6-29-2022

Dealing With Developers

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DEALING WITH DEVELOPERS:

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FORMS OF AGREEMENT

By: Charles J. Lipton

The term "concession" in the mineral industry to-day is an all embracing term, covering any agreement between the government and an operator for the exploration and production of mineral resources. This is not its traditional meaning.

The traditional concession was a grant of a property right in minerals, usually for a very long period; 99 years was by no means unusual. The investor had an almost complete property right in the minerals in the ground, that is to say all the interest but the bare legal title. In the Anglo-Saxon system, it was a mining lease which conveyed the property right. In the Old British colonial mining legislation, a patent was issued confirming the property right.

Concession agreements granted exceptions to the investors from the laws of general application. The early concessions actually created enclaves, a form of extra-territoriality in which the government's writ did not quite run. The enclave became in a sense a foreign country: They did things differently there.

The operators were assured that government would not interfere with what they termed "management prerogatives". It was for the investor alone to determine how the minerals would be mined, at what rate, at what cut-off grade; the extent to which they would be processed in the host country if at all, where they would be sold, on what terms and conditions and prices; where the revenues would be kept, in fact; complete discretion unhampered by any view that government had an interest or concern in these basic decisions.

In part, however, and in the context of that period, this was the result of the law and the regulations of the host country not being sufficiently developed into a system to regulate the mining industry. The concession agreement itself often filled the void or vacum which then existed. It goes without saying that seldom was the concessionaire a legal entity organized under the laws of the host country, but almost without exception a foreign legal entity.

In the concession, the government usually agreed to give more favourable treatment to the investor, with respect to the fiscal regime, that it would have given to one of its own nationals.

In the early concessions, the government revenue was based solely on a royalty, usually expressed as a fixed amount per ton of the mineral extracted and sold. The value of the minerals or the profit made on the sale of the mineral became, therefore, irrelevant to the government under such a concession. In turn, the investor provided all the capital for the mining project, not just for the plant and equipment, but for the infrastructure as well. Railways, port facilities, roads, townships, power and water supplies were proved at the concessionaire's expense, and became company property, run solely for the benefit of the operation, except to the extent that excess capacity existed which could be made available to the public or to third parties on specified terms. Having contributed all of the capital, the concessionaire expected to receive all of the profit.

It should be recognized however, that governments have to a large extent participated in the financing of the mining industry, both directly and indirectly; directly through privisions of public roads, ports and the like, and indirectly by providing for tax free treatment of interest payments and their complete deductibility as well as capital allowances and accelerated depreciation.

A good many of these concessions were granted by colonial administrations. Their concern was usually to make profits for the investor from the "home country". Those profits were to be brought home, and so a good many of the issues that concern us now were not only irrelevant, but they were unthought of in those days.

The times changed and operators were made subject to income taxes as the colonial administration sought to generate its own revenues to meet its own expenditures.

After the breaking of the waves of political nationalism after the Second World War which resulted in the independence of most of the former colonially administered countries, there came a recognition that political independence did not necessarily mean real independence. As long as new governments depended on subsidies for their recurrent expenditures from their former colonial administrators, real independence was doubtful. The developing countries then entered into a new era, one of asserting

economic independence. It is clear that the waves of economic nationalism have not subsided. In some countries this took the form of giving their nationals preference in operating certain types of business. It also led to nationalizations.

Economic nationalism has affected the older independent countries as well as the newer. The Prime Minister of Australia, in a speech at this year's Commonwealth Conference, referred to the multinational companies and said that Australia would not be master of her own house as long as the Australian mining industry was dominated by such companies.

In July of this year, the government-owned Canadian Development Corporation (CDC) tendered to acquire about one third of the shares of Texasgulf, Inc., sufficient to give CDC working control of this American Company. Texasgulf derives more than 50 per cent of its income from Canada, including the famous Kidd Creek copper mine in Timmins, Ontario. CDC was organized by the Canadian Government which is concerned about the extent to which foreign companies control or influence its economy.

In negotiating mineral development agreements, governments, particularly those of new independent countries, were negotiating in unfamilar areas of technology, law and economics. Information was difficult to obtain. Traditionally the terms and conditions of concessions were kept secret. It was rare that government negotiators knew of the terms and conditions in comparable agreements. Hence, they were at a disadvantage in negotiating alternatives to proposals made to them by investors.

However, governments increasingly became aware of the terms and conditions of exploration and mining agreements negotiated in other countries. In part, this was a result of the establishment of the Organization of Petroleum Exporting Countries (OPEC) and the shift in the pattern of supply and demand in the petroleum industry. OPEC publicized negotiating positions and the terms and conditions of agreements. Governments that were not members of OPEC nonetheless began to appreciate that they had a source of information with respect to agreements which have their definite counterparts in hard minerals. OPEC became a significant force in changing the concession pattern in the petrolem industry and this in turn, with a time lag that still exists, is affecting the mining industry.

There has been a comparative information explosion in the last ten years. Articles appeared in the magazines and journals as

academic specialists (economists and lawyers particularly) interested themselves in mineral agreements. Increasingly the technical journals began to report the terms and conditions of new agreements. International and national organizations provided governments with experts and advisers who themselves had information about comparable terms and conditions and were able to draw on their own experience and sources of information to advise governments in mining negotiations. Lawyers and other experts became available to advise governments in the very negotiations themselves.

At the same time, governments are sending their own officials and promising students to study mineral economics, marketing, finance, law and business organization so as to be able to obtain their own counterparts to the investor's negotiating team. Government in-house expertise in most countries is still limited however, and usually not equivalent to that available to mining companies; nor is their information nearly as complete as that available to them.

Other more fundamental, technological and economic factors have become increasingly important. Improved technology allowed relatively low-grade deposits to be economically mined. These deposits, because they are low-grade, inevitably have to be large deposits to be economically viable. In turn this requires enormous capital expenditures, often too large for any mining house. This leads to the formation of consortia and often multinational consortia, as a method of raising necessary equity capital and to enlarge potential sources of loan capital.

One of the post-war developments has been the extent to which capital has been made available to developing countries under multilateral and bilateral arrangements on advantages and soft terms. This has not only resulted in the savings in the cost of capital to a mining venture through the government contribution of infrastructure but sometimes in the supply of a part of the loan capital itself which is a very significant contribution to large-scale mining projects.

Such funds have been obtained from the International Bank for Reconstruction and Development (World Bank). Industrial countries themselves recognized responsibility to assist the developing countries and many aid agencies were established, such

as the United States Agency for International Development, the British Overseas Development Administration and similar agencies and institutions by Canada, Sweden, France, the Federal Republic of Germany and others. Governments thus have a source of finance for infrastructure which have been traditionally supplied and paid for by the operators. As the costs of mining projects mushroomed, operators became more interested in having infrastructure paid for by government so as to relieve them of the burden of finding sources of finance for infrastructure as well as for the mining operation itself. At the same time, government sought the ownership of infrastructure so as to be in a position to control railways, ports, roads, and power and water facilities to further development plans unconnected to the mining sector.

Proposals by foreign investors into joint venture agreements were attractive, particularly to developing countries anxious to find new revenues to finance their development plans. Governments did not wish to increase the rate of company income tax beyond a certain level, and this in part accounted for the relative attractiveness of the joint venture form of agreement as a method of increasing revenue through profit participation without increasing the income tax rate. Governments which only had a fixed per ton royalty and a generally applicable company income tax rate of 25.40 per cent found that a 50 50 joint venture proposal was most attractive. Operators, on the other hand, were interested in limiting government's take to 50 per cent of the gross profits.

Sometimes these joint ventures were not necessarily what they appeared to be. Political pressures often resulted in the government negotiating joint venture agreements in which the government would have 50 or 51 per cent of the equity of the operating company. However, this was sometimes not a real 50 per cent as dividend and voting restrictions operated to make such participation apparent but not real.

Management agreements with compensation set as a percentage of gross profits also operated to substantially change the apparent distribution of revenues in a mining joint venture between an investor and government.

The psychological attractiveness of a 50-5- partnership cannot be exaggerated. It had domestic political value. Newly

independent countries were also particularly anxious to participate in the development of their own mineral resources. They saw the joint venture as a way by which the operation of mining companies could be harmonized with the development objectives of the government.

In a classic case, a government completely abrogated its position as a government and elected to be treated as a commercial partner in a 50-50 partnership. This government gave up its right to tax and even to inspect books and records. It is or should be apparent that a tax of 50 per cent of taxable income calculated by a Collector of Internal Revenue in accordance with a Fiscal Code and established procedures will yield more revenue to a government than a 50 per cent interest in dividends when and as declared with no taxes otherwise payable.

The development of the joint venture form did inevitably lead to the establishment of operating mining companies under the law of the host country instead of under foreign law and this is proving to be of great benefit. Where the operator is organized under local law, it is then subject to all of the applicable company laws including reporting and record keeping requirements. It is also easier to understand the organization and structure of a company and its records if they are in a form that is familiar to government officials rather than in a foreign form frequently unfamiliar.

Governments had become aware of the importance of having access to the books and records of the operators. Unless they have such access, it is difficult to be sure that a complete picture of the operations is obtained. This is especially the case in understanding the accounting treatment of operating costs, inter-company transactions and sales realizations which result in taxable income. Moreover, increasing sophistication with respect to the variations possible within the formula of generally accepted accounting principles even when "consistently applied" has resulted in a greater interest in examining the actual books and records of operators.

The use of a local company in a joint venture avoids the issue of extra-territorial treatment and limits the extent to which a mining company is treated differently from any other type of business.

Operators themselves recognize the difficulties inherent in being foreign companies and its disadvantages. One of the complicating factors in this regard is undoubtedly the tax treatment afforded a foreign subsidiary by the investor's company with respect to losses and profits abroad. There are problems with regard to the use of consolidate balance sheets and the ability to take advantage of certain tax benefits at home when operating as a foreign company abroad.

Investors indeed were trying to look less like foreigners and more like local companies. To this end, in the early joint ventures, they sometimes encouraged private local participation, not only because it to some degree ameliorated the foreign image, but also because the local shareholders became an influential lobby group to insure the profitability of the venture itself. Those joint ventures sometimes were with private individuals or locally organized mining companies. Citizens of the host contry went on the board of directors of the joint venture company, though almost invariably taking only a minority of the seats. Management committees were established with the foreign investor having the dominant role, or management agreements entered into, insuring that the foreign investor would still continue to enjoy its "management prerpgatives".

Governments now seek to retain as many of the benefits from the development of their minerals within their own borders as they can. Provisions in agreements to ensure this result include:

- preference for local good and services,
- preference for nationals in employment and promotion,
- minimum plant size and processing commitments,
- the establishment of air market value for purposes of royalties and taxation,
- the limitation on the loan to equity ratio,
- taxing interest payments and dividends remitted and outside of the country,
- limitations on the repatriation of capital, interest and profits, and
- limitations on the extent to which revenues generated by the minerals can be kept outside of the country.

Governments retaining these benefits would of course in-

crease the multiplier effect of foreign investment. Another way of referring to it is for the mining industry to have "backward and forward linkages" with the rest of the country's economy.

Insistence on a preference for local goods and services is a method of ensuring the development of small manufacturers, material supply industries and the service agencies. Unless agreements contain provisions requiring such preferences, there may be a tendency for operators to remain with the suppliers and agents with whom they are familar. Indeed there is a case in Southern Africa of a mine which imports everything from an adjoining country, even to the extent of virtually all of its food supplies. The development of small industries and service organizations would yield not only jobs but increase government revenues.

It has become increasingly apparent that without an adequate provision assuring nationals of preference in employment and promotion, mining companies seldom localize as quickly as governments desire. This must be an unaboicable conflict as operators wish to minimize expenditure for training and promotion and at the same time be assured of efficiency which only experienced employees can provide. At the same time there is an element of foreign control which must be appreciated. Agreements increasingly contain a formula for localization on a time-table so as to reduce friction between government and the operators in this regard.

Plant size is usually determined by technical and financial considerations. However, in dealing with multi-national corporations, governments sometimes encounter problems where such corporations want to have several alternative sources of supply. It is the interests of government to negotiate agreements which contain appropriate assurances for the optimum utilization of mineral deposit.

Processing minerals within a country results in added value to the minerals and perhaps more than any other requirement will have the greatest multiplier effect. However, within a country this is realistically possible only if shown to be economically viable. In part this is a function of size and location of markets, the extent to which there is available capacity in already-existing

processing facilities the costs of operating processing facilities and, not least, the political risks involved.

Provisions in agreements can provide for periodic review of the viability and the extent of processing in the event that the circumstances do not permit such a commitment at the time an agreement is negotiated.

OPEC has probably sensitized most governments to the problem of determining prices of minerals for purposes of royalties and taxes. Undoubtedly, the use of the transfer price device has been abandoned in almost all countries. That was a device to limit the amount of royalties and taxable profit in the host country by selling the minerals at an artificially low price to an affiliated company, which would then resell at a higher price. The OPEC Response was to establish under agreements a government determined price, usually called the "posted price". Within these two extremes of the spectrum most hard mineral agreements refer to a "fair market price" or less favourably a "realized price" with protection against affiliated company transactions. One method of avoiding the difficulty in constantly monitoring the determinations of market value or the fairness of realized prices is to adopt a reference price formula utilizing appropriate deductions to an agreed computation point.

It is only recently that governments have realized the extent to which their revenues from mining are reduced as a result of unconscionable loan to equity ratios. Where the amount of loan capital is unreasonably high in relation to equity capital, there is an unfairly large interest deduction in the calculation of taxable income and the profits available for dividend distribution to government in a joint venture. To the extent that the withholding tax on interest is not equal to the tax on company profits (which it rarely ever is), governments will lose revenue and may in effect finance the loan capital in part. Moreover, such large interest payments can be a serious balance of payments drain. Some modern agreements, therefore, have established limitations on the extent of the loan to equity ratio (or the deductibility of interest payments) and provided formulae for their adjustment in appropriate circumstances. The number of agreements with blanket exemptions from withholding taxes on interest and dividends appears to be decreasing.

Taxing interest payments is a method of recouping to some extent the loss to Government revenues resulting from interest payment deductions for loan capital. It is also frequently used as a device, together with a withholding tax on dividends, to permit a host country to obtain the benefits of foreign tax credits or double taxation agreements with the investor's country. Here elaborate claims have sometimes been included both to take advantage of such provisions by the host country and provide for compensatory arrangements if this results in a decrease in the total net profits available to the investor.

Those countries with severe balance of payment problems and shortages of hard currency have been acutely aware in recent years of the benefits of providing for the repatriation of revenues from the sale of minerals to the maximum possible extent. The use of the float of such hard currency by a host country can be a major economic benefit. This has led to agreements which have limited previously automatic rights to send abroad, without restriction, capital, interest and dividends, and provided for agreed upon formulae to determine the amount of such payments that can be made at any given time so as to lessen their adverse balance of payment consequences.

Governments seem now to be preoccupied with the "multiplier effect" of mining agreements and their employment possibilities, even though it is well known that mining enterprises are capital intensive rather than labour intensive particularly the large-scale low-grade mines that have been developed in the last decade. This, coupled with the concern for infrastructure, has led one observer to suggest that the negotiation of a mining development agreement is not the zero sum game of the old concession. In a zero sum game, one side loses and the other wins, in the new development game, everyone wins.

Stripped of the fancy combinations and permutations, it is suggested that what is still happening is that basically governments are selling their minerals in the ground to the operators. A mineral development agreement is little more than a sales agreement. Governments do not seem to conceive of themselves as sellers. They think they are using mining agreements as part of their five-year development programme. There is thus a pre-occupation with the investment aspect, of bringing in new capital, the multiplier effect, the balance of payment benefit and the infrastructure which could be used for other development. This accounts for the pioneer industry legislation and foreign capital investment incentives which are made

applicable to mining ventures.

If governments recognize that they are a seller of minerals, then their attitude might be different with respect to tax holidays, customs exemptions and the like. Governments should attempt to quantify the benefits from a mining project so as to sell their minerals for the highest return possible. It is the "bottom line" figure which really counts. Any seller, whether it be of automobiles, shoes or houses, tries to get the highest price for what is being sold. Governments should do the same. Integrated mining companies do the same, for their basic tool is not just the discounted cash flow rate of return on investment; they also determine the projected cost of a mineral on a per ton basis.

Most concessions and early joint venture agreements are negotiated prior to the start of exploration. Investors usually insist on negotiating the terms and conditions for the production stage before beginning exploration. It is argued that no substantial exploration funds can be committed unless the investor is assured of the precise terms and conditions applicable to mining operations in the event that a discovery is made. It is always stated that mineral exploration, being a notoriously uncertain venture, involves commitment of substantial funds which are completely at risk. Hence, the acceptance of this exploration risk by the investor requires that they have as a reward the opportunity to obtain substantial profits in return.

Developing countries have found it very difficult to be able to carry out their own exploration. However, the United Nations has conducted an exploration programme in certain developing countries in the past ten years which has resulted in the discovery of mineral deposits. These countries in turn have been able to negotiate agreements in which they have not been required to compensate an investor for the exploration risk. At this stage, the level of United Nations mineral exploration activities falls far short of being able to affect the negotiating positions of most developing countries.

However, it is not unreasonable to anticipate that developing countries in future may find methods of financing their own assumption of the exploration risk, directly or indirectly. In this connexion, perhaps the proposed United Nations Revolving

Fund for Natural Resources Exploration, if it comes into being, could make a significant contribution to changing the relationships and the terms and conditions of agreements between mining houses and developing countries.

There is, in any event, an increasing reluctance for governments to enter into agreements prior to exploration in which all of the terms and conditions, especially the fiscal regime applicable to the mining stage, are agreed in advance of any discovery. Governments now wish to examine feasibility reports so as to negotiate fiscal regimes with knowledge of their economic results. It is claimed that it is difficult to give exemptions when it is not known whether exemptions are really necessary.

Moreover, the investor must always have a better concept of the projected costs and expected revenues of a project, than do government negotiators. Few such negotiators have the tools and techniques for projecting success and profitability and so are at a disadvantage in assessing their relative bargaining strengths and weaknesses.

As a result a few governments are now refusing to enter into mining agreements per se but only exploration agreements. In some cases there is attached to the exploration agreement, as an annexure, a form of production agreement to be entered into when a discovery is made and a satisfactory feasibility report presented to the government. The salient features of the fiscal regime during the production stage are frequently left blank in the annexure for insertion after the feasibility report has been reviewed and the regime thereafter negotiated.

One or two governments recently have decided not to agree even to the form of such mining agreement. In their view all negotiations for such agreements are premature until after a discovery has been made and the feasibility report rendered.

Naturally investors have been reluctant to enter into such exploration agreements without any commitment with respect to the mining state. This has sometimes been met by an assurance of first refusal or exclusive rights to negotiate for a specified period of time.

No doubt only countries with very great mineral potential will be able to maintain such a negotiating position.

Most of the infrastructure made available to the mining companies such as power, water, railroads and port facilities because of their location are frequently basically single facilities. It is only seldom that these facilities are substantially used other than by the mining operation itself. In those ciurcumstances, it should be recognized that the financial risk for the mining enterprises is no longer just on the operator, but is shared by the government itself. The government through guarantees of loans to the mining company or directly under bilateral and multilateral loan arrangements, has accepted the financial risk. On that basis it may be well to inquire what the reward to a government is for the total financial risk accepted, compared to the reward to the operator for the total financial risk that he has accepted.

The actual equity contribution of the operator compared to the total capital involved in a mining project (including plant, equipment and infrastructure) is becoming smaller, yet the rewards to the operator are sometimes disproportionately greater for his equity contribution (even including parental guarantees of loans to an operating company) than a government receives for its contribution, discounting the return that the government may obtain on its infrastructure resulting from the spread between user charges and the costs of obtaining the capital through soft loans and other favourable terms.

At least one government may have come to the conclusion that the joint venture agreement form is an illusion, in that it did not give a government any greater revenue or greater control over the basic decision making process that was obtained in the traditional concession, and developed a form of mining development agreement sometimes called a "contract of work". Under such a format an investor was not given any of the property rights or extra-territorial rights of the old form of concession. The investor was subject to the general laws of application of the country, the only exception being with respect to the fiscal regime. Government asserted its control over the development of its mineral resources under law, giving the investor only the specified rights of the contract of work. Generally, title to the minerals does not pass from the government under such a contract until that point when they are loaded for export.

Most importantly, in a contract of work, the government revenue is obtained through the conventional system of surface rentals royalties and taxes. The government does not take shares, or agree to accept its taxes partly or wholly in the form of dividends which are under the control of the operator's board of directors as in the usual joint venture.

The logical extension of the contract of work is the service contract. In many respects, the service contract is more analogous to a public highway construction contract and those are generally oil rich countries. It is an agreement where in effect the government hires the foreign mining company to develop a specified mineral deposit at a fixed price with the government maintaining complete control over the basic decisions affecting the deposit. All profits belong to the government and the government supplies all of the necessary capital. Title to the minerals remains in the government until such point as the minerals are sold to the buyer, the service contractor having no property right or interest in the mineral whatsoever. Needless to say, only governments with substantial revenues available to invest in mining enterprises are able to enter into service contracts.

In some respects one can expect that service contracts will come full circle when governments, as an incentive to the service contractor, offer a 10-15 per cent equity interest as a "kicker" to encourage efficiency and economy. This would be almost the mirror image of the early forms of the joint venture agreements.

All commentators would now probably agree that the relationship between investors and host governments is in the process of changing. This is a function not only of economic nationalism, but of the continuously improving technology and the new forms and methods of finance. Legal and financial terminology will parallel these changes and adapt themselves so that the relationships between a government and an investor and the forms of agreement which embody those relationships will change in tandem.

The process can be seen more vividly in the petroleum industry than in hard minerals but the hard mineral industry will be looking into the future when they examine the host government and investor relationships and the sorms of agreements in the petroleum industry.

GOVERNMENT NEGOTIATING TECHNIQUES AND STRATEGIES

By: Charles J. Lipton

Negotiation is the process by which an agreement is reached reconciling or compromising conflicting interests put forward as specific proposals. There are a few accepted assumptions: the process is supposed to be non-violent, based on mutual good faith and the intention is to reach an agreement.

It has become fashionable lately to apply games theory to negotiations. In an era of computer technology, there is a tendency to try to reduce almost every human process to numbers which can be programmed for the computer. There are still, however, some areas of human experience which defy the computer, including among others, the art of negotiation.

The choice of title does imply, however, that this is an adversary type of art form, a series of conflicts and confrontations.

Governments should approach negotiations with a thorough understanding of their own interests and those of the other side. It is necessary to determine the objectives of the negotiation and decide how important each point to be discussed really is to the government. These can be ordered as a set of priorities. There will be areas which will be of such importance that the government cannot compromise and other areas in which there will be considerable room for compromise. The art of negotiation is to obtain one's own objectives to the maximum extent possible and compromise in those areas which are of least importance to your side. This in turn depends upon an appreciation of those objectives which are most important to the other side.

Most governments use a team approach in negotiating mining agreements. It is common to have on the negotiating team, members with relevant financial and technical knowledge. A negotiation will usually affect more than one ministry or department of government and it is therefore not unusual to have representatives from the different departments on the negotiating team. Occasionally governments believe that there is political safety in numbers. However, too many members make for an unwieldly team and in such cases one discovers that the real negotiation takes place between the team leaders when they meet outside the negotiating room. With too large a group, the negotiation becomes a form of staged play in which roles are acted, there is sound and occasionally fury, but the meaningful discussions are held elsewhere.

In organizing a team, it is important to decide who is to speak for the government. Only one person should be responsible for putting forth the government's arguments, posing alternatives and agreeing to compromises. Others may speak in their own area of competence, but only the team leader should be empowered to commit the government.

It is non-productive to have too many people speaking. While members of the negotiating team should act as advisers to the leader, they should not all be authorized to speak. Speaking parts should be carefully limited and assigned to two or three and seldom more than four persons. Usually technical areas may be assigned to the specialists on a negotiating team, but the parts should be assigned in advance in the rehearsal, not at the negotiating table.

It should go without saying, but it seldom does, that only one person at a time should do the talking and that there should never be dissension demonstrated in the ranks of one's own team. Arguments among team members should be reserved for private sessions and never take place in front of the other side.

Selection of the team leader is often of crucial importance. Some governments make the mistake of considering that this is one of the perquisites of a particular government position, be it minister, permanent secretary, director or attorney general. Regardless of title, the leader should be the best negotiator available to the government. This in part is a function of his experience but most importantly his personality. The leader should be a strong personality, able to make decisions and take the responsibility for them to the extent that authority for such decisions has been delegated to him. He must be a man of intelligence, ability and experience and he must be effective. The leader should be articulate, both flexible and tough, practical, perhaps a bit of an actor, quick minded and impersonal, in short professional. While it is always a mistake for a negotiator to attempt to curry favour with the other side, to seek to be popular or liked, it is important that he establish the other side's respect, both for himself as an individual and for the positions that he is advocating.

Senior government officials must understand the importance of supporting their negotiating team. Attempts to undercut a government negotiator by the investor's negotiating team leader

seeing the president, the prime minister or the minister alone should never be permitted. The only position to take such an event, if the other side's team or leader must be received, is to arrange for the government's team leader to be present as well. Senior officials should refuse criticism of their negotiators and should always take the position that they speak for them and are following their instructions.

Each side in a negotiation will be trying to seize the initiative, to make its proposals the basis of discussions. Here the government has an inherent advantage. As a government, it should control the agenda, determine the procedure, have its negotiator "chair" the meeting. In this way the order of the presentation of points will be that selected by the government and the other side will then be forced to negotiate the government's proposals, not their own. This is particularly important in making compromises and trading off one point for another.

I find that all too frequently government officials are not adequately prepared for negotiations. Fall back positions should be determined in advance, compromise possibilities worked out in advance, arguments and counter arguments should be rehearsed in advance. No argument, position or compromise not previously considered by the negotiating team should ever be expressed for the first time by a government official at the negotiating table. It could be a particularly weak argument, open to an easy rejoinder and could well adversely affect other points. One should be especially careful in putting forth alternatives which have not been thought through and the ramifications carefully

considered. It is disconcerting if not surprising, how frequently this happens. A negotiation usually has a number of surprises, but a government official should never surprise the members of his own team. The government team leader should not offer a compromise unless this has been discussed in advance with members of the negotiating team.

In short, a script or scenario should be outlined before the government negotiators reach the table and no departures should be made unless there is discussion beforehand by the members of the negotiating team. As a consequence, this may mean that recesses must be taken so as to allow team members to discuss any new point which had not been previously considered. The team leader should not offer any compromise or concede any point unless this is part of the script or unless he calls a recess in which the compromise is considered and weighed and he is given appropriate advice as to its consequences and its effect on the other points in the negotiating position.

There should be a parity between the leaders of the two negotiating teams. If the investor's representative must report back to his president or board of directors to obtain approval, then it is essential that the government retain the flexibility of having its negotiating team leader report back to the minister to obtain such approval. Therefore, the government team leader should be careful to determine the authority of the chief negotiator on the other side. There may be an advantage in representing that the government team leader has no greater authority.

This may avoid the problem of premature commitment and avoid the tactic of finding the government committed only to have another side advise that its board insists on one additional point.

It is good practice for the government's negotiating team to meet in advance of each negotiation session to conduct a post mortum on the last session and to decide on modifications of the overall strategy and any changes in position. I have, however, seldom seen that good practice followed.

In orchestrating a negotiating session it is of value to provide opportunities for the team leaders to meet alone over lunch, dinner or during coffee breaks. It is those times when compromises are frequently reached. The informality and face saving possibilities of such meetings may lead to compromises which are more difficult to reach in the confrontations of the large plenary sessions.

There is sometimes advantage on occasion in asking the other side to speak first. At the end of a negotiating session, it is frequently a good tactic to ask the other side to consider overnight the government's position and determine whether and how they may be prepared to meet it. At the next session, wait for the answer before volunteering concessions to meet the other side's position. It may be that the other side is prepared to surrender some points without further concessions on the government's part.

One can never over-emphasize the importance of listening carefully. Listening is sometimes more important than talking. One must look for the signals of where areas of compromise lie.

The importance of language is frequently overlooked. It is necessary to realize that the language of the negotiation may be a second or third language of some of the participants. One well-known negotiator has referred to psycho-linguistics-- the effect of language on cultural sensitivity and the "psychology" of a negotiator. Some words really do have different meanings in different cultures, even (or especially) in translation.

Incidentally, never assume that because a man is not speaking your language that he does not understand it. Frequently, he may understand a language better than he speaks it.

Using interpreters sometimes has advantages, particularly when one knows both languages - it gives additional time to evaluate arguments and form counter-arguments. And don't forget that the other side may know your language when you hold whispered conversations on your own side of the table.

Negotiating experience is most important: there is simply no substitute for it and it is always difficult to obtain. Recognizing this, some academics have attempted to devise courses on negotiation and even stage mock negotiations patterned after the mock trials and appellate arguments which are used in the training of lawyers. I suppose this academic experience is better than no experience at all. But again, as in other areas of human relations, there is just no substitute for actual experience

One method of providing a government with experienced negotiators is to assign bright young men to negotiating teams just so they listen, get the feel of negotiation and in that way acquire experience. One must recognize, however, that to be an observer

without responsibility for decisions is not quite the same as to be involved in negotiations with that responsibility. In academic negotiating exercises, it is difficult to reproduce in a vacuum the economic, political and personal factors which are at work in a real negotiation and determine its outcome.

Governments usually put their best people on a negotiating team, particularly for an important negotiation. In some of the least developed among the developing countries, where there is a shortage of trained and experienced officials, the same team members move from one negotiation to the next. The cream of the government's personnel is used in the negotiation, and the administrators who then follow up after the agreement has been made are often not of the highest calibre. The result is that what is won at the negotiating table is frequently lost in administration. It will prove to be of great value to include on a negotiating team at least one member who will be responsible for the administration of the agreement after it has been placed in operation.

One must recognize that there is frequently an imbalance of information between governments and major mining companies. The investors invariably have more detailed and accurate cost and revenue information. They are in a better position to make realistic estimates and projections. After all, they have their own experience in other places to use as a yard stick.

At the same time, the investors have a greater understanding of the industry and the market forces which will be at work. They best know how to measure the government's projected revenue and know

where to make their compromises and trade offs at the least cost to themselves.

The investors are usually much better informed about the terms of comparable agreements made by other governments. They are constantly presenting themselves as having to compete with investors in other countries and thus asking for concessions on the basis that they cannot afford to pay more to country "X" than their competitor pays to country "Y" for the same minerals in comparable markets. Governments should exert every effort to obtain information on the terms and conditions of comparable agreements entered into by the investor across the table with other governments.

Of course, I could be accused of prejudice, but I find that there frequently is a role to be played by the outside adviser. In part, such an adviser redresses the imbalance of experience and information. At the same time, such an outsider can frequently serve as a lightening rod in negotiations. He can be the cutting edge, taking the hard positions. If they are not successful, they can of course be easily disowned by the government. The outside advisor is particularly useful in providing information on similar agreements entered into by the same investor that is on the other side of the negotiating table.

One must be careful in the selection of outside advisers to make sure that there is no conflict of interest in their advice to government and that they really have relevant expertise and experience.

Frequently the outside adviser becomes a form of political insurance, used to forestall an opposition party which may criticize an agreement and even within a government as a screen to avoid criticism by other ministries and departments.

It is most important to obtain as much information about the investor as possible. At the minimum, governments should insist on having annual financial reports containing balance sheets and profit and loss statements. They should check on the credit rating of the potential investor and its performance in other projects in other countries.

Here it is important to recognize that a government may be dealing with only the very thinly capitalized subsidiary of a major mining house whose assets may not be sufficient to meet contingent liabilities. In such an event, it is in the government's interest to ensure that the investor will be in a position to meet its financial obligations under the agreement which is eventually reached, through parental guarantees or through performance bonds.

One technique which is of considerable use in negotiation is to put yourself in the other fellow's shoes. What does the investor actually want; what are his own tax laws; what points are most important to him; what alternative proposals will he find most attractive. The object of such an exercise is to find those areas in which government can offer something which will benefit the investor without necessarily being detrimental to the government. An understanding of the investor's tax laws can frequently produce several such attractive possibilities.

It is very helpful to have a record of the negotiation. I am not a believer in tape-recording negotiating sessions because I feel that this inhibits the negotiating process. I prefer that each side take its own notes and that there not be an agreed upon record of the proceedings. It should suffice to record only the agreements reached between the parties themselves. The note taking should never be done by the team leader but one team member should be assigned as secretary for that purpose. A draft of the notes should then be prepared and circulated to the team members for comments before the minutes are placed in final form. The minutes should be carefully treated as a confidential internal document and be used for that purpose only.

The side that takes the drafting intitative has a definite advantage. It has been obvious since the very beginning that it is better to fight a battle on one's own territory rather than on the stranger's. The side that prepares the draft agreement forces the other side to negotiate its proposals, its concepts, its language. The only effective equalization is for the other side to produce its own draft too and insist that the two drafts be considered side by side.

Logically, it would appear sound to agree on general propositions before going to specific ones. Obviously it is better to agree on principles before one comes to discuss the actual text to reflect such an agreement. There is therefore some virtue in attempting to work out first an agreement on principles which can then be refined in a text setting out in detail the specific agreement of the parties.

I find that faster progress can be made if negotiations deal first with principles rather than with the specific language to be used in the final agreement. The British practice to use "heads of agreement", a statement of the agreed upon principles, is very useful in negotiations. There are of course frequent drafts of the "heads" or the "principles" but the negotiation will move faster if such a document is agreed before considering the final definitive agreement.

The extent of the detail in an agreement is a function of the practices of individual governments and the nationality of the investor. The American practice is to be extremely detailed, while British and Continental practice is to use general clauses. The objective course is to spell out the agreement that has been reached in sufficient detail so that it is clearly understood and as many potential points of misunderstanding eliminated as possible.

Someone once said that the best drafting committee is a committee of one, and of course we are all familiar with the old adage that a camel is a horse designed by a committee. In my view the optimum number to have on each side of the table in a drafting session is two.

Publicity in the course of negotiations should generally be avoided. Premature publicity almost always works to the disadvantage of the government officials who are conducting the negotiations; it tends to expose them to criticism. Advance publicity forces them into negotiating positions which may not be advantageous to their government. Occassionally it frightens the investor, leads

to public criticism, to expectations which can only end in disappointment and is frequently used to embarrass government officials. Progress reports may be useful and the texts of press releases agreed upon by both sides could be issued. Generally speaking, however, it is best to turn the light on only after a final agreement has been reached.

It may be well at this stage to briefly review some of the better known techniques or "gambits" used in negotiations.

There are a number of cultural gambits which depend on so-called national characteristics. There are some that maintain that one should negotiate with Japanese in a different way than with British and similarly, with Germans in a different way than with Americans or Italians. Needless to say, I shall side-step such national gambits for purposes of this paper.

One of the best known gambits is the divide and conquer tactic. This is a tactic increasingly used by governments in negotiating recent mineral development agreements. As the projects get larger and require more capital, the risks become too great for just one or two companies. In addition, various national and international sources of finance must become involved in order to provide large loan capital. For these purposes, a multinational consortium is frequently created with companies of two, three and sometimes four or five countries represented. In dealing with such a consortium, a government should be knowledgeable about the tax laws, investment strategies and marketing requirements of the

different members of the consortium. As a result, there are frequently built-in conflicts of interest among the consortium members and it is possible to take advantage of them in negotiations.

Curiously enough, the most frequent gambit that I have encountered in advising governments on mineral development agreements is the "marginal project". I say curiously, because I have never been in a negotiation where the project has been described by the mining company other than as a marginal project. It is fantastic the amount of time, energy and money that will be committed to the negotiation of marginal projects by investors. It is obvious that the investor refers to the project as marginal only in hopes of obtaining added financial inducements from the government. One method of dealing with this gambit is to enquire what the investor believes is a reasonable return and to ask what the projected return is on the basis of the negotiations to that point. This information is seldom forthcoming, but if it is, a government can offer to increase the incentives to reach the reasonable return level but that any higher profit must either be shared with or go entirely to the government. I have found that this frequently leads to an abandonment of the marginal project gambit.

A variation on the marginal project gambit is the walk-out, or "we have finally reached a breaking point". This can be very effective, particularly when the government negotiating team is led by a civil servant who is then faced with the unhappy prospect of having to explain to his minister just why this large project might never materialize and how the loss of a large hard currency investment will affect the development plan. One needs good

nerves and a strong stomach to combat this particular gambit. Frankly, I never believe in the seriousness of walk-out threats until the door is actually closed behind the other side's negotiator. There are those, however, who quickly offer increased incentives when the hand is on the doorknob: others wait for the VIP lounge at the airport. I usually advise to let them go. If it is a good enough project, they will be back. In any event, it is always possible to begin talks again. Remember, the other side wants the projects, or they wouldn't be negotiating for it.

I am not very fond of the "let's be partners" approach. There are those who feel that a negotiation should not be an adversary proceeding. Mining negotiations, they maintain, are an attempt by both sides in a spirit of reasonableness to work out the rules for an arrangement by which the government and the investor will live together for an agreed upon period in the future. It is, they suggest, a marriage, and one should enter into such a state with understanding, love and affection. My own view is that a mining development agreement is basically a contract for the sale of minerals, with the government as seller and the investor as buyer. I have elaborated on this view elsewhere. Such a negotiation is more of a "horse trade" where the government as seller attempts to get the highest price for its minerals and conversely the investor seeks to obtain them for as little as possible. This is no romance to it.

Investors, and frequently governments, many times present their chief negotiator in the role of "nice guy" in the hopes perhaps that the other side will not wish to appear rude. I have

been doubtful of the value of this approach. A negotiation is not a popularity contest. The basic economics will out in the end and I suspect that it is only wishful thinking to believe that by playing the nice guy role the other side will be more forthcoming than it would otherwise be.

A variation of the nice guy gambit is the tactic to refer to the senior officials, to whom the government and the investor's negotiating team report, as being very difficult. The intention is to make the other side believe that it is more advantageous to negotiate with the man across the table than those really impossible people who will come to the negotiating table if agreement isn't reached with the nice guys presently sitting there.

Another use of this tactic is to ask for the concession of a point just to be able to convince these difficult senior people of the seriousness and reasonableness of the other side. It is amazing how many company chairmen and boards of directors have thus been slandered by their negotiators and, on the government's side, how many ministers and cabinets have been so maligned by their own officials.

More successful is the "good guy/bad guy" gambit. A lawyer is usually cast as the bad buy and the chief negotiator as the good guy. There are a good many advantages to this particular gambit. A bad guy is aggressive, hard, tenacious and unyielding. The good guy appears to be reasonable, is willing to compromise and is usually the chief negotiator or the administrator who must live with the other side after negotiations are completed. This of course

pre-supposes a continuing relationship, as is the case with a mining development agreement, rather than the one-shot contract. The successful use of this gambit depends on a good understanding between the role players through experience or through rehearsal.

Governments frequently meet with success using the "it must be seen to be fair" gambit. The script here calls for the government's chief negotiator to point out that the real assurance of the stability of the agreement is whether it is accepted by the general public as a fair agreement. Like Caesar's wife, it is not enough to be virtuous; it has to be seen and appreciated as being virtuous. This of course also carries the complication that there is some possibility of instability, even in the face of all the assurances that the investor has extracted from government. The gambit must, therefore, be used with some sensitivity and restraint.

The "split the difference" gambit is of course one of the oldest known. The standard defense to this particular technique is to always ask for more than you are willing to take and keep one's distance in the bargaining. Do not get committed to a figure in compromise only to have the other side move to split the difference. Flexibility, and the use of the package or tie-in compromise are the best defenses.

In the package or tie-in compromise gambit, two or more points are negotiated together: for example, combining the depreciation schedule with the loss carry forward provision or the limitation on the loan to equity ratio with the percentage of the withholding tax on interest. In part, this is also a

a method of insuring that nothing is ever conceded without obtaining something in exchange.

The great difficulty with the deliberate delay tactic is that it frequently cuts both ways. It is to the government's advantage, particularly after significant exploration costs have been incurred and a feasibility report obtained and paid for, to put pressure on the investor by stringing out the negotiation while the investor watches the anticipated costs escalate beyond his projections, including inflation factors and contingencies. On the other hand, government may have already planned for the use of the expected revenues from the project so that it is sometimes the investor rather than the government that utilizes this pressure tactic.

Several years back in the United States it was quite popular for one side in a negotiation to make what was termed a "non-negotiable" demand. The popularity of this approach seems to have waned, but tagging certain positions as non-negotiable is still a fair tactic, particularly when the government negotiators are bound by principles enunciated by the head of state or embodied legislation.

The precedent gambit is a favourite among lawyers, and this particular argument has been used by both sides. The investor maintains that if it agrees to a particular government demand, then it will find itself in a position of having to do so in all the other countries in which it has comparable investments. Government, of course, makes the same argument on its side. One then spends considerable time drawing the distinctions. The quintessence of this particular gambit is the most favoured company or the most

favored government position. Investors have in the past been able to obtain most favoured company treatment by arguing that otherwise they would be discriminated against. I find that when the investor asks for most favoured company agreement, the most effective reply is to point out that this should be a two-way street. The government must then obtain in exchange most favoured country treatment, so as to have the benefit of any better terms that the investor may have offered to any other government. After all, the investor would not want to discriminate against this government, would it? This almost always ends the negotiation on the particular point without either provision being included.

The precedent argument is sometimes met through the use of that pernicious instrument, the side letter. This is a useful device if one side or the other is concerned that the inclusion of a particular provision in a public agreement would cause other investors or other governments to ask for parity treatment. Such a provision can be excluded from the public document and placed in a private one. This is usually in the form of a letter or exchange of letters and hence termed a side letter. Some particularly scrupulous observers have commented a government should not enter into such secret covenants, secretly arrived at.

Negotiators find that the most difficult problem that they face in negotiations is one of timing: deciding at just what point to be reasonable and give in or how long to maintain one's position. There really are no guidelines that can be handed down because in many respects this is the essence of the negotiating process. All

I can suggest is that one does not give in too easily, too quickly and certainly not unless it is part of the script agreed upon in advance or after consultation among the members of the negotiating team. As I have indicated before, my rule is to give up nothing unless something is obtained in exchange. Some believe that it is important to make concessions in order to keep up the tempo of a negotiation or to keep a positive atmosphere. Economic realities and other pressures dictate at what point a negotiator compromises. Here I suspect is the real mystery of the art of negotiation, and the relative experience of the negotiators will have its greatest effect.

The lawyers I know have won and lost cases in the courts but I have yet to meet a lawyer who has lost a negotiation. Needless to say, when a point is conceded, it is considered significant by the side conceding and trivial to the side accepting the concession. But it is well recognized that each side has almost an obligation to attempt to convince the other side that they have in fact got the better of the deal. This is no doubt another tactic to ensure the stability of the agreement once made, though others may say it is just good manners.

In conclusion, perhaps it would be well to list some of the pitfalls that should be avoided:

(1) Never threaten, unless you are prepared to carry out the threat. Don't permit any credibility gaps; once your bluff is called, credibility is difficult to regain.

(2) Don't lose control over the negotiation. The government should negotiate on its own ground, frame the issues and determine the procedures.

(3) Ask for more than you are prepared to accept and don't get committed to an inflexible position. Always leave room for the bargaining process and don't be timid in putting forth knowingly unacceptable proposals.

(4) Never allow a mistake to go uncorrected. Sooner or later it will be discovered and result in mistrust.

(5) Protect your side's intersts: let the other side worry about theirs. But an agreement to be stable must be fair and reasonable to both sides.

(6) Never give anything without getting something in return.

Finally, remember that negotiation, like politics, is supposed to be the art of the possible.

Fiscal Aspects of Negotiating Third World Mineral Development Agreements

by Charles J. Lipton

Third World countries have lately taken a variety of actions to improve their revenues from the development of their mineral resources. Increasingly, their governments seek to negotiate production agreements on the basis of feasibility studies and discounted cash flow projections. Developing countries are now more selective in giving incentives to encourage investment in the mining sector. They recognize the value of their contributions to mining projects by way of guarantees and the provision of infrastructure. Third World governments now seek to participate in the basic decision making which determines profitability, such as loan-equity ratios, plant capacity, and processing and sales arrangements. They are alert to the benefits of large-scale development and appreciate their risks. They seek to increase their benefits from foreign exchange earnings and the multiplier effect of mining projects. New forms of arrangements are being used to insure that the mining sector is developed in harmony with the national objectives of the Third World.

The most significant recent event affecting the attitude of Third World countries in negotiating mineral agreements is the increase in the price of petroleum brought about by the Organization of Petroleum Exporting Countries (OPEC). The success of OPEC has lead to rising expectations by Third World countries and it has also stimulated the development of other producer associations. CIPEC, the copper producers' association, has been in existence for some time. The International Bauxite Association was formed in March 1974 and the International Association of Mercury Producers in April 1975. The Association of Iron Exporting Countries was formally organized in September 1975. As a consequence, the developing countries will have more information than before and become increasingly knowledgeable about mineral economics. The result will be that the Third World will seek to improve the terms for the development of their mineral resources.

It should not be surprising if hard-rock mining agreements follow petroleum agreements with a time lag so that the hard-rock agreements of 10 or 15 years from now look more like the petroleum agreements of today.

But this should not be viewed as a zero sum game. It is not necessarily a case where one side wins and the other side loses; one at the expense of the other. There are still quite acceptable profits to be made by mining companies in the Third World countries. Mining companies now should adopt a negotiating position which would allow them to meet the objectives of the Third World countries.

Third World Objectives

What are these objectives? Of course primarily, to get a fair share of the revenue. And the Third World perception of a fair share is changing.

Their governments will also seek to have some degree of control over the basic decisions that determine what that revenue will be or, otherwise put, the size of the pie which they seek to share. Obviously sales prices and operating costs are going to be most important, but Third World countries now recognize that other, less obvious factors also influence the size of the pie, such as the loan-to-equity ratio and the plant capacity.

Governments of Third World countries will watch loan-to-equity ratios closely because they will wish to know the extent to which government revenues will be offset by interest deductions and the effect both the interest expense and a relatively small equity will have on the discounted cash flow (DCF) return to the investor.

They understand that processing in the investor's existing plants will improve the DCF to the parent company, but would not increase the multiplier effect for the country.

Third World countries will put greater emphasis on processing in the host country. The mining companies will have the burden of proof to demonstrate that it is not economically viable to process. Governments may also insist on periodic reviews to ensure that processing will be undertaken locally when it becomes economic to do so.

They are aware that the rate of operations will affect the DCF. They also know that the cutoff grade determination, the overburden ratio, and the mining method selected may maximize profits to the investors, but may not necessarily maximize the economic return to the government as the owner of the mineral deposit.

The Third World is now more sophisticated about sales arrangements, particularly long-term sales contracts. To some degree this has been an educational process through OPEC itself. Most government officials appreciate the hazards of uncontrolled transfer pricing and understand the use of credit arrangements in intercompany sales to increase the return to the parent organization.

They are alert to various methods by which a parent organization may increase the DCF on its investment through affiliated company charges such as shipping and insurance fees, buying and selling commissions, the rate of interest charged or paid on intercompany loans, licensing charges for technology, and, of course, management fees. It should be expected that Third World countries will consider the multiplier effect for the investor as well as the multiplier effect for the host government.

Foreign Investment Incentives

In future it will be important to segregate out those areas which are the most significant to the investor in

C. J. LIPTON is a lawyer practicing in New York, N.Y. TP 75K148, AIME Annual Meeting, New York, Feb. 1975. Manuscript, Jun. 2, 1975. Discussion of this paper, submitted in duplicate prior to Jun. 15, 1976, will appear in SME Transactions, September 1976, and in AIME Transactions, 1976, Vol. 260.

negotiating mining agreements rather than seek across-the-board benefits, exemptions, and lower charges that have been granted in the past. The whole foreign investment incentive package will probably be examined to identify incentives necessary for a government to offer an investor in a mining project. A mining venture may not necessarily be given the whole package under the standard foreign investment legislation. Mining companies cannot expect to be treated the same way as a company manufacturing shoes or textiles. Developing countries may no longer be persuaded that they are in a situation where they have to compete with one another for mineral investments.

One may strongly disagree with this and suggest that a mining company, just like a shoe company, does have a choice as to where it will invest its exploration and development dollars. Some developing countries maintain that a mining company must go where copper, uranium, or gold can be found. In any event, it should be recognized that a developing country need not necessarily offer a mining company the same package of incentives given a shoe company.

When asked to give fiscal incentives, some developing countries are going to insist that incentives can only be given when justified and they will not know whether they are justified until a proper feasibility report is produced and studied. For they believe that in the final analysis, no matter what the form of a mineral development agreement, it is basically a contract for the sale of minerals in the ground by the owner to the operator. Hence, they will assert that it is premature to ask a government to agree to sell a mineral deposit until it has sufficient information to appreciate its value.

It should be expected that Third World countries will in future try to avoid definitive mining agreements in advance of exploration. Letters of intent will be preferred which will spell out basic principles and leave significant aspects of the fiscal regime to be negotiated in the future. They will take the position that it will be necessary to study the feasibility report and determine what the DCF is going to be before they will be able to negotiate a fiscal regime.

Some developing country governments will not grant production rights at the same time as exploration rights. To many, this is a form of heresy for mining companies have traditionally taken the position that they will not accept exploration risks without being guaranteed the right to mine in the event of discovery. But this has already happened in countries in Africa, Central America, and Asia. Mining companies have undertaken exploration and spent large sums without the assurance of production rights. Certain Third World countries have given instead a right of first refusal; others an exclusive right to negotiate for mining rights for a period of time. It may, however, be possible to negotiate for assurances that exploration costs would be paid back in the event that the mining rights are granted to a third party.

Bonus Payments and Taxes

The Third World countries should be expected to ask for bonus payments as has been traditional in petroleum agreements. It wouldn't be surprising to find not just signature bonuses, which are not unusual today, but discovery and production bonuses as well.

Of course, the level of profits taxes will rise. In the past, a good many developing countries have taxed mining enterprises at the ordinary company tax rate and then given incentives so as to reduce that tax level even further. It should be anticipated that more governments will tax mining enterprises at a different and higher rate than that applicable to other companies. Profits taxes will increasingly be made progressive or subject to escalation.

We would probably all agree that it will be extraordinarily difficult if not impossible today to reduce the effective tax rate by way of percentage depletion allowances. It may even be difficult to charge off cost depletion. A signature bonus or payment to obtain rights to explore or produce may not be allowed as deductions in the computation of taxes. Some Third World governments have already insisted that the parent write this off against its taxes at home, rather than the operating company against its taxes in the host country.

Tax holidays are certainly going to be more difficult to negotiate in future, even though they are part of the traditional foreign investment package. Third World countries are going to argue that the result for an American company would be to transfer the tax from the host country to the United States government because the United States government, as is well known, does not recognize tax holidays by way of tax "sparing."

A host country should be expected to maintain that while a tax holiday will increase an investor's cash flow, the taxes will still be paid when the profits are taken home. Payment is only postponed. They will claim that this will be a very expensive incentive as the host government will lose tax revenue to the investor's government. The benefit to the investor may not be proportionate to the loss to the developing country.

Moreover, Third World countries are concerned that tax holidays only encourage abnormally high operating rates and, where it can be done, selective mining so as to take the high-grade material first and increase the profits that can be earned during the tax holiday period.

Even where governments may be persuaded to give tax holidays, it would not be surprising to find that they will ask that notional amortization and depreciation be taken at the same time. The effect of this may be to limit the benefits of a tax holiday to a greater or lesser degree.

In future, it may be that the better advised mining company will be negotiating not for tax holidays, but for advantageous methods of taking depreciation instead. The effect of accelerated depreciation on the DCF may be substantially equivalent to a tax holiday.

A whole new generation of lawyers and accountants have trained at home and abroad and are now taking their places in the ministries of developing countries. They know the DCF consequence of using the declining balance method of charging depreciation or using the sum of the digits method rather than straight line. Traditional accounting concepts may be revised and this may offer opportunities. For example, it may be possible for an operating company to use replacement accounting rather than cost depreciation.

Developing countries are probably going to reexamine other elements of tax policy in hard rock mining. Governments are increasingly aware of the use of foreign tax credits and therefore it should prove increasingly difficult to avoid dividend withholding taxes. What the level is going to be may very well be the subject of negotiation on an individual basis, where double taxation treaties are not applicable.

For the same reason, interest payments to lenders will probably no longer be exempt from withholding taxes, as they have been in the traditional concession agreement of the past. The argument has always been made that the lender will gross up and charge a higher interest if it has to pay a withholding tax in the host countr[illegible] Governments will want to know why a lender cann[illegible] use a foreign tax credit too. This will become especially important when negotiating loan-to-equity ratios.

Royalties

As a result of OPEC, it should be anticipated that the Third World will experiment with the mix of royalties and taxes. Certain of the Third World countries have imposed export taxes as one method of increasing their return quickly. Production and severance taxes cannot be ruled out.

The fixed royalty of so many cents a ton, is probably completely obsolete now because governments believe that the value of their raw materials, particularly minerals, is bound to rise in the long term. Where a royalty is denominated in U.S. dollars, Third World countries are concerned that the value of the dollar will be eroded by inflation and other factors, so that a fixed royalty per ton may work out to be the worst of all possible arrangements for a developing country.

Royalties will be keyed to a percentage of market value as most recent agreements provide, or to profits, but in future it is more likely that this may escalate or be on a progressive basis.

Developing countries now understand the DCF concept to the degree that one has now put forward a "variable royalty" formula which would assure the investor an agreed upon DCF. The royalty is increased so that the government takes all profit above that which would result in the investor realizing the agreed DCF return each year. The royalty would therefore vary in accordance with profitability. Note that this concept did not originate in a Third World country, but in Western Canada.

If the OPEC countries have done nothing else, they have made it more difficult for other governments to accept prices on a realized basis in calculating royalties. There has been a great deal of publicity about transfer prices, but some governments are also now aware, through producer associations, of swap outs and transfer arrangements between mining companies. This may result in suggestions to establish posted prices for hard minerals and this will undoubtedly create tremendous difficulties.

Governments in the Third World frequently insist on using reference prices for royalty purposes. For example, it is quite common in copper agreements for the London Metal Exchange (LME) quotations to be used as reference prices. However, some have questioned whether the LME price is really a fair market price for copper. Producer prices on a weighted or formula basis have been used as an alternative to the LME. If there is a proliferation of reference prices, the result must be negotiated prices with each government for the purpose of royalty payments. Such prices might then be used for the determination of taxable income as is now the case in certain agreements. Ironically, this could be considered a parallel to the old Jamaican agreements, which taxed on an assumed or negotiated profit per ton of bauxite.

There may also be pressure to push back the pricing point in the calculation of royalty. Governments of developing countries may not accept in future the traditional net back-to-mine pricing point and seek to establish the pricing point f.o.b. port, so as to increase the amount of the royalty.

As a result of OPEC, it should also prove to be increasingly difficult to negotiate a royalty payment as a credit against income tax rather than as a deduction in the computation of taxable income.

Third World governments may seek minimum royalties, not so many cents per ton, but a minimum annual royalty amount keyed to a minimum operating rate and a projected floor price. This could be the reaction to the multisource strategy of certain mining companies. Governments will be cautious when they find the same mining company or group of mining companies mining the same mineral in different countries. A developing country would not want the rate of operation of a mining project fixed lower than the rate of operation in another country where the same group may have an investment in the same mineral and the cost of operation may be lower.

Similarly, they are concerned that plant capacity may be arbitrarily reduced in one country so as to limit the capital investment and exposure in that country, while saving capital for similar projects in other countries. The response to protect national interests may be to establish a minimum plant size and rate of operation or a minimum royalty, or both.

Exemptions and Preferences

Exemptions which have been negotiated in the traditional concession agreement will probably be limited or reduced in future. One such example is bound to be the exemption from import duties. A good number of countries now only exempt imports which are necessary and unique to a mining operation. As there is tremendous interest in the Third World in encouraging local enterprise, both goods and services, there is a disincentive to encourage the import of anything which can be supplied at home. Some developing countries argue that import duty exemptions are really hidden subsidiaries to the mining sector which they claim should do without them.

For the same reasons, it will be harder to convince Third World governments to give mining companies preferences in user charges for infrastructure such as port facilities, or lower tariffs for water and power, or lower freight rates. They will maintain that a company mining a nonrenewable resource should pay its own way and should not expect to be subsidized by a developing country in the form of concessionary freight rates, or lower water and power charges.

In the past, governments have charged a surface rental per acre or hectare, regardless of the use of the surface. These charges have usually been very low and this may change. While mining surface areas may continue to be subject to a relatively low surface rental charge, it should be expected that there will be higher charges for those surface areas which will be used for plant and equipment, housing, infrastructure, and for access and rights-of-way. Commercial rents are being charged for such use by some developing countries.

Third World countries are, almost by definition, chronically short of hard currency. This situation, if anything, has become more critical than before in the last year. As a consequence, exchange control provisions are bound to become more stringent.

Some developing countries will insist on full repatriation, but it may be possible in others to negotiate agreements to set up arrangements to permit hard currency earnings to be kept abroad to service loans or pay for equipment which must be bought overseas.

One mining company made an arrangement to deposit funds in a bank owned by a host country but located in a third country. This gave the host country the benefit of the hard currency float and, at the same time, allowed the investor to meet its hard currency obligations, subject to certain restrictions, without going through the usual exchange control procedures and encountering the usual delays.

With respect to exchange control, Third World countries will readily give assurances on nondiscriminatory treatment on procedures, but resist assurance of a particular rate of exchange.

More developing countries will place limitations on

the ability of investors to bring profits home. Many such countries have already limited such payments in a given period to a percentage of the equity investment or imposed similar restrictions.

In the past, investors asked for "most favored company" treatment. Now one hears of governments asking investors for "most favored nation" assurances. Mining companies should consequently be very alert to any precedents that may be established in negotiating agreements. It will be more difficult than ever to keep agreements confidential, even by resorting to the side letter device. Information will be exchanged in producer associations. Indeed, that is a principal reason given for their organization. Of course this only parallels the practices of mining companies in exchanging information about particular countries.

The traditional concession agreement was designed in part to "freeze" the host country's legislation. This is being resisted more strongly than before in the light of the United Nations Declaration on Permanent Sovereignty over Natural Resources. Such freezing is considered by some Third World countries as incompatible with their sovereignty. Mining companies are being assured by such countries of nondiscriminatory treatment.

Perhaps the most sensitive areas in negotiating mineral development agreements lately are renegotiation and reopener provisions. In the past, investors have steadfastly maintained that concession agreements were not subject to renegotiation. We are all familiar with recent history in that regard, particularly with antiquated agreements which were not in keeping with expectations or current practices.

Some investors and developing countries have thought that it would be to their mutual advantage to negotiate clauses in mining agreements which would allow for reviews periodically or when the expectations of both parties have not been realized with respect to revenues and the return on the investment that were the basis for the agreement. Some believe that this is asking for trouble, but this does provide a mechanism to ensure that precipitous actions are not taken. This kind of flexibility adds appearance to reality and may prove exceptionally useful.

Joint Ventures and Service Contracts

It has been suggested that the form or structure of a development agreement may reduce the risk of nationalization and may even increase a mining company's profitability. Two such forms of agreement are the joint venture and the service contract.

A joint venture company is consistent with the national aspirations of developing countries, but their governments recognize that taking shares in a company is not going to change the "bottom line" figure to an investor. Whether a mining company pays a government in the form of dividends, royalties, profit taxes, bonuses, or surface rentals, such payments must come out of the "bottom line"—the return to the investor, its DCF. Thus joint venture agreements, with government participation in the equity, may be useful to obtain certain fiscal advantages which a mining company might not otherwise be able to negotiate.

For example, as we all recognize, there are advantages to trading off a tax for a dividend payment. Then the company determines what the profits are, how much will be available for distribution and when dividends are paid. This is a far cry from paying taxes where it is the government's tax collector who determines what taxes are paid and when they are going to be paid.

The joint venture form may also be useful to trade off "free shares" against payment of a bonus or to reduce tax or royalty rates.

There are of course many methods for government participation and many levels of government equity participation. There probably has been too much emphasis on whether a government has 51% of the equity, or 50%, or 49%. Where a government has control of an operating company, no mining company is going to make an important capital investment unless this is also coupled with a management agreement.

One is reminded of the country that insisted on 51% ownership and so 100,000 shares of stock were issued. Class A, 51,000 shares, all went to the government. Class B, 49,000 shares, went to the foreign consortium. It was a 51-49% split and all shares ranked pari passu, or equally, except in two respects: the 51% government shares were nondividend participating and nonvoting.

Of course this cannot be negotiated any longer, but it is suggested that joint venture agreements can be negotiated in which the bottom line figure won't be lower than the levels experienced using other forms of agreement, and where the investor still has control to a large degree over its capital investment through a management agreement.

That leads to the service contract. It is being used now for a copper deposit in Iran where a large American mining company was retained to carry out the project. It has also been used by Venezuela, where a smaller American company was hired to mine an iron ore deposit.

Under a service contract, a mining company is hired for a fee to carry out the mining operations. Under this kind of arrangement, there is no capital contribution by the mining company. There is nothing to nationalize, because there is no property interest that is held by the investor. It is management know-how and marketing ability which is sold. Compensation can be paid in different ways: on a fixed fee basis, percentage of sales, or percentage of profits, or a combination of the above. The result in terms of profits cash flow or the bottom line may not be radically different from that found in the traditional concession agreement. But the investment and the risks are much smaller. At the same time, Third World countries will be assured that their objectives will be met.

In future, it may be more advantageous to negotiate joint venture or service contract types of agreements rather than the traditional concession. While the legal arrangements may be different, the return could be the same, or even significantly better.