather than placing additional burdens on mining companies in this respect, the focus should be on supporting municipalities to fulfil their constitutionally assigned role.

## 9. The inappropriate basis for calculating "trickle dividends"

The Draft Mining Charter requires a mining company to pay a "trickle dividend" of 1% of its earnings from the sixth year onwards to employees and host communities, if no dividends are declared.

The Draft Mining Charter uses the criterion of EBITDA for calculating the "trickle dividend", i.e. earnings before interest, tax, depreciation and amortisation. Expressed in everyday language, EBITDA means a company's operating profit, without taking account of its cost of finance, the tax it pays and the estimated the cost of the acquisition of assets (which is progressively depreciated on an annual basis over the expected useful life of the asset). Whilst EBITDA may have its uses in specific circumstances, it can be extremely deceptive when it comes to looking at the financial health of a mining company, in not taking into account critical costs relating to finance, taxes and capital. Mining companies often have substantial debt (and therefore associated financing costs), together with very significant capital expenditure commitments.

To take an example, Lonmin's 2017 financial statements show EBITDA of USD 40 million. However, if we analyse the actual cash movements in Lonmin's operations in 2017, there is a net cash outflow of USD 73 million (as a result of, *inter alia*, capital expenditure of USD 100 million). What this shows is that trickle dividends which are calculated from a non-cash flow concept such as EBITDA, may well mean that a company which already has negative cash flow, nevertheless has to pay a dividend to certain shareholders.

Furthermore, most mining projects do not repay the original development capital back within five years and the proposed "trickle dividend" is likely to result in this category of shareholders receiving a return before the original capital and interest thereon have been recouped. This makes term debt funding problematic and is a disincentive for equity investors. The effect of this

[21] http://www.treasury.gov.za/documents/national%20budget/2018/review/FullBR.pdf, page 199

is to place further financial burdens on an already loss-making enterprise or a new mine which is trying to pay back its debt. It is difficult to imagine that the intention of the Draft Mining Charter is to implement measures which have such damaging consequences.

## 10. The HSF's approach

In order to be 'open for business', South African mining needs to escape its present stagnation and realise the growth potential of its plentiful mineral resources. The Draft Mining Charter as it stands would make matters worse rather than better, by;

- damaging an already poor policy reputation;
- increasing risk;
- imposing unsustainable burdens;
- creating incentives for BEE shareholders to exit mining as soon as they can;
- choking off prospecting; and
- failing to invest resources taken from mining companies in community development.

The sensible approach is to focus unceasingly on three principles:

A. **In order to create a contract, all parties must have their 'participation constraint' satisfied.** The investing entity needs to have confidence in attaining its return on capital and Government will need to feel that its empowerment and social objectives are attainable. Otherwise, there is nothing, and 14%, 26%, 30% and 51% of nothing are all nothing. The Draft Charter pays no attention at all to the participation constraint of mining companies. It implicitly assumes that it is always satisfied. Indeed, the Draft Charter shows no evidence of financial conditions in the mining sector having been considered.

B. **In order to reduce risk, the burden of fiscal and social policy appropriations should increase when conditions in markets are favourable and reduce when conditions are difficult.** A determination to extract a steady flow of resources from mining companies, come what may, has the effect of increasing risk in an already risky industry, entailing both increased company bankruptcies and an increased required rate of return on mining projects, to compensate for increased risk.

C. **The principles of taxation indicate that the best approach to distributive issues is to design one or two taxes to care of them, rather than loading impost after impost on the system.** The more taxes you have, the greater is the probability of adverse unintended consequences as they accumulate.

Gold mining company taxation has long recognised these principles. The rate of tax drops to zero when profit margins are less than 5%, while rising towards 34% as margins increase. The Davis Tax Committee, while preferring, for administrative reasons, that mining company tax be aligned with company tax elsewhere in the economy (currently a constant 28% of taxable income), was obliged to recommend that gold mining taxation remain as it is[22]. The correctness of the Committee's preference is debatable. Indeed, a case may be made for bringing the rest of the

[22] Davis Tax Committee, *Hard Rock Mining: Second and Final Report,* 2016

mining sector into a system akin to gold mining taxation and/or a revision of the approach to royalties.

One avenue which should be investigated further, is how the royalty mechanism can be used and whether the current formula is still fit-for-purpose. The royalty amount payable should be linked to the actual profitability of a company and not to turnover, as the latter approach may just add yet another cost to what may already be a loss-making enterprise. In the final analysis, the trick here is to ensure that a royalty level is reached which does not disincentivise the industry by becoming too burdensome, but where at the same time, it can make a contribution to social goals.

The search would then be on for a company tax and royalty regime which just satisfies the mining company participation constraint. Any further imposts, such as a free carry, additional equity requirements and a "trickle dividend", would then mean that the constraint could not be satisfied. The policy question would then become: how should the optimal appropriation be allocated between the government's general revenue fund, on the one hand, and BEE entrepreneurs, workers and communities on the other.

As things stand, the basic misconception of the Draft Mining Charter is that it provides little by way of real incentives to mining companies to speed up transformation - unless one considers the potential loss of its mining licence as an incentive. The one exception to this lack of incentives is that of beneficiation: if a mining company contributes materially to local beneficiation of its product, it is able to decrease its BEE shareholder obligations by up to 11%.

The Draft Mining Charter itself says that "it is recognised that competitiveness, growth and transformation are mutually re-enforcing." However, except for beneficiation, there is no sign of any other incentives that would at the same time boost economic activity and employment. Instead of the stick approach, Government should rather consider investigating, together with the mining industry, how more carrots, evidencing an incentivising approach, could advance a policy of increased black ownership and empowerment more quickly. Listening to the mining industry is essential if the government is to discover the optimal (from its point of view) solution.

## 11. Conclusion

Much can be achieved by Government and the mining industry in reviewing how the latter can be incentivised, to increase the effect of their joint efforts regarding black ownership and employment. However, the focus needs to be directed at making use of a company tax and profit-based royalty system in a much more substantial way, in order to develop an efficiently run, sensibly regulated and growing mining industry. On the other hand, increasing BEE ownership requirements without regard to the financial health of any particular mining company, will often simply worsen the company's financial constraints. In addition, it will not only not encourage further investment, but may actively discourage it.

Mining companies are in the difficult position of not being able to increase prices to fund BEE-requirements and investors will not continue to support them or invest in new ventures, if they feel they cannot rely on the predictability of the regulatory regime. The authors of the changes to the Mining Charter seem to have proceeded from the assumption that they can change whatever they think is appropriate and that the mining industry will make the necessary amendments to comply and will have sufficient funding to do so. This approach does not take account of the following:

- the high risk and capital-intensive nature of the mining industry (as described in some detail in this submission); and
- the fact that over the longer term, optimal taxation of the mining industry will increase government revenue and the resources available for BEE entrepreneurs, workers and communities.

The Draft Mining Charter's approach is akin to that of a centrally planned economy, where the state takes all economic decisions on its own and places little reliance on what consumers or investors want, and what industry can profitably produce. Global events over the past decades have discredited this as an economic model. Governments on their own do not have the insight or power to ensure the profitability of an industry, without taking into account the workings of the market. It is disheartening to see that the planned economy model persists in the Draft Mining Charter.

Whilst it is accepted that the Draft Mining Charter has been prepared with the best of intentions, it unfortunately adds to the effective cost of mining in South Africa, without providing the incentives to invest in and to continue operating businesses in a sector which is not only technically difficult but also subject to commodity prices and exchange rates over which it has no control.

A radical change of approach by Government is needed: the industry needs to be supported, on the assumption that Government will be able to rely on taxes which will flow in a favourable economic climate. A longer term and more strategic view needs to be taken, rather than the short-term approach contained in the Draft Mining Charter. The current approach has the effect of placing additional burdens on the mining sector in the bad economic times, which will not only prevent companies from making the necessary investments to blossom in the good times, but will also scare away new investors. The net effect of this is that the mining sector will not obtain the funding that is required not only for its growth, but for its survival. Simply put, the policy approach needs to change, in order to support the mining industry.

The Government's desire to broaden black ownership and employment in the mining industry is laudable, given South Africa's history. This policy is supported by the HSF. However, the real problem in this undertaking is that Government has not taken the fundamental aspects of the mining industry into account and as a result, the mining industry is not incentivised in a sensible manner to implement what is required, in order to enable BEE policies to be successful.