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National Treasury  
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Cc: Mr. Jacinto Rocha, Deputy Director-General, Mineral Regulation  
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To Whom It May Concern:

Pursuant to the call for public comment on the Mineral and Petroleum Resources Royalty Bill, 3<sup>rd</sup> Draft (the Draft Royalty Bill), the Revenue Watch Institute (RWI) offers the following observations and suggestions. RWI is a non-profit policy institute that promotes the responsible management of oil, gas and mineral resources for the public good. With effective revenue management, increased citizen engagement and real government accountability, natural resource wealth can drive development and national growth. RWI provides the expertise, funding and technical assistance to help countries realize these benefits.

#### **I. General Observations on the Draft Royalty Bill**

The Draft Royalty Bill marks a significant departure from prior versions of the royalty bill—and from common international practice in the assessment of mineral royalties. In general we are concerned with the potential of a pure profit-related royalty rate to prevent South Africa from capturing any revenues with respect to potentially significant amounts of its natural resource wealth. This possibility arises where Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) are zero or negative, resulting in a royalty rate of zero. This will mean that some portion of South Africa's resource wealth could be extracted, and very likely exported, without any payment to the owner of those mineral resources, the State. Such an arrangement deprives the State of fair payment for the depletion of its non-renewable resources. This possibility, of course, is a basic feature of any profitability-related royalty system; however, we would argue that the mineral fiscal regime should not allow completely free exploitation of the State's natural endowment. We would suggest that a profit-based

royalty could be coupled with some level of royalty on gross value to assure minimal revenues to the State, while still allowing variability on the upside and substantial protection of investors rates of return under low profitability scenarios.

Annexure 2 to the Media Statement accompanying the Draft Royalty Bill compiles industry-supplied data on average EBITDA suggesting equivalent royalty rates of between 1.0 percent and 3.7 percent for the period 2002-2006. There is no indication of whether the industry-supplied data has been audited, or whether there are any potential differences between the method of calculation used in that instance and the method that would be used under the Draft Royalty Bill and associated regulations. Inaccuracies in the supplied data or variations in method of calculation could have significant impacts on the actual level of royalties received by the State—a risk exacerbated by the lack of a minimum rate set at some level above zero.

We recognize that the move to a profit-based mechanism is the result of a long process of engagement with industry, and that it reflects trade-offs made elsewhere, but we would urge further analysis of the royalty rate mechanism and provision of more detailed explanatory examples to illustrate how it might operate in a variety of circumstances.

#### *Interaction of Royalty Rate and Royalty Base*

Beyond our general concerns with the purely profitability-related royalty rate calculation, we are troubled by the mechanical interaction of the rate and base calculations. The royalty rate and the royalty base in the Draft Royalty Bill formula are not wholly independent of each other, creating the possibility that the effects of changing market conditions could be amplified to an unforeseen extent. To illustrate, we can re-write the royalty calculation as follows, where “S” is gross sales and “A” is allowable deductions:

$$\frac{EBITDA}{S \times 12.5} \times (S - A) \rightarrow \frac{EBITDA}{12.5} \times \frac{S - A}{S}$$

If one assumes that “S-A” is approximately equal to EBITDA, then the State’s revenue will be a function of EBITDA squared; that is, revenues will rise or fall faster than EBITDA changes. Though EBITDA and “S-A” will generally differ, there will in any event be significant positive covariance between them, which may lead to unanticipated fluctuations in royalties relative to profitability measures. For instance, suppose mineral prices increase. EBITDA will increase, as will aggregate gross sales minus allowable deductions. The reverse is also true: if costs go up then EBITDA will fall, as will (S-A)/S. The net effect of any price or cost increase is thus likely to be that royalties rise faster than anticipated (measured relative to profits) or fall faster than anticipated (again relative to profits). Finally, note that both EBITDA and “S-A” can be positive even if overall profitability is zero or negative if profitability is measured relative to economic standards. Thus, effective rates can be rising when profitability is stagnant or falling.

South Africa’s forecasting and management of royalty revenues would be enhanced by a simpler formula. One option is to use a standard royalty with a fixed rate and a base measured

relative to realized sales values as a minimum charge while employing the proposed formula as a supplemental or super royalty.

### *EBITDA*

EBITDA is central to the determination of the royalty rate in the Draft Royalty Bill, but there is very little information within the bill to explain how it would be calculated. Greater clarity is warranted up front. How will EBITDA be computed for “financial reporting purposes”? Will it include dividends, hedging expenses, and other items on an accrual basis? In the case of mineral operations that are vertically integrated, will EBITDA “attributable to mineral resources” be publicly available? That is, how will EBITDA “attributable to mineral resources” be separated from other downstream profits, such as marketing and manufacturing, for practical purposes.

### *Ring-fencing*

Though it is not stated explicitly, we infer from the text of the Draft Royalty Bill and the accompanying explanatory materials that EBITDA will be an aggregate value calculated for all mineral resources won or recovered by an extractor in South Africa. Thus, the royalty will not be ring-fenced. A ring-fenced royalty insures that costs from new or marginal investments do not reduce the State’s share of revenues from more profitable mines. While a lack of ring-fencing may be appropriate in some circumstances with respect to a corporate income tax, the same is not necessarily true for a royalty, profits-based or otherwise. As noted, the purpose of the royalty is to compensate the owner of mineral reserves, the state in this case,<sup>1</sup> for the depletion of these non-renewable assets. The resource owner should be compensated more for high quality low cost mines relative to lower quality high cost marginal mines other things equal. An average may distort decisions and reduce revenues and impede relative efficient production given administrative costs.

### *Timing of Royalty Accrual*

The Draft Royalty Bill provides that royalties accrue upon a transfer of mineral rights, which may occur at any number of points along the chain of value added, depending on the facts and circumstances. Such factors as an extractor’s level of vertical integration, normal sales and marketing practices for a given product, the existence of mineral tolling arrangements, and the use of minerals as inputs into manufacturing processes will affect the timing and calculation of royalties, making some degree of non-comparability across minerals and firms inevitable. Over time, profit margins at the various stages of the value chain are likely to shift relative to each other, creating ever-changing incentives for firms to restructure. In order to avoid distortions in the market, the effective tax rate on both extraction and processing activities should not differ significantly based on the level of integration of mining companies. This is clearly not the case in the Draft Royalty Bill as we understand it. Suppose that the value of refinery input purchased at arms-length from an unrelated mine is 100. Furthermore, suppose that EBITDA for the mine is 12.5. The royalty payable by the mine would be 1 ( $12.5/(12.5 \times 100) \times 100$ ). In contrast,

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<sup>1</sup> Of course, we recognize that this Draft Royalty Bill has been developed in the context of a transfer of mineral rights to the State, which may have played a role in the trade-offs made.

suppose that an integrated firm owns a mine and a processing plant which can process identical input for 60 (short-term operating costs). Assume a price of refined output of 200. The royalty, assuming identical EBITDA for the mining activity, would be 2.94 (or  $(52.5/(12.5 \times 200)) \times (200 - 60)$ ). Thus, other things equal the tax rate will be higher for the integrated firm—not only on extraction, but on processing as well (despite the allowances provided in the royalty base calculation).

In most royalty regimes internationally, royalties accrue upon extraction, using the wellhead, mine-mouth or similar price of ore for calculations. Such a system has the benefit of allowing greater comparability across firms as well as capturing mine-specific advantages. The fact that the Draft Royalty Bill calculates value at first transfer—which can occur anywhere from extraction to transfer of refined products—raises a number of questions that should be addressed in the text of the bill, regulations, or explanatory materials.

For instance, if a domestic mining company extracts ore and sells ingot but pays an overseas refiner on a tolling basis, when does the royalty accrue and how is the tolling charge accounted for? In Example 2 on page 3 of the Draft Explanatory Memorandum, the domestic extractor (Company Y) is subject to a royalty based on the R90,000 price for the refined mineral. The treatment of the smelting charge for purposes of calculating EBITDA and allowable deductions is not addressed specifically. Nor is it clear whether a tolling charge paid to a foreign smelter would qualify as an allowable deduction (this very well may be addressed in the regulations anticipated by Section (5)(1)(b)). Also, where an integrated natural gas producer is engaged in extracting, transporting and distributing natural gas to final consumers, and there is no transfer until the sale to the final consumer, at what point does the royalty accrue?

We are also concerned that it appears valuable material that is extracted but not transferred will be free of royalty. This will include production losses, consumption by the extractor (e.g., in the case of natural gas) and other disposals. South Africa may lose significant revenue by providing what are effectively free inputs. A modified definition of “transfer,” together with detailed regulations, is necessary to address this. We would urge further examination of this issue.

### *Small Mine Relief*

The small mine relief is inefficient. As structured, the effect of the small mine relief provision is that the government would be giving small miners ore free of charge. That is, the government would be effectively subsidizing an input (value minerals) which may lead to economic inefficiencies. More efficient mechanisms are available. Because even small mines are likely to have accounts simple enough to allow computation of profits, it would be more effective and efficient to charge a standard royalty and provide a tax credit against income taxes. Moreover, it may be difficult to administer the small mine relief provisions in the Draft Royalty Bill in the context of a sizeable small mining sector as both output and turnover must be monitored.

Technical improvements to the small mine relief provisions are also warranted. Transition rules from small mining to the regular regime will be needed (as well as from the regular regime to

small mining); at a minimum, miners should be required to stay in the regular regime for a specific time period in order to avoid arbitrage via regime choice. Finally, the relief is based in part on turnover, but turnover is not adjusted for inflation.

### *Stabilization*

The stabilization provisions (Sections 13 and 14) are too general and are asymmetric. By and large, it is preferable for stabilization provisions to be limited to provision for compensation in the face of a legislative change that significantly affects return. General provisions restricting the ability of the state to legislate or providing that legislative changes are to have no force and effect in certain instances unnecessarily curtail state autonomy and can impede proper administration and enforcement of the law by effectively resulting in a number of separate fiscal and regulatory regimes. We appreciate the extractors' (and investors') desire for a stable economic environment. We believe, however, that stabilization clauses such as the one proposed might in fact be destabilizing. If revenues are not reasonable relative to investor returns, then political pressure for structural change can create sharp and significant adjustments in the fiscal regime, whereas allowing the government to make marginal adjustments in a transparent manner can be less disruptive for investors. In addition, stabilization should be a two way street. That is, it should be made clear that any extractor that is party to a binding agreement should be unable to benefit from any amendment to the Act or any other legislation affecting the fiscal liabilities of extractors. Stabilization that operates only to the benefit of extractors is unfair to the government and unnecessary.

## II. Additional Comments by Section

| Section Number | Comment  |
|----------------|--|
| 1              | <p>The definition of “extractor” should be clarified to include any person who is deemed to have won or recovered a mineral resource. This would make clear that the government has the right to determine the true owner of any minerals upon extraction and assess royalties accordingly.</p> <p>There is a need for a better explanation about the timing of title transfers and the criteria for beneficial ownership in the law.</p>  |
| 2              | <p>The bill should provide greater clarity regarding the “assessment period.” The Draft Royalty (Administration) Bill sets out rules for determining when a registered person’s six month assessment periods start and end. As we understand it, where a mineral resource is transferred within a particular assessment period, the royalty payable for that assessment period is to be calculated by reference to all the costs and receipts with respect to that mineral resource, regardless of when they accrued. However, the Draft Royalty Bill defines EBITDA with respect to earnings “arising during an assessment period” and allowable deductions are defined to equal aggregate expenditures “incurred during an assessment period.” These phrases could be read to suggest that only those earnings and expenditures accruing during the six months of the assessment period in which a transfer is made are to be taken into account when calculating the royalty for that assessment period. While the example on page 7 of the Draft Explanatory Memorandum belies this interpretation, the language of the Draft Bill should be improved.</p> |
| 4              | <p>Paragraph (2) should be amended to read “include but not limited to” since amounts received or accrued could include additional items not listed in (a) through (d).</p> <p>Paragraph (3) provides that aggregate gross sales are to be taken into account in the assessment period when they become quantifiable. Section (5) includes a similar rule for determination of unquantifiable deductions. The Bill should incorporate an interest charge to prevent any economic benefit to extractors from structuring sales and expenditures such that significant amounts are unquantifiable so as to delay assessment of royalties. Section 13(2) of the Draft Royalty (Administration) Bill provides for monthly accrual of interest where an amount due is unpaid within 30 days of the end of the assessment period, but unquantifiable sales and deductions, insofar as they are deemed to be received only once they are quantifiable, would not qualify as “due” under the Draft Bill.</p>   |

| Section Number | Comment  |
|----------------|--|
| 6              | Regulations are anticipated defining a mineral resource’s “readily saleable condition.” We would suggest that regulations similarly will be needed to define “process of manufacture” as conceptions may differ across industries. It could be preferable to simply impose the royalty at the first “marketable” stage—i.e., the first point at which a reasonable arms-arms length price or reasonable basis for value can be determined. This point will vary across minerals. Using the first marketable point as the point for assessing the royalty will help distinguish manufacturing from mining and processing. Thus, manufacturing might be defined as any process using minerals as an input beyond the point where the mineral is in a readily saleable condition. |
| 7              | For the sake of clarity, the write off for bad debts should explicitly not apply to bad debt reserves. This seems to be the clear intent of section 7, but greater clarity is warranted, especially in light of the fact that the Draft Royalty Bill does not adequately address the time value of money in instances where the payment—or reduction—of a royalty is shifted to a subsequent assessment period.  |

**III. Further Observations**

*Local Community Participation*

Though not a feature of the Draft Royalty Bill per se, equity participation by traditional communities currently receiving royalties is encouraged “where appropriate” in the Media Statement accompanying the bill. We would caution that equity participation is not necessarily the best way for local communities to receive monetized benefits for extracted mineral resources. Depending on how an equity interest is structured, equity participation may expose local communities to excessive risks. The challenge of effectively monitoring an equity interest is often well beyond the capacity of small communities. Further information on this process is necessary to evaluate the best alternatives for communities to share mining risks and revenues.

*Transparency*

RWI recommends that South Africa—whether in the context of this bill and its associated regulations or other laws and regulations governing the minerals sector—adopt the highest standards of transparency as articulated in the principles and criteria of the Extractive Industries Transparency Initiative.<sup>2</sup> Such a commitment will increase the likelihood that revenues collected pursuant to this royalty bill will contribute meaningfully to growth and development in South Africa.

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<sup>2</sup> See <http://www.eitransparency.org/eiti/principles> and <http://www.eitransparency.org/eiti/criteria>.