

# MINERAL ROYALTIES: A REVIEW OF THE DEVELOPMENT OF MINERAL ROYALTY LEGISLATION IN SOUTH AFRICA



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## ABSTRACT

### **MINERAL ROYALTIES: A REVIEW OF THE DEVELOPMENT OF MINERAL ROYALTY LEGISLATION IN SOUTH AFRICA**

DEPARTMENT : TAXATION  
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A dynamic shift in the ownership, management and development of the country's mineral heritage took place after the inauguration of the new political dispensation in South Africa in 1994. This resulted in the enactment of the Mineral and Petroleum Resources Development Act (28/2002) (MPRDA) in 2002. In accordance with the MPRDA the country's mineral and petroleum resources are the common heritage of the people of South Africa and the State acts as the custodian of these resources for the benefit of all people. In this capacity, the State may determine and levy a fee or consideration payable in respect of these resources. The Minerals and Petroleum Resources Royalty Act (28/2008) (MPRRA) was enacted on 24 November 2008 to impose a mineral royalty on the extraction of South Africa's mineral resources to compensate the nation for the depletion of its mineral wealth.

This legislation is likely to have a significant impact on the South African mining industry. The aim of this study was to review the development of this legislation to gain an understanding of the issues considered when it was developed and to identify certain aspects of the MPRRA that may require further research in order to be improved in future. The analysis consists of a qualitative comparison of the draft versions of the Mineral and Petroleum Resources Royalty Bill (MPRRB) and related commentary.

The study recommends that legislators reconsider the level of royalties to be levied as well as the mechanism contained in the MPRRA to promote downstream beneficiation to ensure optimal benefits from extracting the nation's mineral resources. Further research of these aspects could improve the South African mineral royalty regime in future.

**Keywords:**

Mineral royalties; Mineral Extraction Tax; Mineral and Petroleum Resources Development Act (MPRDA); Mineral and Petroleum Resources Royalty Act (MPRRA); Mineral and Petroleum Resources Royalty Bill (MPRRB)

## OPSOMMING

### **MINERAAL TANTIÈME: 'n OORSIG OOR DIE ONTWIKKELING VAN MINERAAL TANTIÈME-WETGEWING IN SUID-AFRIKA**

DEPARTEMENT : BELASTING  
GRAAD : MAGISTER COMMERCII BELASTING

Die inlywing van Suid-Afrika se nuwe politieke bedeling in 1994 het 'n dinamiese verskuiwing in die eienaarskap, bestuur en ontwikkeling van Suid-Afrika se minerale welvaart tot gevolg gehad. Dit het aanleiding gegee tot die promulgasie van die Mineral and Petroleum Resources Development Act (28/2002) (MPRDA) in 2002. Ingevolge die MPRDA is die land se minerale- en petroleumhulpbronne die gemeenskaplike erfenis van al die inwoners van Suid-Afrika en tree die Staat op as toesighouer daarvan tot voordeel van al die inwoners. As toesighouer mag die Staat enige fooi of vergoeding bepaal en hef in verband met hierdie hulpbronne. Die Minerals and Petroleum Resources Royalty Act (28/2008) (MPRRA), wat op 24 November 2008 gepromulgeer is, hef tantième op die ontginning van Suid-Afrika se minerale hulpbronne om die nasie te vergoed vir die uitputting daarvan.

Hierdie wetgewing sal waarskynlik 'n wesenlike effek op die Suid-Afrikaanse mynbou-industrie hê. Die doel van die studie was om 'n oorsigstudie te doen om 'n begrip te ontwikkel rondom die kwessies wat oorweeg is tydens die ontwikkeling van hierdie wetgewing en om sekere aspekte van die MPRRA te identifiseer wat verdere navorsing benodig om in die toekoms verbeter te word. Die studie bestaan uit 'n kwalitatiewe vergelyking tussen die verskillende weergawes van die witskrifte van die wetgewing (Mineral and Petroleum Resources Royalty Bill (MPRRB)) en verwante kommentaar.

Die studie beveel aan die wetgewers die vlak van die tantième wat gehef sal word, asook die meganisme in die MPRRA wat die verdere verwerking van minerale hulpbronne aanmoedig om te verseker dat optimale voordele uit die land se minerale hulpbronne ontvang word, sal heroorweeg. Verdere navorsing oor hierdie aspekte kan die Suid-Afrikaanse minerale tantième-stelsel in die toekoms verbeter.

**Sleutelwoorde:**

Minerale hulpbronne; Minerale Hulpbronbelasting; Mineral and Petroleum Resources Development Act (MPRDA); Mineral and Petroleum Resources Royalty Act (MPRRA); Mineral and Petroleum Resources Royalty Bill (MPRRB)

## TABLE OF CONTENTS

CHAPTER ONE: BACKGROUND AND OBJECTIVES OF THE STUDY .....	1
1.1    BACKGROUND.....	1
1.1.1    Historical perspective on mineral ownership and legislation to reform the mining industry .....	2
1.1.2    Overview of the development of the legislation to impose royalties .....	3
1.2    RESEARCH OBJECTIVES .....	5
1.3    DELIMITATIONS .....	5
1.4    RESEARCH DESIGN AND METHODS .....	6
CHAPTER TWO: MINERAL ROYALTIES .....	8
2    INTRODUCTION.....	8
2.1    RESOURCE TAXATION IN THE MINING INDUSTRY .....	8
2.1.1    Objectives of fiscal Instruments used to tax the extraction of mineral resources.....	8
2.1.1.1.    Perspective of the owner of the mineral resources.....	9
2.1.1.2.    Perspective of the private mining operators .....	11
2.1.1.3.    Striking a balance between the requirements from the perspectives of the stakeholders involved in the South African mining industry .....	11
2.2    THE CHOSEN FISCAL INSTRUMENT: AN OVERVIEW OF MINERAL ROYALTIES .....	13
2.2.1.    Unit based mineral royalty instruments .....	14
2.2.2.    Value based royalty instruments .....	15
2.2.3.    Profit based royalty instruments .....	16
2.2.4.    Hybrid royalty instruments .....	17
2.2.5.    Concluding remarks on existing forms of mineral royalties.....	18
CHAPTER THREE: A REVIEW OF THE FIRST DRAFT OF THE MPRRB.....	19
3.1.    ROYALTY CHARGING PROVISION .....	19
3.1.1.    Royalty rate .....	20
3.1.2.    Royalty base.....	22
3.1.3.    Impact of the charging provision on downstream beneficiation .....	24
3.2.    RELIEF PROVISIONS.....	25
3.2.1.    Marginal mine relief .....	26
3.2.2.    Fiscal stabilisation provision .....	27
3.2.3.    Other relief measures .....	28
3.3    ANTI-AVOIDANCE PROVISIONS.....	28
3.4.    OTHER CONCERNS RAISED BY COMMENTATORS.....	29
3.5.    SUMMARY AND CONCLUSION OF THE FIRST DRAFT BILL .....	30
CHAPTER FOUR: A REVIEW OF THE SECOND DRAFT OF THE MPRRB.....	32
4.1.    ROYALTY CHARGING PROVISION.....	32



4.1.1.	Royalty rate .....	32
4.1.2.	Royalty base.....	35
4.1.3.	Credit for bad debts.....	36
4.2.	RELIEF PROVISIONS.....	37
4.2.1.	Marginal mine relief .....	37
4.2.2.	Small mining business relief .....	39
4.2.3.	Royalty rate guarantee .....	40
4.3.	ANTI-AVOIDANCE PROVISIONS.....	40
4.4.	OTHER CONCERNS REGARDING THE SECOND DRAFT OF THE MPRRB.....	41
4.5.	SUMMARY OF THE PROVISIONS OF THE SECOND DRAFT OF THE MPRRB.....	42
CHAPTER FIVE: A REVIEW OF THE THIRD DRAFT OF THE MPRRB .....		44
5.1.	ROYALTY CHARGING PROVISION.....	44
5.1.1.	Royalty rate .....	45
5.1.2.	Royalty base.....	48
5.1.3.	Credit for bad debts.....	51
5.1.4.	Balance of fiscal risk as a result of the revised charging provision .....	52
5.2.	RELIEF PROVISIONS.....	53
5.2.1.	Small mining business relief .....	54
5.2.2.	Fiscal guarantee.....	54
5.3.	ANTI-AVOIDANCE PROVISIONS.....	55
5.4.	OTHER CONCERNS REGARDING THE THIRD DRAFT OF THE MPRRB.....	57
5.5.	SUMMARY OF THE PROVISIONS OF THE THIRD DRAFT OF THE MPRRB.....	58
CHAPTER SIX: A REVIEW OF THE FOURTH AND FINAL DRAFT OF THE MRRB AND THE MPARRA.....		60
6.1.	ROYALTY CHARGING PROVISION.....	60
6.1.1.	Royalty rate .....	62
6.1.2.	Royalty base.....	65
6.1.3.	Credit for bad debts.....	66
6.2.	RELIEF PROVISIONS.....	66
6.2.1.	Fiscal stability agreements .....	66
6.2.2.	Rollover relief .....	67
6.2.3.	Transitional provisions.....	67
6.3.	ANTI-AVOIDANCE PROVISIONS.....	68
6.4.	SUMMARY OF THE PROVISIONS OF THE FINAL MPRRB AND MPARRA .....	68
CHAPTER SEVEN: SIGNIFICANT ASPECTS OF THE MPARRA THAT REQUIRE FURTHER RESEARCH .....		70
7.1.	LEVEL OF ROYALTIES LEVIED.....	71
7.1.1.	The issue identified .....	71



7.1.2. Area for further research .....	73
7.2. THE PROMOTION OF DOWNSTREAM BENEFICIATION IN THE MECHANICS OF THE ROYALTY EQUATION.....	74
7.2.1. The issue identified .....	76
7.2.2. Area for further research .....	77
CHAPTER EIGHT: SUMMARY OF FINDINGS .....	78
8.1. DEVELOPMENT OF A MINERAL ROYALTY REGIME .....	78
8.2. ISSUES FOR FURTHER RESEARCH IDENTIFIED .....	80
LIST OF REFERENCES.....	82
APPENDIX A – FIRST DRAFT BILL ROYALTY RATES .....	87
APPENDIX B – SECOND DRAFT BILL ROYALTY RATES .....	88

Abbreviations used in this document

<b>Abbreviation</b>	<b>Meaning</b>
MPRDA	Mineral and Petroleum Resource Development Act (28/2002)
MPRB	Mineral and Petroleum Royalty Bill <sup>1</sup>
MPRRA	Mineral and Petroleum Resources Royalty Act
MPRRB	Mineral and Petroleum Resources Royalty Bill

- <sup>1</sup> The first draft bill was titled the Mineral and Petroleum Royalty Bill. All subsequent draft bills were titled the Mineral and Petroleum Resources Royalty Bill.

## CHAPTER ONE: BACKGROUND AND OBJECTIVES OF THE STUDY

### 1.1 BACKGROUND

South Africa is a country with rich mineral wealth that is found in diverse geological formations. These formations are often unique and extensive by world standards ([www.info.gov.za/aboutsa/minerals.htm](http://www.info.gov.za/aboutsa/minerals.htm)). Minerals found in South Africa include inter alia gold, diamonds, titanium, manganese, platinum-group metals, bituminous coal and anthracite, copper, phosphate as well as iron.

The mining industry is an important contributor to the South African economy. The Chamber of Mines (2007) released information that illustrated the importance of the sector to the economy. The mining industry contributed approximately 6% to the GDP in 2007 while accounting for an estimated 1 million jobs in 2007.

Notwithstanding the industry's contribution to the economy, it has however been crippled by difficult economic circumstances. The domestic market for the mineral resources extracted is relatively small, causing the mining industry to be export orientated ([www.info.gov.za/aboutsa/minerals.htm](http://www.info.gov.za/aboutsa/minerals.htm)). This exposes the industry to foreign exchange fluctuations as a result of transactions denominated in currencies other than the South African currency (the Rand) as well as factors affecting the foreign mineral resource markets. The sector has been severely affected by the global and national economic recession. Official GDP data for the first quarter of 2009 indicated that the sector's contribution to the GDP has shrunk to 5%. The seasonally adjusted real value added to the GDP by the mining and quarrying industry had decreased at an annualised rate of 32,8% during the first quarter of 2009 if compared with the fourth quarter of 2008 (Statistics SA, GDP report Q1, 2009). In addition to this, the industry has been adversely affected by a looming national electricity crisis since 2007.

According to Cawood (2004) the inauguration of the new political dispensation in South Africa in 1994 initiated a dynamic shift in the ownership, management and development of the country's mineral heritage. An overall transformation of the national mineral and mining policies resulted in the enactment of the Mineral and Petroleum Resources Development

Act (28/2002) (MPRDA) in 2002. As part of this reform, the South African National Treasury (National Treasury) in conjunction with the Department of Minerals and Energy undertook the process to develop legislation to introduce royalties on all mineral and petroleum resources extracted in South Africa in 2003. From the outset it was clear that this proposed mineral royalty would have a significant impact on the South African mining industry (Cawood & Macfarlane (2003)). The South African mining industry's reaction was not unique; Otto, Andrews, Cawood, Doggert, Guj, Stermole, Stermole and Tilton (2006) stated that it is a global phenomenon that no type of mining tax causes as much controversy as mineral royalties.

### **1.1.1 Historical perspective on mineral ownership and legislation to reform the mining industry**

Since 2002 the ownership of mineral rights in South Africa has been governed by the MPRDA. Prior to the introduction of this legislation a number of alternatives existed as to the ownership of surface and mineral rights in South Africa. According to Cawood & Minnitt (1998) ownership of mineral rights and surface rights could have vested in either private owners or the State. Ownership was determined by the categorisation of the land in terms of previous mining regimes as well as the provisions of the Minerals Act (50/1991). From an administrative point of view uncertainty often existed in respect of the owner a mineral right. The onus rested on mineral right owners to proof ownership of the right before prospecting rights could be awarded.

No legally enforceable or uniform compensation to the owners of mineral resources existed when these mineral resources were extracted by third parties (for example, mining operators). If mineral rights were owned by the State, mineral lease agreements or nomination agreements were entered into between the mining company that extracted the mineral resources and the State to compensate the State for the use of its mineral rights as well as the depletion of its mineral resources. In the case of privately owned mineral rights a compensation package had to be negotiated with the owner of the mineral rights. One of the forms of compensation used by private mineral right owners was a mineral royalty.

In 2002 the MPRDA was enacted. One of the fundamental principles of the MPRDA is that the mineral and petroleum resources are the common heritage of all the people of South Africa. The MPRDA furthermore stated that the State is the custodian of these resources. This implied that the ownership of all the mineral wealth beneath the soil was transferred to the State in its capacity as custodian of the resources if it was owned by entities other than the State prior to the enactment of the MPRDA ([www.info.gov.za/aboutsa/minerals.htm](http://www.info.gov.za/aboutsa/minerals.htm)). The MPRDA allows the State to grant real limited rights such as prospecting, mining, exploration and production rights with regards to the minerals and petroleum resources as well as the land to private mining companies.

### **1.1.2 Overview of the development of the legislation to impose royalties**

Section 3 of the MPRDA stated that the mineral and petroleum resources are the common heritage of the people of South Africa and that the State is the custodian of these resources for the benefit of all people. In its capacity as the custodian of the nation's mineral and petroleum resources the State, acting through the Minister of Minerals and Energy, may in consultation with the Minister of Finance determine and levy, any fee or consideration payable in terms of any relevant Act of Parliament (section 3(2)). This provision paved the way for the development of legislation for the State to collect compensation for the use of the nation's mineral and petroleum resources.

The National Treasury elected to use a mineral royalty as the fiscal instrument to give effect to section 3(2) of the MPRDA to collect consideration for the use of the nation's mineral and petroleum resources. This fiscal instrument was implemented by developing and enacting the Mineral and Petroleum Resources Royalty Act (MPRRA) that imposes a royalty on the extraction and transfer of mineral and petroleum resources (any reference hereafter to mineral resources include petroleum resources). Four drafts of the Mineral and Petroleum Resources Royalty Bill (MPRRB) were issued by the National Treasury before the MPRRA was enacted in 2008.

Chapter 2 provides an analysis of the objectives of the fiscal policy in respect of the extraction of mineral resources and a review of mineral royalty instruments implemented in other countries.

The first draft of the MPRRB was not welcomed by the mining industry. Cawood (2003) concluded in a report to the National Treasury that there would be reason for concern if royalties were to be imposed in terms of the first draft of the MPRRB (this draft bill was titled the Mineral and Petroleum Royalty Bill (MPRB)). After numerous consultations with the role-players in the mining industry the second draft of the MPRRB was issued approximately three years after its release was initially anticipated. The third draft of the MPRRB introduced sweeping changes to the proposed royalty. Comments from influential role-players such as the National Union of Mineworkers in South Africa (NUMSA), which were published in the Response document to Portfolio Committee on Finance (2008), suggested that the development of the legislation has swung to such an extent that the provisions of this draft bill was unfavourable to the State and no longer in accordance with the spirit of the MPRDA. The fourth and final draft of the bill reverted back to principles contained in the second draft of the bill. The provisions of this draft bill formed the core of the MPRRA that was promulgated in the Government Gazette on 24 November 2008 to come into effect in respect of any mineral resource transferred on or after 1 May 2009.

A comparison of the draft versions of the bill and the related media statements that were issued by the National Treasury indicate that the bulk of the development and debate surrounding the legislation related to the royalty base and royalty rates to determine the amount of mineral royalties to be levied. Chapters 3 to 6 provide an in-depth discussion and evaluation of each draft of the MPRRB and the main points of contention contained in them.

After a process spanning over more than five years most parties involved agreed that the Bill was much improved since the first draft version issued in 2003 and that consultation with mining experts paid dividends in the process of drafting the MPRRB (Mail & Guardian Online (2008)). The role-players in the mining industry however still have different opinions on the most appropriate basis for determining the mineral royalties and the potential impact of the levying provisions included in the MPRRA for the South African mining industry.

The extent of the potential implications and the uncertainty surrounding the impact of the MPRRA was evident when the implementation process took an unforeseen turn. On 11 February 2009 it was announced that the implementation of the MPRRA, which was enacted 2 months earlier, will be delayed until March 2010 as a result of the potential impact it could have on employment in this sector (National Treasury, 2009:18).

## **1.2 RESEARCH OBJECTIVES**

The above overview of the development of the MPRRA provides evidence that the imposition of royalties on mineral and petroleum resources in South Africa, especially the basis for determining the amount of royalties, was lined with controversy. The provisions included in the MPRRA to determine the royalties may potentially have a significant impact on the South African mining industry when this legislation becomes effective.

This study was undertaken to review and analyse the development of the MPRRA because of the importance of the mining sector to the South African economy and the potential impact of the MPRRA on this sector. The review and analysis of the development of the MPRRA was guided by the following specific research objectives:

- The South African mining environment is unique in many ways. To achieve the objectives of the MPRDA, a mineral resource taxing system's design should be tailored to the South African context. The first objective of this study is to analyse the development of the MPRRA to gain an understanding of the issues, including issues unique to the South African context, that were given consideration during the development process.
- There were many areas of dispute during the process to develop the MPRRA. The second objective of this study is to identify provisions of the MPRRA that may require improvement in future and would therefore justify further research, based on the understanding of the development process.

## **1.3 DELIMITATIONS**

As stated by Cawood (2003) in an analysis of the first draft of the MPRRB, consideration must be given to the total taxation package to evaluate the impact of taxation on the

mining industry. Despite the fact that certain types of taxes, such as mineral royalties, affect only the mining industry, this industry often enjoys unique tax benefits. Otto *et al.* (2006) stated there is discrimination as to the way that the mining industry is taxed when compared to other industries. Reasons for this are, amongst others, the significant capital investments required for initial exploration activities, the long start-up period required and the fact that the minerals extracted are of a non-renewable nature and are often owned by the State. According to Meyerowitz (2006) taxation of mining operations in South Africa differs from the taxation of other income with the regards to, amongst others, allowances and recoupments available to companies performing these operations and the treatment of preliminary expenses. Mineral royalties can therefore not be viewed in isolation when evaluating the South African tax package for mining companies.

This study only focused on the economic and financial implications of the imposition of royalties on the extraction and transfer of mineral and petroleum resources. The development of administrative provisions, which were issued in a separate bill together with the last two drafts of the MPRRB, has not been addressed in the study.

#### **1.4 RESEARCH DESIGN AND METHODS**

The study was conducted in the form of conceptual research.

The sources of the study were publically available sources on the development of legislation to impose mineral and petroleum resource royalties in South Africa. The primary sources of information were the four draft versions of the MPRRB, the MPRRA as well as related media statements and explanatory memoranda that were issued by the National Treasury. This was supplemented by the following resources:

- the views of academic commentators that were published in mining journals;
- comments presented to the National Treasury by significant role players in the South African mining industry in response to the third draft of the MPRRB that were published in the Response document presented to the Portfolio Committee on Finance;

- comments presented to the National Treasury by significant role players in the South African mining industry in response to the draft versions of the MPRRB issued that were made available on the websites of the entities or that were provided on request; and
- legislation to impose similar royalties in other countries.

It was anticipated that the sources mentioned would view the proposed legislation from the perspectives of their respective divergent mandates. The commentators considered ranged from large private mining companies operating in South Africa, mine workers' unions, the South African Chamber of Mines, the South African Mining Development Association as well as the Revenue Watch Institute, an international non-profit policy institute that promotes the responsible management of oil, gas and mineral resources for the public good. It is expected that the views of these parties should result in a balanced view of the issues resulting from the legislation.

The application of this research design achieved the research objective of the study through a critical evaluation of each version of the MPRRB to establish the implications of its provisions as well as the reasons and consequences of changes from each version to the next.

## CHAPTER TWO: MINERAL ROYALTIES

### 2 INTRODUCTION

The enactment of the MPRDA was followed by the development of legislation by the National Treasury and the Department of Minerals and Energy in 2003 in terms of which compensation could be collected for the extraction of the nation's mineral and petroleum resources.

As mentioned in Chapter 1, the fiscal instrument elected to be used to collect the compensation for the extraction of the mineral and petroleum resources is a mineral royalty. This chapter commences with the review of the objectives of mineral resource taxation as well as a review of global development of mineral royalties. An analysis of the provisions of each of the four draft versions of the MPRRB to develop and impose mineral royalties in the South African mining environment is provided in Chapters 3 to 6.

#### 2.1 RESOURCE TAXATION IN THE MINING INDUSTRY

The mining sector differs from other sectors because non-renewable resources are depleted by the companies operating in this industry. Otto *et al.* (2006) stated that the motivation for levying taxes on the extraction of mineral resources is to provide compensation to the owners of the mineral resources for the use of their non-renewable resources by the private mining companies. It is therefore imperative to understand the overall objectives of fiscal policies in this extractive industry in order to analyse a fiscal instrument that is used in this sector.

##### 2.1.1 Objectives of fiscal Instruments used to tax the extraction of mineral resources

The mining industry is a major contributor to national wealth in many countries that have mineral deposits. Given the industry's economic importance it is critical that the implications of any taxation on this industry are considered from the perspective of all

stakeholders involved. Mining taxation can influence the economic decisions and behaviour of each of the stakeholders. The objectives of a fiscal instrument to collect compensation for the extraction of mineral and petroleum resources is therefore be analysed from the perspective of all stakeholders involved in the following sections.

#### **2.1.1.1. Perspective of the owner of the mineral resources**

As stated by Otto *et al.* (2006) the motivation for levying taxes on mineral resources extracted is to provide compensation to the owner of the mineral resources for the use of their non-renewable resources by the private mining companies. The objective of taxation on the extraction of mineral resources from the owner's perspective is therefore to collect a fair compensation for the depletion of his non-renewable mineral resources. The owner should however not collect a level of compensation that will discourage optimal exploration or the mineral resources as this will significantly decrease or even eradicate the his income stream from his resources

A feature of mineral rights that often adds another dimension to the equation is that in the majority of nations, mineral resources are owned by the state, by the people generally, or by the crown or ruler (Otto *et al.* (2006)). Sharma & Naresh (2001) stated that the government or State needs to collect taxes or compensation as its share of this national wealth to contribute to achieving its economic and social objectives in addition to the objectives of any other owner of a mineral resource.

This is the case in South Africa, where in terms of section 3(1) of the MPRDA the mineral and petroleum resources are the common heritage of the people of South Africa and the State acts as custodian thereof for the benefit of the people. The State's economic and social objectives should therefore be taken into account when determining and understanding the objectives of a fiscal instrument to impose tax on the extraction of mineral resources. The remainder of this discussion assumes the perspective of the State as the owner of the mineral resources.

From the state's perspective a method of taxing the mining industry that results in a consistent revenue stream would be the favoured method to collect compensation for the

extraction of its mineral resources (Otto *et al.* (2006)). This can be achieved by determining the tax to be levied without taking into consideration the profits realised by the mining companies and by solely basing the tax on the volume of mineral resources extracted. The only factor affecting the consideration will be the amount of mineral resources extracted. An example of this type of taxation is a tax that is based the quantity of mineral resources extracted, ignoring the sales value and the related costs to extract the mineral resources. A hypothetical example can be used to illustrate this type of tax. The tax levied would be determined as R1000 per tonne of mineral resources extracted. This tax would be levied as soon as mineral resources are extracted irrespective of the cost to extract these resources and the revenue generated when it is sold.

Otto *et al.* (2006) however warned that a tax that is relatively high in comparison with the profits generated by mining operators can discourage exploration and development of a country's mineral deposits. Taxes determined without considering the profitability of the person extracting the mineral resources (extractor) have more potential to be high in comparison to profits generated than those determined with reference to profits generated. Foreign investment in mining companies operating in this regime can be discouraged by high levels of mineral royalty taxes. This could result in large deposits being left unexplored. As a result the government's revenue received from mineral resources would decrease or could even be eradicated. This in turn could impact the State's ability to achieve its broader economic objectives. The same facts as the earlier hypothetical example are used to illustrate the impact of high royalty levels on the decision making process of mining operators. If the costs to extract the mineral resources are R10 000 per tonne (excluding the compensation to the owner of the resources) and the revenue generated by the mineral resources equals R11 000 per tonne, the full profit of R1 000 would be eliminated by a compensation of R1 000 per tonne that is levied by the government based on the quantity of the mineral resources extracted. In most instances profit may still be available after deduction of the compensation payment, but these profits may not be sufficient to encourage mining operators to explore mineral resource deposits.

### **2.1.1.2. Perspective of the private mining operators**

Otto *et al.* (2006) states that economic principles determine that mining operators will be driven by a profit motive to come to a decision as to whether mineral resources should be explored or extracted. As mentioned previously the government or State is often the owner or custodian of mineral resource deposits that are available to be developed and extracted by private mining companies.

From the perspective of the private mine operating company a tax that is levied only when the company has the ability to pay the tax (i.e. has a realised profit available) will encourage the company to explore and develop the mineral resources over the long term.

An example of this is a tax determined based on profit, similar to income tax. A tax that is levied at a rate of 30% of the profit generated will result in an amount of R300 tax on the profit of R1 000 in the earlier example. This leaves the mining operator with a R700 profit to serve as a motivation to further explore and develop resources. This however implies that the government's income stream depends on the mining operator's profitability and that a low or negative mine operating margin could result in no or little compensation being collected by the owner of the mineral resources even though a non-renewable resource has been depleted.

### **2.1.1.3. Striking a balance between the requirements from the perspectives of the stakeholders involved in the South African mining industry**

The perspectives described above are the two extreme tax desires of the parties directly affected by the mineral resource extraction tax. If the tax is determined without reference to the value of the mineral resources and costs to extract it, the mining company will carry the full fiscal risk of its activities. A profit-based tax system will shift the fiscal risk to the government because the government will not collect any compensation if the mining operator realises no profit, even though a non-renewable resource has been depleted. According to Otto *et al.* (2006), the tax policy for the mining industry should attempt to share the fiscal risk fairly between the mining industry and the government while still maintaining a reliable revenue stream to the government, encouraging exploration and

development of economically viable deposits and investment in the mining sector. According to Cawood (2003) an appropriately designed mineral resource tax is critical to achieve these objectives. Otto (2000) however also stated that to date no one has been able to define what a fair and equitable system that balances the fiscal risk between the government and the mining companies fairly is.

The State's fiscal policy with regards to the mining sector should however not be measured against fiscal objectives alone. Otto *et al.* (2006) noted that governments often utilise the wealth of mineral resources to achieve broader objectives to benefit the greater community. The South African mining industry is subject to a number of broader government objectives that would be affected by the decision to introduce a tax on the extraction of mineral resources as well as the manner in which the fiscal instrument is tailored to the needs of the South African mining environment. These broader objectives had to be considered as factors in implementing a tax to collect compensation for the extraction of mineral resources.

The first broad objective was the need to transform the South African society from being racially exclusive into one that allows full participation of all its members. Prior to the development and enactment of the MPRRA, the mining industry had already received particular attention with the development of the Broad-Based Socio-Economic Empowerment Charter for the South African Mining Industry simultaneously with the MPRDA to transform the industry.

According to SAMDA (2003) the MPRRB was the third statute introduced to govern this transformation process. The MPRRB had however raised more concerns in the industry than the first two statutes. Even though the SAMDA (2003) was in favour of a royalty regime being implemented, they cautioned that the level of royalty as well as the manner in which this regime is introduced may have a severe impact on the challenges faced by black economic empowerment (BEE) companies in the mining sector. The Competition Commission (2003), a body instituted to ensure that small and medium enterprises have an equitable opportunity to participate in the market, raised the concern that the royalty added another hurdle to entry into mining ventures and probably threatened the viability of many BEE projects. This view was shared by the mining operators in the private sector. In

a press release in reaction to the release of the first draft of the MPRRB Impala Platinum Holdings Limited (2003) made reference to the impact of the potential increase in borrowings required to finance the costs faced by new BEE entrants into the sector.

The second broad objective that had to be considered was the impact of the new type of tax on the attractiveness of South Africa as a mining investment destination in a developing country. In a paper presented at a SAMDA workshop the Canadian based international mining company Placer Dome Incorporated (2003) identified a number of burdens which impacted on South Africa's attractiveness as a mining investment country when compared to other countries before the introduction of mineral royalties. These burdens included the labour intensive mining methods used in South Africa, the cost of funding BEE participation in the mining industry, BEE procurement subsidies, the costs of meeting the requirements of the Mining Charter, the charging of skills development levies as well as the cost of providing social development and upliftment programmes.

## **2.2 THE CHOSEN FISCAL INSTRUMENT: AN OVERVIEW OF MINERAL ROYALTIES**

One of the instruments used by governments around the world to impose tax on the use of non-renewable mineral resources by mining companies is a mineral royalty. A mineral royalty is defined by Otto *et al.* (2006) as an instrument that provides compensation to the owner of a non-renewable natural resource in return for firstly access to the minerals which is granted to the mining company and secondly the right to develop the non-renewable resource for the benefit of the mining company. A mineral royalty consists of two elements namely a level of royalty, which is reflected in the royalty rate, and a tax base, which is reflected in the royalty base, for the computation to impose this level on the quantity of resources consumed (Cawood (2003)).

According to Cawood (2003) the benefits of this instrument are that it is relatively easy to administer and that it can be tailored or adapted when the need arises. The popularity of this instrument can be attributed to the fact that the flexibility of the instrument enables it to balance the fiscal risk between the objectives of the government and the private mining companies. Otto *et al.* (2006) stated that governments around the world have developed a number of types of mineral royalties to suit its stakeholders' needs in the specific

countries. Each type of royalty has unique characteristics that have an impact on the government's income stream, the achievement of economic and social objectives, mining operators' behaviour, investor decisions as well as the tax administering authorities. A study of the tax policy in Argentina that was undertaken by the World Bank (1990) noted that no single type of royalty instrument is superior to another in all instances because the risks and challenges faced in one country, the government's objectives and the nature of the mineral resource deposits differ from those of other countries.

This chapter concludes with a review of the characteristics of the major types of mineral royalties which have been designed and implemented elsewhere before the mineral royalty that was developed for the South African mining industry is analysed in the next 4 chapters. Otto *et al.* (2006) classified mineral royalties into the following categories based on the characteristics displayed by each method of determining the royalties:

### **2.2.1. Unit based mineral royalty instruments**

According to Otto *et al.* (2006) the oldest form of mineral royalties is a unit based royalty. These royalties are determined with reference to the volume, quantity or weight of the mineral resources at a defined point in the extraction and production process. Unit based royalties do not take profits or elements of profits (revenue or costs) of the extractor into account.

Otto *et al.* (2006) used the resource royalties levied by the Chinese government in terms of Resources Royalty Regulations (Temporary) People's Republic of China - Decree [1993] No.139 of the State Council December 25 as an example of a typical unit based royalty legislation. This regulation stated in article 5 that the tax payable for Resource Tax should be computed in accordance with the assessable volume of the taxable products and the prescribed unit tax amount. The formula for computing the tax payable was as follows: tax payable = (assessable volume) x (unit tax).

The following Resource Tax Taxable Items and Tax Amount Range Table appeared as a schedule to the regulations to prescribe the tax amount per unit (unit tax in the formula) of mineral resources extracted:

<b>Taxable Items</b>	<b>Tax Amount Range</b>
1. Crude oil	8-30 yuan/ton
2. Natural gas	2-15 yuan/1,000 m <sup>3</sup>
3. Coal	0.3-5 yuan/ton
4. Other non-metal ores	0.5-20 yuan/ton or ml
5. Ferrous metal ores	2-30 yuan/ton
6. Non-ferrous metal ores	0.4-30 yuan/ton
7. Salt	
Solid salt	10-60 yuan/ton
Liquid salt	2-10 yuan/ton

Otto *et al.* (2006) indicated that this type of royalty is straightforward to determine in comparison to other forms of royalties and does not leave room for disputes because of the simplicity of its parameters. According to Otto *et al.* (2006) these royalties have grown less popular because of administrative difficulties of keeping the unit based rates up to date. This type of royalty can however significantly influence decision making, because it is an additional cost that is not variable in correlation with profits. In a study of a hypothetical quantity based royalty on the mature gold reserves in South Africa performed by Cawood (2006) it was indicated that insufficient consideration of profit when determining a royalty can lead to a large amount of economically viable mineral resource deposits not being extracted to the detriment of the country.

### **2.2.2. Value based royalty instruments**

The second type of mineral royalty that Otto *et al.* (2006) distinguished incorporates the value of the mineral resources into the calculation of the royalty. Value-based royalties, also known as ad valorem royalties, are based on the value of the mineral resources extracted. The value of the mineral resources is a concept that should be defined in the relevant legislation. Otto (2006) provided several examples of ad valorem royalties implemented by various countries. Two bases to determine the value used in calculating these royalties could be distinguished.

The first type of ad valorem royalty was illustrated by provisions of the Mining Law of the Dominican Republic Law No. 146. An ad valorem royalty of 5% on the Free-On-Board (FOB) value, as defined in the act, of mineral resources exported from the country. The FOB value was determined by the Secretariat of State for Industry and Commerce jointly with the Central Bank and may take into account international reference prices. The value used for this type of ad valorem royalty is therefore determined centrally and prescribed by the government.

The second type of ad valorem royalty is based on the value of an actual sale transaction when the mineral resources on which the royalty is levied are transferred. This was illustrated by Otto *et al.* (2006) by reference to the royalty levied by the Peruvian tax authorities. The holders of mining concessions are subject to ad valorem royalties defined in the Law of Mining Royalty N° 28258.- (06/24/2004). The rate payable is graduated based on the annual cumulative sales, commencing at 1% and rising to a high of 3%. The basis for the second type of ad valorem royalty is the sales value less beneficiation costs.

These royalties are still imposed irrespective of whether the mining company makes a profit on the extraction/transfer or not. Otto *et al.* (2006) identified certain aspects that can significantly affect the effectiveness of this basis of determining a royalty, such as the source used to determine value as well as the point in processing when the value is determined. The value is often determined by adding certain costs back to arrive at a value at a specific point in the beneficiation process. Otto (2006) pointed out that the use of transactions that took place as indicator of value exposes the government to transfer pricing issues which would require anti-avoidance measures when the royalty is computed.

### **2.2.3. Profit based royalty instruments**

The last major type of mineral royalty identified by Otto *et al.* (2006) is the profit-based royalty. The royalty amount is determined based on profit or another similar basis that recognises the costs incurred by the extractor to extract the mineral resources.

Otto *et al.* (2006) provided the royalty levied in the Canadian province of Ontario in terms of the Mining Tax Act, R.S.O. 1990 as an example of this type of royalty. The province of

Ontario assesses a mining tax on profits from mining operations with profits being defined as the gross revenue from sale of mineral products less most operating and capital costs including exploration and an allowance for depreciation. Special processing allowances are deductible reflecting incentives to further process ores in the province. The tax rate applied in the determination of mining taxes is set at 10% of taxable income.

According to *Otto et al.* (2006) this form of royalty is favoured by investors and private mining companies because it takes into account the company's ability to pay the royalty. It can however result in no compensation for the owner of the mineral resource when the extractor operates at a low or negative profit margin, even though non-renewable mineral resources have been depleted.

#### **2.2.4. Hybrid royalty instruments**

The above mentioned three types of royalties are the basic types of royalties used around the world. In addition to this, *Otto et al.* (2006) observed that countries often combine or alter these forms of royalties to produce hybrid royalty instruments to meet the specific requirements of the country.

*Otto et al.* (2006) provided the royalty levied by the Ghana's government, which is determined based on a value (i.e. an ad valorem royalty) with a profitability factor built into the calculation of the royalty rate, as an example of a hybrid royalty instrument which combines the characteristics of the different types of royalties discussed above. The Ghanaian Mining and Minerals Law of 1986 provided for the holder of a mining lease to pay royalties at a rate between 3% and 12% of 'total revenue'. The Mineral (Royalties) Regulations of 1986 provide for a sliding-scale type of royalty that starts at 3% for low grade ore with a maximum of 12% for high-grade ore. These percentages are based on the gross value of the mineral resources. This ratio is based on the quotient obtained by dividing the operating margin (i.e., working profit) by the total value of mineral resources extracted during the relevant fiscal period. The principles of the royalty determination are set out in the Minerals (Royalties) Regulations of 1987, LI 1349. The rate/ratio sliding scale worked as follows:

<b>Operating ratio (OR) (%)</b>	<b>Rate / remarks</b>
0–30	3% (minimum)
31–70	3 + 0,225(OR), maximum = 12%
71–100	12% (maximum)

### **2.2.5. Concluding remarks on existing forms of mineral royalties**

An analysis of mineral royalty instruments used by governments all over the world and their characteristics was conducted by a group of experts in the field of mining taxation under the leadership of Dr James Otto. One of the conclusions of this study was that it is not possible to hold out one approach to mineral royalty taxation as ideally suited to all nations or even to all mines in a country. A form of hybrid royalty instrument is often required to tailor the royalty to the requirements of the country's economy and the mining industry's unique characteristics.

In 2003 South African legislators set about to determine the most appropriate type of royalty instrument to be introduced to the South African mining industry to compensate the nation for the use of its non-renewable mineral and petroleum resources. Several elements of the existing forms of mineral royalties that are used by other countries were incorporated into the draft versions of the MPRRB. Chapters 3 to 6 provide a review the development of the MPRRB as well as the issues and challenges that were considered and discussed over a period of approximately 5 years until the MPRRA was enacted on 24 November 2008.

## **CHAPTER THREE: A REVIEW OF THE FIRST DRAFT OF THE MPRRB**

In 2003 the process to develop legislation to impose mineral royalties in South Africa commenced with the first draft of the MPRRB (first draft bill) being issued by the National Treasury on 20 March 2003.

The preamble to this bill stated that the contents thereof recognised the fact that the nation was entitled to a consideration when mineral resources that are part of common patrimony are extracted. It however affirmed the State's obligation to provide for economic and social development and recognised the need to create an internationally competitive investment environment while implementing the royalty regime.

This chapter reviews the first draft bill as well as commentary relating to it to evaluate the bill against its stated objectives. The discussion focuses on the elements of the charging provision, relief provisions as well as anti-avoidance provisions included in the draft bill.

### **3.1. ROYALTY CHARGING PROVISION**

The charging provision of the first draft bill was contained in section 3. Section 3(1) stated that a mineral resource extractor is subject to a royalty on a quarterly basis for every mineral resource extracted and transferred by that extractor. In terms of section 3(2) the royalty charged will be equal to the royalty rate applicable to the specific classification of mineral resource that appeared in First Schedule of the draft bill multiplied by the published tradable value of the mineral resource. To the extent that a published tradable value is not available, the gross sales value should be multiplied by the prescribed rate for the mineral or petroleum resource.

The event that gives rise to a liability to pay the proposed royalty is a transfer of a mineral or petroleum resource. Section 5 defined a transfer as any agreement, act, or operation of law that resulted in the disposal, distribution, exchange, sale, or any other voluntary alienation of beneficial ownership of a mineral resource. The definition of a transfer furthermore included any physical export of a mineral resource from the Republic. The

date of transfer is the earlier of physical delivery or the date of the bill of entry for export purposes in terms of the Customs and Excise Act.

According to a review of the first draft bill by Cawood (2003), the level of royalty was one of the most contentious issues stemming from the bill. The level of royalty was based on two components, namely a rate (royalty rate) and a base (royalty base). Each component is discussed separately below.

### **3.1.1. Royalty rate**

The royalty rate required to calculate the royalty in terms of section 3(2) was provided in the First Schedule to the draft bill (refer to Appendix A for this schedule). The First Schedule prescribed rates for 10 groups of resources that were grouped together according to their substance classification. According to Cawood (2003) it was difficult to see any rationale behind the specific grouping of mineral resources in the manner set out in the schedule. The prescribed rates ranged from 1% to 8% depending on the classification of the mineral resource extracted.

The first draft bill reflected a policy decision to discriminate between the ten groupings of mineral resources provided with regards to the royalty rates. According to Otto *et al.* (2006) one of the key policy decisions when designing a royalty system is whether the system will discriminate between mineral resources rather than to apply a uniform rate to all mineral resources. Rate discrimination between mineral resources could be implemented to reflect the marketing or physical properties and the relative profitability of the different mineral resources in the royalty levied. It was noted by Otto *et al.* (2006) that it has been the practice of certain countries, such as Botswana, to discriminate between mineral resources by levying the royalty at different rates for different types of mineral resources. Otto *et al.* (2006) was however of the opinion that many nations have tended to move away from this type of system. The question therefore existed as to why legislators included a concept that was being done away with elsewhere in the new royalty legislation in South Africa.

Cawood (2003) furthermore questioned the appropriateness of using different royalty rates for each type of mineral resource if the uniqueness or inherent value of the mineral resource was already reflected in the royalty base (the published tradable value or the gross sales value). According to Otto *et al.* (2006) a discriminatory royalty rate system posed certain practical difficulties if it was applied to products which include a mixture of metals with different rates applicable to each metal, for example Platinum Group Metal (PGM) concentrate.

In addition to concerns raised by Cawood (2003) regarding the method of allocating royalty rates to mineral resources, the level of the royalty rates (1%-8%) proved to be a point of great debate in the mining industry. The press statement (2003) that accompanied the first draft bill stated that the proposed rates were reasonable and in the lower half of the international rate scales.

The mining industry did however not share this view. The South African Mining Development Association (SAMDA) (2003) noted that the majority of the rates which these proposed rates were compared to by the legislators were rates applied to profits rather than rates on gross sales values. This lower tax base (profit as opposed to gross sales value) results in a substantially lower royalty amount even if the royalty rate is higher. The Harmony Gold Mining Company Limited (2003) was of the same opinion in their assessment of the potential impact of the rates proposed in the bill, when they stated in the third quarterly review for the 2003 financial year that the proposed royalty rate for gold was very high compared to other gold producing countries in the world.

Cawood (2003) investigated the mineral royalty rates of countries that were found to be internationally competitive in terms of a 'Competitive Investment Framework' that incorporated fiscal criteria that supports a good mineral policy. This framework identified Chile, Argentina, Mexico, Peru and Brazil as internationally competitive mining countries. It was found that royalty rates in these countries ranged from a minimum of 0% to a maximum of 3% (with an average rate of 1.8%) to be applied to net smelter values, a lower tax base than the tax base proposed in the first draft bill. He was of the opinion that royalties levied at a rate of higher than 3% of a net smelter or sales value could impact project feasibility severely because the royalty would be a significant additional cost that is

payable regardless of project profitability. Entities operating in the mining sector appeared to share this view. This was reflected by a statement in the Harmony Gold quarterly review for the 3 months ended 31 March 2003 that announced that decisions to proceed with two projects had to be postponed until the royalty legislation was finalised.

### **3.1.2. Royalty base**

The allowable bases for the calculation were provided in sections 6 and 7 of the first draft bill.

Section 6 explained the use of published tradable values as the tax base in the royalty computation. Section 6(1) stated that the published tradable value should be determined with reference to the tradable values of mineral resources that will be published by the Department of Minerals and Energy. It also stated that the published values will reflect local and international arm's length sales prices. The draft bill was silent on the frequency of revision of the published values.

One of the reasons for introducing a published tradable price as a royalty base was to avoid situations where actual selling prices are less than the market value of the resource sold, thereby avoiding transfer pricing issues. Otto *et al.* (2006) however stated that from an administrative point of view it was often challenging to keep published tradable values up to date, particularly in the mining industry where significant fluctuations in prices are at the order of the day. COSATO and the National Union of Mineworkers (NUM) (2003) proposed that the published values should be reviewed on at least an annual basis in its initial submission to the National Treasury.

Otto *et al.* (2006) identified a further problem with the use of published prices. Prices are often not quoted in the markets for certain mineral resources that can be transferred, for example products such concentrate which consist of a mixture of metals. The National Treasury's response to this problem was to provide an alternative to published values as a royalty base in the first draft bill, by allowing the gross sales value to be used as the royalty base when a published price does not exist.

Gross sales value, the royalty base when published tradable values are not available, was defined in section 7. Gross sales value was defined as the higher of the total consideration received or receivable in exchange for the mineral resource and the declared price on the bill of entry as required for exported goods. The gross sales value excluded transportation and insurance related to the transfer of the mineral resources in order to ensure that the value used reflected only the sales value of the minerals transferred. When the gross sales value was denominated in a foreign currency, section 7(2) required that it should be translated to South African Rand at the spot rate of exchange on the date of transfer.

According to Cawood (2003) both of the above alternatives constituted *ad valorem* or value based royalties. In the press statement (2003) that accompanied the first draft bill the National Treasury claimed the use of an *ad valorem* royalty was proposed because it is international best practice. There are however several characteristics of this type of royalty instrument that impact on the economic decision making of mining operators that had to be considered. COSATU and the NUM (2003) agreed with the use of an *ad valorem* basis royalty as this eliminated the possibility that mining companies could manipulate profits to result in a lower royalty.

The SAMDA (2003) raised a concern that echoed the view of many role-players in the mining sector. The SAMDA expressed the view that a royalty based on revenue could have disastrous consequences for smaller mines. Smaller mines are more sensitive to changes in the level of working capital available than larger mines. This would imply that smaller mines would possibly not be able to absorb this significant additional cost. The SAMDA also noted this was likely to affect many small BEE mining companies and could threaten the achievement of the broader transformation objectives of the mining industry.

Cawood (2003) summarised the basis of this concern when he stated that this type of royalty does not take into account the mining company's ability to pay because it is levied irrespective of whether the company makes a profit or not. The royalty would be a non-variable direct cost to extract the mineral resources that are transferred. This cost would be incurred in all circumstances when mineral resources are extracted. Marginal deposits of which the extraction costs approximates the revenue that could be earned from extracting it may therefore be left undeveloped as a result of this additional cost. In a cash flow effect

analysis, Cawood (2006) proved that a gross sales value royalty would result in a substantial amount of lower grade gold deposits in South Africa being left undeveloped because the marginal cost to extract one unit of this deposit would exceed the additional revenue earned. This is in conflict with the objectives of a resource royalty tax that was discussed in 2.1.1.

### **3.1.3. Impact of the charging provision on downstream beneficiation**

Cawood (2003) identified the impact on beneficiation of minerals as a further significant criticism of the charging provision of the first draft bill.

On 23 September 1998 the Cabinet Committee for Economic Affairs approved a white paper on Minerals and Mining Policy for South Africa that was prepared by the Department of Minerals and Energy. This paper defined beneficiation as any process that adds value to a raw mineral resource up to the point where it is sold. It is stated that through beneficiation the benefit derived from the exploration of the country's non-renewable mineral resources can be maximised when value is added by further processing. For this reason downstream beneficiation should be encouraged. The document recommended that the Department of Minerals and Energy implement measures to promote downstream beneficiation.

Cawood (2003) however noted that the impact of downstream processing had not been taken into account in the definition of gross sales value in this version of the draft bill. It had not been established whether tradable published values, as per section 6, would have reflected processed or unprocessed values as these values were never published by the National Treasury. He was of the opinion that this shortcoming in the royalty base could discourage downstream beneficiation.

The concern is best illustrated by the following hypothetical example. A company extracts concentrate from ore and is able to sell the concentrate at R100 per tonne. If it is assumed that a royalty of 5% of the gross sales value is payable, the royalty will equal R5 (R100 x 5%) per tonne. If the concentrate is however processed further at an additional cost of R60, it can be sold at R200 per tonne. When the concentrate has been processed further,

the royalty will now amount to R10 (R200 x 5%) per tonne. A company processing the concentrate will be at a disadvantage compared to a company not processing the concentrate from the perspective of the amount of the royalty payable. This would discourage downstream processing that increases the gross sales value of extracted minerals and results in a higher mineral royalty. This will be in direct contrast to the objectives of the national mineral policy.

Based on the definition, a mineral royalty is an instrument that compensates the owner of the mineral resource for the mineral resource extracted. In the example given in the previous paragraph the same mineral resource was extracted, therefore the owner should theoretically receive the same compensation for the mineral resource extracted irrespective of whether it was processed further or not. Cawood (2003) suggested that this problem could be overcome by allowing a deduction cost for downstream processing costs from the selling price or published value of the processed mineral resource. By allowing a deduction for processing costs an estimate of the selling price or value of the unprocessed mineral resource at the point of extraction can be made when mineral resources have been processed further after extraction. This royalty base is commonly referred to as a net smelter value in the academic literature.

### **3.2. RELIEF PROVISIONS**

The above views and reactions of the mining sector to the proposed royalty regime indicated that the potential burden of the royalty might have been hard to bear for the industry, especially smaller mines which included Black Economic Empowered mining companies. The SAMDA (2003) commented that even though it did not contest the fundamental principle of levying a royalty, as levied in many countries, it was questioning the magnitude and the manner in which it was suggested that the royalty should be implemented. COSATU and NUM (2003) shared this view when they expressed that they were strongly in favour of a royalty regime, but it had to be ensured that a balance was struck between upholding that principle (levying a royalty) and applying the royalty in a way that did not trigger detrimental socio-economic consequences.

The first draft bill included a number of relief provisions. The National Treasury attempted to provide relief from this burden of the royalties that would have been imposed in terms of the draft bill in the following instances.

### **3.2.1. Marginal mine relief**

The first exemption, titled the marginal mine rate relief, provided a full or partial relief from the royalty burden. This relief was intended to be made available in the form of regulations that could be issued by the Minister of Minerals and Energy in terms of section 8 of the draft bill. Section 8(1) stated that such a regulation could be issued, at the discretion of the Minister of Minerals and Energy, in respect of mineral resources extracted in terms of a mining right granted under the MPRDA. The exemption had limited application as it was available to mines with only low-grade ores of questionable economic viability remaining. Section 8(2) provided certain minimum requirements that the Minister of Minerals and Energy had to take into account when a regulation was to be issued to the mineral extractor.

Cawood (2003) was of the opinion that the basic wording of the marginal mine provision and the requirements contained in section 8(2) were open to a significant degree of subjectivity as a result of the ministerial discretion. This posed a risk that the application of this relief mechanism could lead to biased treatment with regards to the levying of the royalty to certain mining companies but not to other similar companies. COSATU and NUM (2003) suggested that other parties, such as trade unions, should be involved in the process to determine whether a regulation was warranted before it was issued. This request supported the view that the relief provision should not solely be based on a decision by the Minister of Minerals and Energy.

Other role-players in the mining community expressed concerns with the marginality aspect of the requirements contained in section 8(1). The SAMDA (2003) commented that the legislator appeared to equate a marginal mine with a low grade mine because only mines with low grade ores would qualify for a regulation. It was of the opinion that this was however not the case as marginality is a function of profitability rather than the quality of the ore. Profitability could be affected a number of factors, which included amongst others

the grade of the ore extracted. The SAMDA represent many small mining companies, including emerging mining companies, black economic empowerment miners and small-scale survival miners. In the case of these companies the sources of funding, experience and mining techniques are all factors that affect the profitability of the mining operations.

COSATU and NUM (2003) questioned how the requirement of questionable economic viability would be applied. They argued that this provision could be abused if the evaluation of questionable economic viability rested with the mineral extractor. Cawood (2003) however also warned against subjectivity if the decision rested solely with the Minister of Minerals and Energy. The recommendation was that an independent standard should be set to measure questionable economic viability, rather than to leave it up to the judgement of the Minister of Minerals and Energy or the mining operator.

Cawood (2003) was of the opinion that the subjective application and vague manner in which this relief provision was worded suggested that National Treasury admitted that the basis and/or the level of royalties were such that it could have resulted in the demise of many mines in South Africa. This necessitated the need for this type of a relief as an escape route.

### **3.2.2. Fiscal stabilisation provision**

The preamble of the first draft bill stated that the bill provided royalty rate stability in order to create certainty in the investment community. This would lead to an internationally competitive and efficient mineral royalty regime. The fiscal stabilisation clauses that were designed to provide royalty rate stability were set out in sections 15 and 16 of the draft bill. Section 15 stated that an extractor could elect to apply the fiscal stabilisation provisions of the bill. If an extractor elected to apply the fiscal stabilisation provision it would be guaranteed a royalty rate for a period of 30 years. In terms of section 15(2), the locked-in rate was calculated as the rate contained in the First Schedule to the Bill plus the lesser of 50% of the prescribed royalty rate per the schedule or 2%.

According to Cawood (2003) this provision created the impression that a company that fixed its royalty rate at a higher rate would benefit from this in the future. This implied that

the National Treasury and the Department of Minerals and Energy intended to increase royalty rates in future. This sent out a negative message to prospective investors in the South African mining industry and could potentially discourage future investment in this industry. The fiscal stabilisation clause would therefore not achieve the objective set out in the preamble to the bill. COSATU and NUM (2003) questioned the duration of a stabilisation election, stating that valuable minerals could be monopolised if the term of the stabilisation election became too long.

### **3.2.3. Other relief measures**

In addition to the main relief provisions discussed above, the first draft bill contained a number of exemptions. These included exemptions for minerals extracted for sampling purposes, extraction of certain minerals solely for domestic use and the exploration of petroleum resources. These provisions are not discussed in more detail because they did not affect all mineral and petroleum resources. The impact of these relief provisions was furthermore not likely to alter the impact of core provisions of the bill as significantly as the major relief provisions discussed above.

## **3.3 ANTI-AVOIDANCE PROVISIONS**

As noted earlier, COSATO and NUM (2003) were of the opinion that the use of gross sales value as a royalty base exposed the royalty regime to the use of transfer pricing measures to secure a lower royalty. This could be achieved when the minerals are sold to a party (often a related or connected party), who is not the extractor of the resources and therefore not liable to pay the mineral royalty, at a sales price that is lower than a market value of the mineral resources by the extractor, who is liable for the royalty on the mineral resources extracted by him. This is done in order to reduce the royalty base and therefore the royalty payable on the mineral resources extracted. The mineral resources could then be sold at the normal market related price by the third party who is not the extractor and therefore not liable to pay the royalty on the mineral resources transferred. COSATU and NUM (2003) were of the opinion that anti-avoidance provisions were of particular importance given the strong resistance by the mining industry to the imposition of royalties.

Provisions to prevent the avoidance of the royalties were included from section 12 to section 14 of the first draft bill. Section 12 laid down the principle to prevent avoidance of the royalty. It stated that when a mineral extractor, who is subject to a royalty based on the gross sales value, transfers a mineral resource to a connected person or exports a mineral resource without alienating both the beneficial ownership and title, the mineral extractor will be liable for an additional royalty when beneficial ownership of the mineral resources is subsequently transferred to a person who is not a connected person in relation to the mineral extractor. This additional royalty will be equal to difference between the gross sales value when the mineral resources were initially transferred and the gross sales value when the minerals are subsequently transferred multiplied by the royalty rate applicable to the mineral resources. Section 12(5) however stated that this additional royalty will not apply if the mineral extractor provided reliable external proof of the gross sales value when the mineral resources were initially transferred.

Section 13 stated that an additional royalty will be levied when a mineral resource is exported to a connected person and is held outside the Republic of South Africa for more than a year after the transfer.

### **3.4. OTHER CONCERNS RAISED BY COMMENTATORS**

Impala Platinum Holdings Limited (Implats) (2003) raised a concern over a possible double royalty that it would have to pay to the State in terms of this draft bill as well as a royalty payable to the Royal Bafokeng Nation as its main concern regarding the first draft bill in a press release.

Prior to the enactment of the MPRDA certain forms of royalties were paid to the State, communities and private owners of mineral rights in terms of agreements between these parties (refer to 1.1.1). The MPRDA stated in section 3(1) that all mineral and petroleum resources are the common heritage of the nation and that the State is the custodian thereof. Item 11 of the Second Schedule to this Act however stated that notwithstanding the fact that old order mining rights ceased to exist they were converted or if the owners failed to convert them in terms of the MPRDA, any consideration, contractual royalty or future consideration that accrued to any community before the Act became effective shall

continue to be payable. Item 9(7) of the Second Schedule to the MPRDA contained a similar provision relating to lease payments payable in terms of section 74 of the Precious Stones Act (1994). This would result in a double royalty payment because the extractor will be liable to pay royalties on the extraction of the mineral resources in terms of MPRRB as well as to the beneficiaries of these previously agreed royalties (in terms of the MPRDA).

COSATU and NUM (2003) raised a concern that was closely related to the continuation of existing royalties payable to communities. The concern related to the fact that the first draft of the bill did not specify the purposes for which the royalties that will be collected in terms of this bill would be used. The MPRDA acknowledged that the mineral and petroleum resources that are extracted belong to the nation collectively. For this reason COSATU and NUM (2003) argued that the revenue generated by the royalties should not exclusively be used for the benefit of those directly involved in mining. It should however be kept in mind that the burden of detrimental effects of mining operations was not shared evenly by the nation. This should be reflected in the way the royalties collected are utilised. COSATU and NUM were of the opinion that the revenue generated from the royalties should therefore not only be used for aspects of general consumption, such as servicing the public debt. They suggested that a portion of the royalties collected should be allocated to a dedicated national fund or that a portion of the royalties should be ring-fenced in the national revenue fund to be utilised to the benefit of communities affected by mining operations.

### **3.5. SUMMARY AND CONCLUSION OF THE FIRST DRAFT BILL**

The first draft bill proposed a mineral royalty that was based on a published value of the mineral transferred multiplied by a prescribed royalty rate for the type of mineral. The gross sales value could be used as the royalty base if a published value was not available. Cawood (2003) commented that the proposed royalty rates were relatively high when compared to internationally competitive regimes. It was also noted that other countries in the world were moving away from a royalty system that discriminated between different groups or classifications of mineral resources. Cawood (2003) and the SAMDA (2003) raised questions regarding the royalty base as it did not take into consideration the mining

operator's profitability or ability to pay. Cawood (2003) identified the lack of consideration of downstream beneficiation as a major shortcoming of the first draft bill.

Relief from the burden of the royalty was provided by a marginal mine relief provision. A fiscal stabilisation clause was included in the legislation to ensure a stable royalty regime that will encourage investment. COSATU and the NUM (2003) expressed the view that the relief provisions should not be based solely on the discretion of the Minister of Minerals and Energy. Cawood (2003) also pointed out that a fiscal stabilisation clause that fixed the royalty rate at a level that was higher than the current rate would discourage investment by sending a negative message about future rate increases to prospective investors.

Based on the above review of the first draft of the MPRB and the commentary by role-players in the mining industry, it is questionable whether this proposed legislation would have achieved the objectives to create an internationally competitive royalty regime and provide for economic and social growth that were stated in the preamble to the bill. The SAMDA (2003) was of the opinion that National Treasury did not sufficiently consider literature on resource rent. They also expressed the view that the international comparatives used as a rationale for the royalty were not sufficiently researched and should be re-examined.

The SAMDA recommended that a process similar to the development of the Mining Charter should be followed to develop mineral royalty legislation. This process entailed the involvement of the National Treasury, the Department of Minerals and Energy, representatives from rural communities, SAMDA, the National Union of Mineworkers, the Chamber of Mines and other role-players in the development of the proposed legislation. This recommendation was implemented by the legislators. Extended discussions between the parties involved and consultation with experts in the field resulted in a vastly improved second draft of the MPRRB being released on 11 October 2006. The review and analysis of the second draft of the MPRRB is provided in Chapter 4.

## **CHAPTER FOUR: A REVIEW OF THE SECOND DRAFT OF THE MPRRB**

Three years later than initially anticipated the National Treasury released the second draft of the MPRRB (second draft bill) on 11 October 2006. The National Treasury press release (2006) indicated that revisions were made to the bill after extensive consultations to address most of the concerns raised during the first round of comments. These concerns have been discussed in Chapter 3.

This chapter provides a review of the provisions of the second draft bill, a comparison of these provisions with the corresponding provisions of the first draft bill as well as an analysis of the changes and implications of changes from the previous draft bill to this draft bill.

### **4.1. ROYALTY CHARGING PROVISION**

As discussed in Chapter 3, the royalty charging provision in the first draft bill proved to be one of the major points of contention during the consultations and discussions that followed the release of the first draft bill.

A revised charging provision appeared in section 3 of the second draft bill. In terms of this section a person who extracted and transferred a mineral resource for his own benefit would be subject to a royalty that was determined as the gross sales value multiplied by the royalty rate that is given in Schedule 1 of the Bill.

#### **4.1.1. Royalty rate**

The review in Chapter 3 suggested that the first draft of the bill was heavily criticised by the mining industry for the high proposed royalty rates that ranged between 1% and 8% as well as the discrimination in the royalty rates between different minerals based on substance classification groupings. Cawood (2003) also pointed out that the first draft bill would probably have discouraged downstream beneficiation of mineral resources because the costs and increase in value as a result of further processing were not taken into account in the royalty formula.

Section 4(1) of the second draft bill stated that the royalty rates to be used in terms of section 3 appeared in the First Schedule to the revised bill (refer to Appendix B for this schedule). This schedule classified mineral resources into mineral resources with a single rate, mineral resources with refined and unrefined rates as well as energy resources. The mineral resources were grouped into 11 different categories. This schedule furthermore contained a definition to determine when mineral resources, which had a refined and unrefined rate, were considered to have been refined for the purposes of applying this schedule. Section 4(2) allowed the Minister of Finance in consultation with the Minister of Minerals and Energy to amend the rates in the First Schedule.

The level of royalty rates in the revised First Schedule of the draft bill showed a distinct decreasing tendency when compared to the First Schedule of the first draft bill. The rate for unpolished diamonds, the item that had the highest royalty rate of 8% in the first draft bill, had been reduced to 5%. The rates for certain mineral resources, such as unrefined platinum group metals, however showed a 50% increase as it increased from 4% in the first draft bill to 6% in the second draft bill. Although the proposed level of rates were more competitive than those in the first draft bill, Cawood (2007) remained of the opinion that the decrease in the rates were not yet sufficient to result in an internationally competitive royalty regime. He suggested that all the rates should be between 1% and 2% as was suggested in his Competitive Investment Framework study and should be no more than a maximum of 3%. These rates should be applied to a net smelter value as a royalty base. This implied that the rates should be lower than 1% to 3% if a gross sales value base was used.

The second draft bill proposed the use of lower royalty rates, which were equal to half the unrefined rate, for refined minerals to address the concern raised by Cawood regarding the first draft bill's discouragement of downstream beneficiation. An example of this was the royalty rate of 6% that was applicable to the transfer of unrefined Platinum Group Metals compared to the royalty rate of 3% that was levied on the transfer of the same Platinum Group Metals when it was refined.

Despite the fact that the effect beneficiation had been addressed in the second draft bill, Cawood (2007) questioned whether the benefit provided by a 50% reduction in the royalty rate applicable to refined mineral resources would provide sufficient benefit to encourage and promote further downstream processing of mineral resources if the royalty base (gross sales value) increased significantly as a result of the beneficiation. The potential problem that may still exist is illustrated by an example. A mineral resource can be sold for R1 000 per tonne before any beneficiation has taken place. After beneficiation the mineral resource can be sold for R4 000 per tonne. If a royalty rate of 3% is applicable to the mineral resource in its refined form and 6% when unrefined, the royalty would be equal to R600 if no beneficiation takes place and R1 200 if it processed to a refined form. Any beneficiation that results in an increase of more than 100% of the sales value of a mineral resource would therefore still lead to a higher royalty than the royalty if the mineral resource was unrefined. It should also be noted that any beneficiation resulting in a product that does not meet the definition of a refined mineral would be ignored by this schedule when the royalty was determined.

According to Cawood (2007), the internationally accepted definition of a mineral royalty is an amount levied to compensate the owner of a mineral resource for the loss of the mineral resource, not taking into account the value added to the mineral resource after extraction. In terms of this definition the amount of the royalty levied should always be the same irrespective of whether the mineral resource has been processed or not. The equitability and effectiveness of taking beneficiation into account in the royalty rate applied, rather than the royalty base, remained a point of debate throughout the remainder of the development process up to enactment of the MPRRA in 2008. This is an issue that would justify further research. A summary of the issues relating to this aspect of the royalty bill is provided in Chapter 7.2.

The press release (2006) that accompanied the second draft bill stated that the distinction between refined rates, which were lower than unrefined rates for certain minerals, and unrefined rates resulted in the introduction of a liability sharing provision in the second draft bill. Section 15 stated that this provision was available to domestic companies that jointly elected for the provision to apply. This election could only be made when the companies were not part of the same consolidated group and the transferee would refine

the mineral resources. In terms of section 15 the extractor who transferred the minerals would not be liable to pay the royalty on the transfer of the minerals to the domestic purchasing company. This liability would be transferred to the transferee who could then utilise the lower refined royalty rate. A similar provision was provided to consolidated group companies in section 14 of the second draft bill without the requirement that the transferee company had to refine the minerals.

Cawood (2007) was of the opinion that the option to use these provisions should only be exercised after careful research of the economic consequences as its election may not always have the desired intention of the legislator. The royalty payable by the transferee would exceed the royalty that would have been payable by the transferor when the gross sales value increased by more than a 100% as a result of the refinement but the refined rate is only 50% of the unrefined rate.

Cawood (2007) raised a further concern by stating that the fact that the First Schedule still discriminated between minerals, with the extent of refinement now added to the equation, could result in increased compliance costs for the South African Revenue Services to ensure that refined rates are not abused in cases where one mine produces minerals that would be subject to different royalty rates (i.e. different types of metals (such as Chrome and Platinum) as well as refined and unrefined minerals). It was also noted by Cawood (2007) that the definitions of refined minerals and the implications of these definitions were more complex to apply in practice than it appeared from this schedule. The question of the application of this type of schedule to a mixture of minerals, such as the mixtures found in concentrate, remained unanswered.

#### **4.1.2. Royalty base**

The first draft bill proposed the use of traded published values, or gross sales value when traded published values were not available to be used as the royalty base. The review of the first draft bill in Chapter 3 indicated that the use of traded published values placed an administration strain on the tax authorities and was also likely to result in difficulties when it had to be applied to products which contain a mixture of minerals. Cawood (2003) criticised the royalty base in the first draft bill because it did not take downstream beneficiation into account.

The use of a published tradable value as the primary royalty base had been abolished by legislators in section 3 of the second draft bill. The definition of the gross sales value to which the royalty rate had to be applied was contained in section 5. This definition remained unchanged from the definition in the first draft bill. Section 5(4) added clarification that in cases where the gross sales value was not quantifiable, it would be deemed to have accrued in the period that it becomes quantifiable.

The use of gross sales value as a tax base for determining the royalty payable retained two contentious issues from the first draft bill. The gross sales value royalty base that would be multiplied by a fixed rate to arrive at the royalty still did not consider the mining company's ability to pay the royalty. For this reason it was still likely to influence decision making in the mining industry in an undesired manner. This concern was partially addressed by the profit-based marginal mine relief measure in the second draft bill that is discussed in 4.2.

The second issue was that the royalty base, namely the gross sales value, still increased when mineral resources were processed further. The royalty based on the gross sales value would therefore also increase for processed minerals. Legislators attempted to address this issue in the second draft bill by providing different royalty rates to be applied for refined (processed) and unrefined (unprocessed) mineral resources. As discussed in 4.1.1. the availability of different rates for refined and unrefined rates only partially addressed this concern.

#### **4.1.3. Credit for bad debts**

An additional provision to address bad debts was introduced in the charging provision of the second draft bill. In terms of section 6 a mineral extractor who owes or paid a royalty to the state was entitled to a credit against the royalty paid or payable to the extent that the debt accrued to the mineral extractor was written off, the sales price was reduced or the extractor reacquired the mineral resources. In principle it was questionable whether the compensation paid to the owner of a mineral resource for the depletion of mineral resources extracted should be reduced once the mineral resources have been extracted.

This issue was further contested in the third draft and final Bill and is discussed in more detail in Chapter 5.

## **4.2. RELIEF PROVISIONS**

The first draft bill provided relief in the form of a marginal mine relief provision that was available only to mines with lower grade ore and of questionable economic viability. It furthermore included a fiscal stability clause to fix a royalty rate at a rate higher than currently charged as its two main relief clauses. According to the review of the first draft bill in Chapter 3 these measures were deemed to be subjective and likely to discourage investment in the South African mining industry by creating an expectation of future rate increases.

The relief measures in the second draft bill were revamped significantly. The main relief measures in the second draft bill were a revised marginal mine relief, a small mining business relief and a royalty rate guarantee. The exemption for sampling and incentive for petroleum exploration remained in the second draft bill while the exemption for domestic use had been removed.

### **4.2.1. Marginal mine relief**

The marginal mine relief appeared in section 7 of the second draft bill. This section stated that the royalty imposed on a mineral resource extractor in respect of a mine during an assessment period may not exceed the adjusted net cash turnover of the mine during a period. The royalty could however never be reduced to less than 25% of the royalty that would have been imposed had it not been for this provision. The term adjusted net cash turnover is defined in the second draft bill as the net income (in terms of generally accepted accounting practice) arising from the mineral resources extracted from the mine after taking into account the costs of extraction, costs of conversion and other similar costs but specifically excluding expenses of a capital nature and costs paid to a connected person. This relief measure is not available when mineral resources are transferred to a connected person and all components of net income from a connected person should be disregarded in calculating the above described net income.

The introduction of the comparison between the royalty imposed and the net cash generated by the extraction and processing of the royalty was the first consideration of the mine operator's ability to pay in the development of the MPRRB. Cawood (2007) also noted that this provision effectively provided an automatic profitability royalty reduction of up to 75%. In the opinion of Cawood (2007) a uniform measurable threshold such as accounting profitability provided an objective measure of marginality as opposed to the subjective relief regulations that were available at the discretion of the Minister in terms of the first draft bill. In his opinion this provision was a definite improvement from the first draft's version of a marginal mine relief mechanism.

Even though the intention of the legislator was a step in the right direction, a number of issues were not addressed by the relief measure described in section 7.

Firstly, the term net income left room for manipulation. An internationally accepted accounting framework such as International Financial Reporting Standards does not contain a definition for this term. This could result in uncertainty as to the exact meaning and interpretation of this term and left it open to abuse and possibly costly legal disputes.

The second point of contention was raised by Cawood (2007). The relief was available to a mineral extractor. Certain mineral extracting companies owned a number of mining operations of which certain operations might have been regarded as marginal mines. The wording of section 7 would take into account the marginality of the aggregated operations of the extractor rather than the profitability of each of the operations.

The last issue raised was probably the most significant. As alluded to in the review of the charging provision the extractor's ability to pay the royalty has not been taken into account in that provision. The marginal mine relief provision would allow less profitable extractors to pay a reduced royalty when non-renewable resources are extracted. In order to make use of the relief provided the net adjusted cash turnover of the extractor must however be less than the gross sales value of the minerals transferred multiplied by a royalty rate between 0% and 5% (as discussed in 4.1.1.). This implied that a mine would have to be extremely close to its economic breakeven point (where the costs are equal to the revenue

generated) if the revenue less costs to extract and process the mineral resources equalled 0% to 5% of its revenue.

It was therefore questionable whether mineral extractors that were able to utilise this provision for a sustained period of time would have been able to continue to extract mineral resources in the long run without considering the impact of the MPRRB. It was also debatable as to whether it was feasible from an economic perspective to extract these deposits at all. It therefore appeared as if the scope of this relief provision would not have included a sufficient number of mines if a marginal mine provision was warranted. Cawood (2006) suggested other measures such as a proven Gold Mine Tax Formula and even the use of the definition of marginality that was contained in the MPRDA as alternatives to this provision.

#### **4.2.2. Small mining business relief**

In its comments to the National Treasury the SAMDA (2003) indicated that it was concerned about the impact that the first draft bill could have had on the mines represented by SAMDA. These mines included small and medium sized mining enterprises as well as BEE mining participants. According to the Competition Commission (2003), the imposition of a mineral royalty that pose an obstacle that hinders the transformation process would have been in conflict with the Mining Charter and MPRDA's objective of empowerment of previously disadvantaged persons.

The second draft bill contained a small mining business relief aimed at providing a solution to these concerns. In terms of section 8 a mineral extractor that qualified as a small mining business during a period of assessment (semi-annually in terms of the second draft bill) was only liable for the royalties payable to the extent that it exceeded R50 000 for the period of assessment. The term small mining business was defined in clear and measurable terms in section 8(2) as a domestic company or natural person, that holds no ownership interest of more than 20% in another mineral extractor and in the case of a domestic company where no other mineral extractor holds more than 20% ownership in that company and whose gross sales of all minerals transferred did not exceed R5 million during the period of assessment.

According to Cawood (2007) this provision would assist and stimulate small scale mining operations. In its comments on the first draft bill to the National Treasury, the SAMDA (2003) indicated that its small scale members generated annual revenues of between R500 000 and R1 billion. This implied that only small scale mining companies at the lower end of this range would qualify for this relief measure in section 8. In addition to established entities benefiting from this measure, it could also possibly have provided relief to mining operations in the start up phase. This provision would address certain concerns regarding obstacles to the entry of new black empowerment participants into the industry.

#### **4.2.3. Royalty rate guarantee**

The fiscal stabilisation clause discussed in Chapter 3 that would in Cawood's opinion (2003) have sent out negative messages to possible investors in was replaced by a state royalty rate guarantee in the second draft bill.

Section 17 stated that every person who held a mineral resource right received a state royalty rate guarantee. The person would not be liable to any royalty imposed in so far as it exceeded the royalty calculated at the rate described when the mineral resource right was granted or renewed or when this Act came into effect. The guarantee would remain effective until the right is terminated or renewed. Cawood (2007) commented that this development was once again in the right direction as it would have contributed to investor confidence.

### **4.3. ANTI-AVOIDANCE PROVISIONS**

The anti-avoidance provisions of the first draft bill received little attention from the mining industry in comparison to the other provisions of the first draft bill. As discussed in Chapter 3 the use of tradable published values and prescribed royalty rates as a primary basis for determining the mineral royalty in the first draft of the bill left relatively few opportunities for avoidance of this royalty. COSATU and NUM (2003) however identified the use of a gross sales value as a royalty base as an area where royalties could be

evaded when related party transactions were not at an arm's length price in an attempt to reduce the royalty payable by the extractor.

The abolishment of the use of published prices of minerals resulted in an expansion of the definition of a connected person transfer in the second draft bill to include any transfer that would not have been entered into had it not been for this Act where the person acquiring the minerals and the mineral extractor colluded so that the transaction was not at arm's length and that has the effect of avoiding, reducing or postponing the royalty payable to the state. Section 13 defined the term gross sales value specifically for transfers between connected persons. The crux of this anti-avoidance rule was that the royalty on any transfer between connected persons will be determined based on the greater of the actual sales value or an arm's length value (determined with reference to an uncontrolled transaction price or commercial prices). This provision is in line with similar provisions in the Income Tax Act which have been proven to be effective when implemented.

Section 3(4) included a provision that resulted in the beneficiary of the transfer being liable for the royalty if the transfer was done by another person on behalf of the beneficiary. This provision prevented abuse of relief provisions (which were discussed in 4.2) if entities that qualified for relief were used to make transfers on behalf of entities that do qualify for relief in an attempt to avoid the royalties resulting from the transfer.

#### **4.4. OTHER CONCERNS REGARDING THE SECOND DRAFT OF THE MPRRB**

A number of issues that were identified during discussions of the first draft bill with the mining industry had not yet been addressed in the bill by the time that the second draft MPRRB was released.

The second draft bill did not specify the purpose for which the royalties collected had to be used or identified an appropriate mechanism to keep these royalties separate from the National Revenue Fund.

The bill was furthermore silent on the treatment of consideration payable to communities in terms of Item 11 of the Second Schedule to the MPRDA. The National Treasury indicated

in the press statement (2006) that it encouraged communities and mining companies to enter into negotiations to convert the financial interests of communities into equity stakes in the operating companies.

Various role-players in the mining industry, such as the SAMDA (2003), raised concerns about the implementation and phasing in of the royalty regime in their comments on the first draft bill. According to the Webber Wentzel (2006) the Minister of Finance announced that irrespective of when the bill is enacted by Parliament it would only become effective to transfers on or after 1 May 2009, when all conversions of old mining rights into new mining rights should have been completed. Section 33(2) of the second draft bill confirmed this by including this date as the effective date in the bill.

#### **4.5. SUMMARY OF THE PROVISIONS OF THE SECOND DRAFT OF THE MPRRB**

The second draft bill stated that the mineral royalty should be calculated based on a gross sales value as the royalty base multiplied by a fixed royalty rate. This royalty rate depended on the classification of the minerals. The second draft bill furthermore provided separate refined and unrefined royalty rates for certain minerals in an attempt to promote refinement of minerals. Cawood (2007) was of the opinion that even though the rates have generally been reduced when compared to the first draft bill, they were still high in comparison to international royalty rates. He also raised the question whether it was equitable and effective to take beneficiation into account in the royalty rate, rather than the royalty base. Similar to the first draft bill, the royalty base proposed in the second draft bill did not take into account the mining operator's ability to pay the royalty and increased when the mineral resource was further processed.

The relief provisions included a profit-based marginal mine relief, a royalty rate guarantee and a small mining business relief to enable new participants to enter the market and provide a relief of the burden of the royalties to small mining companies. The marginal mine relief was the first consideration of the mining operator's ability to pay the royalty in the MPRRB. The main criticism of the marginal mine relief was that the application of this provision would have been very limited. Cawood (2007) was encouraged by the introduction of the small mining business relief that in his opinion would have assisted and

stimulate small mining operations as well as start up operations. In Cawood's opinion (2007), the royalty rate guarantee in the second draft bill would have encouraged investment more than its predecessor in the first draft bill.

Pat Cronin, from the law firm Edward Nathan Sonnenbergs, (2006) was of the opinion that the mining industry would find a measure of relief in the second draft bill after it was shaken by the first draft in 2003. This view resonated through the mining industry. The release of the second draft bill was followed by numerous consultations between the Department of Minerals and Energy, National Treasury and the mining industry. The discussions resulted in the release of a significantly amended third draft bill in December 2007. A review of the third draft bill is provided in Chapter 5.

## **CHAPTER FIVE: A REVIEW OF THE THIRD DRAFT OF THE MPRRB**

A year after the much improved second draft bill the third draft of the MPRRB (third draft bill) was released by National Treasury on 6 December 2007. This draft bill made sweeping changes to the royalty charging provision.

The legislative process to consider the third draft bill started with public hearings conducted by the Portfolio Committee on Finance (PCOF). The public comments received by the National Treasury on this draft of the bill as well as National Treasury's responses to these comments were presented in a Response Document to Parliament's PCOF (2008). Despite the fact that the third draft bill was welcomed by the mining sector, the National Treasury (2008) noted there were still a number of policy related issues that could be revised based on the recommendations of the PCOF. This meant that this third draft bill was not likely to be the final draft of the MPRRB.

This chapter reviews the third draft bill and the comments on it that were published in the Response document to the PCOF. The review includes a comparison of the provisions of the third draft bill to the corresponding provisions of the second draft bill as well as an analysis of the changes and impact of these changes.

### **5.1. ROYALTY CHARGING PROVISION**

Similar to the changes from first to the second draft bill that were discussed in Chapter 4, the most significant changes from the second to the third draft bill related to the royalty charging provision.

The charging provision in section 3 of the second draft bill proposed that the royalty should be calculated as the gross sales value of the mineral resources transferred multiplied by a prescribed royalty rate for the category of the mineral resource according to a schedule attached to the bill. This schedule provided different royalty rates for refined and unrefined mineral resources in an attempt to promote beneficiation of these mineral resources. As noted in the review of the second draft bill this charging provision did not take into account the extractor's ability to pay the royalty. The profit-based marginal mine relief did however

consider a marginal mine operator's ability to pay the royalty. Cawood (2007) questioned whether the royalty rate distinction between refined and unrefined mineral resources would sufficiently promote downstream beneficiation.

The third draft bill introduced sweeping changes to the royalty base as well as the royalty rate structure from those proposed in the first two draft versions of the bill. The charging provision in section 2 of the third draft bill stated that the royalty should be determined using the gross sales value to the extent that it exceeds the allowable deductions for the period as a royalty base multiplied by the royalty rate in section 3.

### **5.1.1. Royalty rate**

The components of the royalty rate in the third draft bill differed significantly from the method of prescribing a fixed royalty rate in the second draft bill that was discussed in Chapter 4. The third draft bill proposed the first formula driven royalty rate in the development of the MPRRB. The third draft bill removed the much criticized discrimination between different mineral resources with regards to the royalty rate as the same rate formula applied to all mineral resources. The use of different rates for refined and unrefined mineral resources was also removed after it was introduced in the second draft bill. This meant that the extent of beneficiation had to be taken into account in the royalty base to promote beneficiation.

Section 3(1) of the draft bill proposed that the royalty rate should be calculated using the following formula:

$$Y = X/B \times 100$$

Where the inputs were:

Y = royalty rate

X = earnings before interest, tax, depreciation and amortisation divided by the aggregated gross sales for the assessment period (resulting in a net profit ratio)

B = 12.5

The term earnings before interest, tax, depreciation and amortisation was defined in section 3(2) as the amount measured for financial reporting purposes, to the extent that the earnings were attributable to mineral resources won or recovered by the extractor.

The use of a formula driven royalty rate was regarded as being at the cutting edge of global best practice by the Chamber of Mines (2008). This formula automatically addressed issues such as marginal mines relief, start-up activities and allowed the State to share in commodity price booms as well as to ease the burden of royalties in difficult economic conditions. The National Treasury (2008) explained that the formula resulted in a shift of fiscal risk from the mining companies towards the State. COSATU (2008) was however of the opinion that the impact of this shift was too drastic and that the formula would contribute to the royalties levied in terms of the draft bill not compensating the nation sufficiently for the extraction of its diminishing mineral resources. This issue relates to the charging provision as a whole and is discussed in more detail in 5.1.4.

Amidst this development that was generally welcomed by the mining industry a number of concerns and issues relating to the royalty rate formula in the third draft bill still required the attention of the legislators.

One of the key features of the comments by the mining industry on the first and the second draft bills that were highlighted in Chapters 3 and 4 was the relatively high level of the proposed royalty rate and the impact thereof on the mining industry. In the Response document to the PCOF the National Treasury (2008) indicated that the B value of 12.5 was set in such a way that the royalty rate should vary between 1% and 5% , with an average rate of 2.7% if a net profit factor (X in the above formula) between 10% and 60% was assumed.

The Chamber of Mines (2008) commented that based on a study conducted by the Chamber, they believed that a B-denominator of approximately 20 would result in similar rates to those proposed in the second draft bill. This implied that the average rate calculated in terms of the proposed formula (with a B-value of 12.5) was expected to be higher than the rates proposed in the second draft bill. This view was shared by private

mining companies such as Implats (2008) and De Beers (2008) who suggested an increase in the B factor to prevent the royalty rates from being too penal. A concern raised by Implats (2008) related to the fact that the formula could possibly result in unusually high royalty rates in periods of booming commodity prices and economic prosperity if the royalty rate determined in terms of the proposed formula had no capped limit.

This possible increase in the royalty rate had to however be viewed, and could possibly be justified, in the context of the replacement of the gross sales value royalty base by a significantly lower net smelter return base. The B-factor provided the National Treasury with a flexible input that could easily be amended to change the level of the royalties levied if it was required to do so. The determination of the B-factor solicited varying opinions as to what value would constitute an appropriate value for this input from the mining industry. This is an issue that would require future research. The issue is therefore discussed in more detail in Chapter 7.1 of this study.

Certain practical and policy issues were posed by the introduction of earnings before interest, tax, depreciation and amortisation (EBITDA) in the tax rate formula.

The first of these problems related to the definition of EBITDA. The definition contained in the third draft bill narrowed the term down to EBITDA as measured for financial reporting purposes, but only to the extent that those earnings are attributable to mineral resources won or recovered by the extractor. The accounting framework to be used is not defined in the draft bill. The term EBITDA is furthermore not a term defined in accounting frameworks. This leaves room for manipulation of the royalty rate if the interpretation of the term EBITDA differs between accounting frameworks. Items that are included or excluded from this term by different accounting frameworks could also have caused inconsistencies. The South African Revenue Services (SARS) (2008) noted that it would not be able to prescribe to mining companies the accounting framework that it should use for financial reporting purposes.

The second concern related to the appropriateness of EBITDA as the basis for the calculation. Comments by mining companies, such as BHP Billiton and Implats (2008), highlighted the fact that the mining industry is a capital intensive industry. The ordinary

meaning of EBITDA does not allow to any deductions for depreciation on capital assets. It was recommended that earnings before interest and tax (EBIT) would be a more appropriate basis in view of the capital intensive nature of the mining industry. This basis includes a deduction for the depreciation charge for the period and reflects a measure of the capital expenditure incurred. If implemented this recommendation would however expose the formula to manipulation with regards to the estimates required in determining the depreciation amount to be deducted.

Thirdly, the allocation of EBITDA to earnings attributable to the mineral resources won or recovered posed a practical challenge as the draft bill did not provide guidance on the basis of allocation of earnings and related items to mineral resources won or extracted. This allocation would be open for dispute and possible manipulation. The SARS (2008) confirmed that the draft bill was not clear enough about basis for this allocation.

The last concern relating to the use of EBITDA was voiced by the Revenue Watch Institute (2008). It was noted that the proposed royalty will not be ring fenced per mine or type of mineral. Therefore a start up activity with a low EBITDA will reduce the overall EBITDA of an extractor resulting in a reduction in the State's share in the extractor's more profitable mines. The same principle is true for loss-making mines that could reduce the overall EBITDA for a mineral extractor. The National Treasury (2008) made a valid observation when they stated that the ring fencing of EBITDA for each mine operated by an extractor would place a tax compliance burden on taxpayers that could perhaps prove to be unnecessary in most cases. They were of the opinion that the weighting of the contribution of profitable mines and start up or loss making mines should on average net out to eliminate the effect of this concern.

### **5.1.2. Royalty base**

The royalty base to which the royalty rate had to be applied was changed from a gross sales value of the minerals transferred in the second draft bill to the aggregate gross sales to the extent that it exceeded the amount of allowable deductions for the assessment period in the third draft bill. This represented the use of a net smelter value as a royalty

base. The terms aggregate gross sales and allowable deductions were defined in section 4 and 5 of the third draft bill.

Section 4 defined the term aggregated gross sales as the aggregate of amounts received or accrued to an extractor for mineral resources transferred during the assessment period. This definition of gross sales value was expanded from the second draft bill to include the fair value of property, financial assistance, services and other benefits received, amounts received by way of insurance, indemnity or guarantee and any premium paid in respect of an option on a mineral resource.

Section 5(1) defined allowable deductions as the aggregate of expenditures incurred by the extractor during a period of assessment in respect of:

- (a) the aggregate amount received as gross sales;
- (b) processing a mineral resource which is transferred during the period of assessment beyond its initial readily saleable condition as associated with the beneficiation that will be prescribed by the Minister of Finance by way of regulation; and
- (c) transportation costs to the extent that the transportation expenditure arises after processing the mineral resource beyond its initial readily saleable condition.

The description of allowable deductions continued by listing a number of non-deductible costs such as general overhead, administration costs, management fees, marketing costs as well as depreciation and interest charges. For the purposes of section 5(1)(b) processing was defined as all forms of screening, washing, sintering, sorting, smelting, and refining performed within the Republic of South Africa for the purposes of recovering or deriving any property consisting of that mineral resource. Section 6 of the draft bill contained certain rules regarding deemed transfers that had to be applied in cases where the extracted mineral resources were used by the extractor in a process of manufacturing or were transferred before in its readily saleable condition.

National Treasury (2008) explained that the aim of this royalty base was to determine the value of the mineral resources transferred at a point beyond which true beneficiation would take place. The royalty would then be based on this value before true beneficiation has taken place. By using this royalty base the third draft bill aimed to promote downstream

processing (National Treasury (2008)). This was in contrast to promoting beneficiation through the royalty rate as proposed in the second draft bill in Chapter 4. The point beyond which a mineral was processed beyond its initial saleable condition would be defined in a regulation as this point was expected to be different for each mineral.

The Chamber of Mines (2008) was of the opinion that this royalty base was a better reflection of the value of minerals extracted to base the royalty on than the previously proposed royalty bases. This view was supported by the mining industry.

The Revenue Watch (2008) and Assmang (2008) however argued that the proposed royalty base would still not be equal to the value of a mineral when it is sold without further processing because the value added (thus the margin earned by the extractor on the beneficiation costs) remained included in the tax base after the allowable expenditure have been deducted. The problem is illustrated by the following example. Mine A only extracts and sells a mineral resource at R1 000 per tonne. Mine B extracts and processes the same mineral resource at an additional cost of R800 in order to sell the output at R2 500 per tonne. If a royalty rate of 5% is assumed, Mine A will pay a royalty of R50 ( $R1\ 000 \times 5\%$ ) while Mine B pays a royalty of R85 ( $((R2\ 500 - R\ 800) \times 5\%)$ ). The difference between the two royalties is attributable to the margin on the processing activities of Mine B or in other words the value added by the beneficiation of the mineral resource ( $((R2\ 500 - R1\ 000) - R800) \times 5\%$ ).

The practical application of the revised royalty base posted a number of further questions that were raised by participants in the sector. This discussion can only address potential issues that could have arisen from the definition of the term 'point at which a mineral was in its initial readily saleable condition' because this concept would only have been defined by the National Treasury at a later stage. The process to define this term was however not finalised for the purposes of this draft bill and the term was subsequently removed from the final bill that will be discussed in Chapter 6.

The South African Chamber of Mines (2008) raised the point that the concept of readily saleable condition could be more difficult to implement and define in an equitable manner in practice than it sounds in theory. This concern was particularly relevant to mining

companies where fully integrated processing took place and the various points in the process were not easily distinguishable. The Chamber of Mines identified a valid concern regarding transfer pricing issues that could arise when costs had to be allocated to unidentifiable points in a fully integrated process that which could significantly affected the royalty base. The Revenue Watch (2008) took the above argument further by recommending that the term 'processing costs' should also have been defined, as this may vary between different mineral resources and could have resulted in confusion as to which costs would have qualified for a section 5(1)(b) deduction.

An interesting point of contention was around the deduction of foreign processing costs. Section 5(4) implied that processing activities performed outside of Republic of South Africa should be disregarded for the purposes of determining the deductible costs in terms of section 5(1)(b). The rationale behind this provision was unclear as the purpose of the deduction of processing costs was to arrive at the true value of the mineral resource extracted before any beneficiation took place. This value would not be affected by the location of the processing activities. This provision could possibly have deterred foreign investment by internationally integrated mining companies in the South African mining industry.

The liability sharing provisions of the second draft bill were not included in the third draft bill. These provisions would be redundant if the true extent of beneficiation was reflected in the royalty base.

### **5.1.3. Credit for bad debts**

A contentious provision that remained in the third draft bill was the credit for bad debts provision. The National Treasury explained the problem with this provision in its Response document to the PCOF (2008) as follows. The proposed royalty would be a mineral resource rent in contrast to other forms of tax on income. This form of tax should therefore always be payable when a mineral resource is extracted, irrespective of whether the mining company received compensation for the resources or not. The royalty only becomes payable when the mineral is transferred or sold and not when it is extracted for

practical and cash flow reasons. If this argument was followed, this bad debt credit provision was not warranted in proposed resource royalty legislation.

#### **5.1.4. Balance of fiscal risk as a result of the revised charging provision**

COSATU (2008) had a different opinion on the charging provision of the third draft bill from the opinion of the majority of the private mining companies. They contended that the purpose of the proposed legislation had to be taken into account when evaluating the proposed charging provision. The preamble to the first draft bill and section 3 of the MPRDA stated that the rationale for levying the royalty was to collect compensation for the depletion of non-renewable mineral resources that belong to the nation. The State should therefore be entitled to a reasonable compensation for the extraction of these mineral resources in order to utilise to provide for the economic and social development for the benefit of the whole nation. COSATU (2008) were of the opinion that the proposed charging would have provided too many benefits to mineral extractors and in doing so deviated from the spirit and the purpose of the MRPDA. These benefits stemmed from the profitability-based royalty rate in combination with the significant deductions that were allowed against the royalty base compared to the royalty bases that were proposed in the previous versions of the draft bill.

In order to achieve a balance between the fiscal risk of both the state and extractors the following observation by National Treasury (2008) should be kept in mind – the narrower the tax base, the higher the tax rate would need to be to ensure that the government receive a fair compensation for the non-renewable mineral resource extracted. While the third draft of the bill narrowed the royalty base from gross sales to gross sales less numerous deductions, the formula driven royalty rate was also likely to reduce the rate to be applied to the royalty base, especially in times of financial difficulty. A good illustration of this would be in periods when commodity prices are under pressure and mining operators are breaking even or making losses. If the formula is applied no royalty will be payable as soon as the earnings before tax, interest, depreciation and amortisation becomes zero or negative. The nation's mineral resources would still be extracted without the state receiving any compensation for this use of the non-renewable mineral resource.

The concerns of COSATU were shared by the Revenue Watch Institute. The Revenue Watch Institute (2008) illustrated the potential problem with the charging provision by simplifying the mathematical royalty equation.

The proposed royalty in terms of the third draft bill is determined in terms of the following formula: (where gross sales = S; allowable deductions = A)

$$\text{Royalty} = \text{tax base} \times \text{royalty rate} = (S-A) \times \frac{\text{EBITDA}}{S \times 12.5} = \frac{(S - A) \times \text{EBITDA}}{S \times 12.5}$$

Two of the inputs into the royalty amount ((S-A) and EBITDA) reflect profitability and the economic conditions. The final royalty is a product of two inputs that both reflect economic conditions, thereby implying that the economic conditions and profitability of a company will be reflected exponentially in the royalty amount. This would result in an exceptionally high royalty in times of economic prosperity and an exceptionally low royalty in times of economic difficulties. This result is not ideal from the fiscal risk perspective of the government.

## 5.2. RELIEF PROVISIONS

The second draft of the Royalty Bill contained three major relief provisions namely the marginal mine relief, the small mining business relief and the state royalty rate guarantee. The review of the second draft bill in Chapter 4 suggested that the scope of the marginal mine relief provision could have been too narrow to provide relief to economically viable operations. The small mining business relief and state royalty rate guarantee provisions were welcomed by the mining industry.

The marginal mine provision, which provided relief to mines where the royalties payable exceeded the net cash turnover, was abolished in third draft bill. This provision was redundant because the profitability of the extractor was automatically taken into account by

the royalty rate formula in section 3. This development was commended by the Chamber of Mines (2008).

The third draft bill amended the criteria of the small mining business relief as well as the state royalty rate guarantee.

### **5.2.1. Small mining business relief**

The small mining business relief in the second draft bill stated that extractors were only liable for the royalties imposed to the extent that those royalties exceeded R50 000. This provision was amended in the third draft bill to state that an extractor would not be liable for the royalty if the extractor was a resident whose aggregate gross sales did not exceed R5 million during a period of assessment and the royalty to be imposed did not exceed R50 000. This implied that a mineral extractor whose gross sales exceeded R5 million for a period of assessment or whose the royalty liability exceeded R50 000, would not qualify for any small mining business relief. Certain anti-avoidance related party exclusions were included in this section.

The Revenue Watch Institute (2008) warned that the implementation, specifically with regards to monitoring the output and turnover, of this relief measure in the large small-scale mining sector of South Africa may pose a challenge. The Ingonyama Trust (2008) suggested that the fact that the provision contained a hard cut off point may discourage small mines to expand if they would become liable for the full royalties as soon as they exceeded the pre-determined thresholds. With regards to the thresholds the Revenue Watch Institute (2008) suggested that these thresholds, especially the gross sales threshold, should be adjusted for inflation on a regular basis as a possible method to curb stagnation in production levels in order to qualify for this relief.

### **5.2.2. Fiscal guarantee**

The state royalty rate guarantee in the second draft bill was replaced by a fiscal guarantee in the third draft bill. In terms of section 13(1) the Minister of Finance may conclude a binding agreement with an extractor in respect of the extractor's mineral resource right or

in the anticipation of the acquisition of a mineral resource right. This binding agreement would guarantee that the terms and conditions that were set out in section 14 would apply in respect of that right for as long as the extractor held the right. The rights held in terms of a fiscal guarantee could be assigned in certain circumstances. Section 14 stated the terms and conditions of the guarantee. Firstly, legislation to amend the definitions, charging provision or relief provisions of the Royalty Bill would have no force and effect in respect of a transfer by an extractor that was a party to a fiscal agreement if the amendment resulted in a greater liability than the liability had the amendments not been made. Secondly, legislation to impose a direct or indirect charge on the transfer of mineral resources in addition to or in lieu of this Bill will have no effect when the extractor is a party to a fiscal guarantee, unless the charge is an export charge that can be avoided by beneficiating the minerals. In the case of non-observance by the State, a mineral extractor who was a party to a fiscal guarantee would be entitled to compensation for the loss of market value as a result of the non-observance as well as interest on this amount.

COSATU (2008) was concerned that this fiscal stability clause could promote large monopolies in the mining industry and could hinder small companies and new entrants that did not have these rights. They proposed that a duration limit should be placed on the period for which these rights would be granted. The Revenue Watch Institute (2008) was of the opinion that the guarantee clauses were too general and asymmetric. This could result in destabilisation of the mining environment when political pressures require sharp and significant adjustments to the royalty regime to counteract the effect of these guarantee agreements as opposed to making transparent marginal adjustments from time to time.

### **5.3. ANTI-AVOIDANCE PROVISIONS**

As noted in Chapter 4, the second draft bill included anti-avoidance provisions to ensure that the royalties were based on arm's length prices rather than transaction specific gross sales values that could be manipulated. This draft bill also proposed a provision that imposed the royalty on the beneficial transferor to prevent abuse of relief provisions.

The third draft bill cast the anti-avoidance net significantly wider by removing the definition of a connected person. It introduced two general anti-avoidance provisions in sections 11 and 12 that were applicable to all transfers and not only those between connected persons.

The first of these provisions was found in section 11. Section 11 stated that any earnings, gross sales or allowable deductions used to determine the royalty levied in terms of section 2 that was different to the input had it been determined at an arm's length value may be adjusted by the Commissioner to reflect arm's length values. The term arm's length value was defined as the open market value at which two independent persons acting in good faith (without regard to the royalty) would freely agree to transact in the ordinary course of business.

The second anti-avoidance measure that appeared in section 12, was similar to the general anti-avoidance rules of section 103 of the Income Tax Act of 1962 before amendments in 2007. This provision determined that when Commissioner was satisfied that a transfer, operation, scheme or understanding, including any steps thereto –

- (a) has been entered into a manner not normally employed for bona fide business purposes other than obtaining a royalty benefit;
- (b) has created rights or obligations that are not normally created between persons dealing at arm's length; or
- (c) has been entered into or carried out solely or mainly for the purposes of obtaining royalty benefit;

the Commissioner may determine the royalties, penalties and interest as if the transfer, operation, scheme or understanding had not been entered into or carried out, or in a manner that the Commissioner deemed appropriate for the prevention or diminution of the State royalty benefit (where a royalty benefit was intended to mean a reduction, avoidance or postponement of a royalty).

The change from specific to general anti-avoidance rules could possibly have an impact on the effectiveness and the enforceability of these provisions. SARS (2005) issued a discussion paper for comment on tax avoidance. This paper identified certain application shortcomings in section 103 of the Income Tax Act at the time. SARS stated that it had

regarded section 103 to have been inconsistent and ineffective in deterring abusive avoidance schemes. It could be questioned whether some of the shortcomings noted by SARS could have posed challenges if the anti-avoidance provisions of section 12 of the Royalty Bill were to be applied by the Commissioner. It should however be kept in mind that the limited application of the proposed royalty legislation would possibly have limited the extent of schemes to avoid these royalties.

A specific weakness that could have affected the application of section 12 of the draft bill related to the requirement for the manner or the rights and obligations to not be in line with the normal way of dealings. SARS commented that the tax world was not neatly divided between clear distinguishable bona fide and impermissible tax schemes. The question whether the sole or main purpose of a transaction, operation or scheme was the avoidance or deferment of tax required significant judgement. In order for this requirement to apply it had to be evident that the tax consideration was the predominant factor in transaction, scheme or arrangement taking place. As soon as a transaction, scheme or arrangement had a colourable commercial rationale, this became very difficult to prove. According to SARS (2005) this test also often proved to be a subjective test.

#### **5.4. OTHER CONCERNS REGARDING THE THIRD DRAFT OF THE MPRRB**

The issue of potential double royalties payable in terms of the MPRRB and the Second Schedule of the MPRDA was once again raised by the mining sector in its comments on the third draft bill. De Beers (2008), BHP Billiton SA Limited (2008) and Trans Hex (2008) argued that it was concerning that the bill was silent on this matter that could have a significant impact on the royalties payable (and similar lease payments) by these companies. In the media statement (2007) that accompanied the third draft bill the National Treasury made its stance clear that community royalties were protected by the MPRDA and no deduction would be granted to reduce mineral royalties when these royalties are payable. The National Treasury again encouraged mining companies to negotiate with the communities to convert these royalty arrangements into equity participation in order to empower the communities.

An issue regarding the implementation of the MPRRB was raised by De Beers (2008), the Chamber of Mines (2008) and BHP Billiton SA Limited (2008). The question was posed whether the royalties would be imposed on mineral resources discovered in tailing dumps that were created prior to the effective date of the bill, namely 1 May 2009. It was suggested that the definition of a mineral resource or the effective date provision should be amended to clarify this matter.

The National Treasury (2008) further noted that the royalties determined in terms of the MPRRB would be allowed as a deduction in terms of section 11(a), the general deduction provision of the Income Tax Act (58/1962).

## **5.5. SUMMARY OF THE PROVISIONS OF THE THIRD DRAFT OF THE MPRRB**

The third draft bill proposed a royalty calculated as a net smelter royalty base multiplied by a profit-based formula driven royalty rate. The net smelter base should be calculated as the gross sales minus allowable deductions. Allowable deductions included processing costs incurred to process a mineral beyond its initial readily saleable condition. The mining industry welcomed the formula driven royalty rate as it took into consideration the extractor's ability to pay the royalty. Concerns were however raised regarding the use of EDITDA in the rate formula rather than EBIT that reflects the capital intensive nature of the industry. The level of royalty once again proved to be a point of discussion in the mining industry. The use of a net smelter royalty base was encouraged by the mining industry, even though questions existed as to how the point beyond which true beneficiation would take place would have been determined in practice. COSATU (2008) raised the concern that the fiscal risk relating to the royalties had swung into the favour to such an extent that the royalties no longer reflected the spirit and objectives of the MPRDA.

The marginal mine relief was removed from the bill because the profitability based charging provision automatically provided relief to marginal mines. The bill modified the small mining business relief provision to have a hard cut off point. The Ingonyama Trust (2008) suggested that a hard cut off point could discourage expansion of small mines in the long run. The state royalty rate guarantee was replaced with a fiscal guarantee provision. COSATU (2008) noted that the 30 year term of the fiscal guarantee could possibly result in large monopolies in the industry. The National Revenue Watch (2008)

indicated that the guarantee provisions were too general and could lead to drastic changes in royalty legislation if adjustments to the royalty regime were required.

Despite the fact that the third draft bill was welcomed by the mining sector, a number of policy related issues in the bill as well as the public comments were considered by the PCOF. Based on the recommendations of the PCOF the MPRRB was amended for the last time. This resulted in the release of the fourth and final draft of the MPRRB on 3 June 2008. A review of the final MPRRB is provided in Chapter 6.

## **CHAPTER SIX: A REVIEW OF THE FOURTH AND FINAL DRAFT OF THE MRRB AND THE MPRRA**

The public comments on the third draft bill that were submitted to National Treasury and the Parliamentary Committee on Finance indicated that several significant issues had to be reconsidered before the bill could be finalised. These concerns were discussed and concluded on based on the recommendation of the PCOF. The fourth and final MPRRB [B59-2008] (final bill) was released by the National Treasury on 3 June 2008. The media statement (2008) that accompanied this bill indicated that the bill was only open to technical comments as the policy framework had been finalised.

The final bill was tabled in Parliament on 24 June 2008 together with the Mineral and Petroleum Resource Royalty Administration Bill (MPRRAB). The MPRRAB prescribed how the royalty would be charged, to whom it is payable and the consequences if the royalty was not paid (SabinetLaw (2008)). On 24 November 2008 the final bill was enacted and the Mineral and Petroleum Resources Royalty Act (28-2008) (MPRRA) was published in the Government Gazette (GG 31635). The MPRRA stated that it would apply to all transfers of mineral or petroleum resources on or after 1 May 2009.

This chapter reviews the provisions of the final bill. A comparison to the corresponding provisions in the third draft bill is provided as well as an analysis of the changes and the reasons for the changes. The contentious issues that remain included in the final bill are discussed as areas that would require further research in Chapter 7.

### **6.1. ROYALTY CHARGING PROVISION**

The main point of contention over the course of the development of the mineral royalty legislation was the structure of the royalty charging provision. Stakeholders in the mining industry had still not formed a uniform opinion as to the most appropriate method of determining the mineral royalty that would satisfy the needs of all role-players. The contentiousness of the charging provision was evidenced by the number of the changes to

this provision from each version of the draft bill to the next and in particular the magnitude of the impact of each of these changes.

As discussed in Chapter 5, the third draft bill attempted to address the ability to pay requirement of the mining industry by proposing that the royalty should be determined using a royalty base as well as royalty rate that reflected the profitability of the mineral extractor. The bill suggested the use of gross sales value less processing costs as the royalty base to encourage downstream beneficiation in accordance with the national mineral policies. The royalty rate was a profit-based formula driven royalty rate with no discrimination between different minerals or between refined and unrefined minerals.

These provisions were generally welcomed by the private mining companies. Warnings of a fiscal imbalance to the detriment of the South African people however sounded from the trade union, COSATU, and the international mineral policy evaluator, the Revenue Watch Institute. This concern was acknowledged by the National Treasury (2008) in its response to the public comment and resulted in the revision of the charging provision based on the recommendation of the PCOF. This revised charging provision in the final draft formed the basis for South Africa's first enacted mineral royalty policy.

Section 3 of the final bill returned to the royalty base that was suggested in the second draft bill, namely gross sales for the year of assessment. From an administrative point of view, it should be noted that the royalty in terms of the final bill would be levied for an assessment period that was equal to the year of assessment of the taxpayer for income tax purposes. The principle of a profit-based formula driven royalty rate that was introduced by the third draft bill was retained in the final bill. The royalty rate however stipulated a minimum royalty rate irrespective of the profitability of the extractor. Because the effect of beneficiation had been removed from the royalty base, it had to be re-included in the royalty rate. The final bill therefore proposed the use of different royalty rates for refined and unrefined mineral resources even though it made no distinction between different types of mineral resources.

### 6.1.1. Royalty rate

The third draft bill proposed the use of a pure profit-based formula driven royalty rate. This rate would have been calculated as a net profit ratio (earnings before interest, tax, depreciation and amortisation divided by the aggregated gross sales for the assessment period) divided by a B-value of 12.5. This single rate formula applied to all mineral resources irrespective of whether the mineral resources have been refined or not. The promotion of beneficiation of the mineral resources was reflected in the royalty base and not in the royalty rate. The mining industry expressed positive views regarding the formula. The main criticism of the formula was that a pure profit-based rate that was applied to a profitability driven base would be unfavourable to the State. Extractors also debated what an appropriate value for the B-value input into the formula would be.

The revised royalty rate formulas appeared in section 4 of the final bill. Separate royalty rates were provided for refined and unrefined mineral resources in section 4(1) and 4(2) respectively. These formulas were as follows:

(where EBIT = earnings before interest and taxes)

The royalty rate for refined mineral resources was (section 4(1)):

$$0.5 + (\text{EBIT} / [\text{Gross sales of refined mineral resources} \times 12.5 (\text{B-factor})]) \times 100$$

The royalty rate for unrefined mineral resources was (section 4(2)):

$$0.5 + (\text{EBIT} / [\text{Gross sales of unrefined mineral resources} \times 9 (\text{B-factor})]) \times 100$$

The terms refined and unrefined mineral resources were defined in the First and Second Schedule of the final bill respectively. In an improvement to the second draft bill the terms refined as well as unrefined were clearly defined in order to eliminate any confusion that may have existed. An important feature of these schedules was that all oil and gas would be regarded as refined for the purposes of determining the royalty. Section 4(3) imposed a cap for the refined rate at 5% while the unrefined rate was limited to 7%.

The meaning of the term EBIT was defined for the purposes of the final bill in section 5. The definition stated that EBIT was equal to the gross sales less amounts that are allowed to be deducted in terms of the Income Tax Act (58-1962). The final bill replaced references

to accounting frameworks in the third draft bill with references to amounts determined in accordance with the Income Tax Act. A number of items that had to be excluded from the calculation of EBIT were provided in section 5(3). EBIT was furthermore defined separately for refined and unrefined mineral resources. The section 4(1) (refined mineral resources) required that the deductions allowed for the purposes of that section should only be those deductions in respect of assets used or expenditure incurred directly to win, recover and develop refined mineral resources. Similarly section 4(2) (unrefined mineral resources) required that the deductions for the purposes of this section should only be those deductions in respect of assets used or expenditure incurred directly to win, recover and develop unrefined mineral resources. The section concluded by stating that a negative EBIT would be deemed to be zero, in order not to reduce the minimum proposed royalty rate below a level of 0.5%

The revised royalty rate formulas took a number of the concerns that were raised by role-players in the mining industry on the third draft bill into account.

In reaction to the comments of private mining companies, such as BHP Billiton SA Limited (2008), the use of EBITDA as the profitability indicator was replaced by EBIT to acknowledge the capital intensive nature of the mining industry. Both of the royalty rate formulas resulted in a minimum royalty rate of 0.5%, irrespective of the profitability of the extractor. This minimum royalty level addressed the concern of the Revenue Watch Institute (2008) that a pure profit driven formula could have resulted in the State receiving no royalties in times of economic difficulty even though non-renewable mineral resources are extracted.

As indicated by Cawood (2003) the challenge relating to downstream processing that was faced by National Treasury was to arrive at a mineral royalty that would be equal for the same mineral resource, irrespective of whether the mineral resource had been beneficiated or not. Comments on the third draft bill indicated that it was difficult from a practical perspective to allocate costs to activities before and after a specific point in integrated processing activities. The National Treasury (2008) indicated that the difficulties posed by this allocation of costs resulted in the decision to move the provisions to promote beneficiation back to the royalty rate, by providing a refined and unrefined rate, rather than

as a deduction from the royalty base. The final bill proposed the use of a lower B-factor for unrefined minerals. This will result in a higher royalty rate for unrefined minerals compared to refined minerals. The incentive of a lower rate should promote beneficiation. The question however still remains whether the incentive of a lower rate would compensate the extractor sufficiently for the increase in the gross sales value royalty base when minerals are processed. This issue remains relevant and is discussed as an area for further research in Chapter 7.

One of the concerns with the use of EBIT as a profitability indicator was that this term exposed the tax authorities to disputes as this term was not defined in accounting frameworks. This term furthermore exposed the royalty regime to the misuse of accounting estimates, such as depreciation and amortisation. The use of deductions allowed in terms of the Income Tax Act rather than accounting profits addressed these concerns regarding the misuse of accounting estimates, such as useful lives and residual values, to manipulate the royalties payable.

An aspect of the proposed royalty rates that has been controversial all through the development of the MPRRB was the level of royalty rates. In the media statement (2008) that accompanied the final bill the National Treasury provided an estimate of the royalty rates that they anticipated when the formulas in section 4 were used. Based on quarterly financial statistics that were published by Statistics SA it was determined that the average refined mineral royalty rate would have been 1.56% in 2006 and 2.55% in 2007 when commodity prices increased. The average unrefined royalty rate would have been 1.97% in 2006 and 3.4% in 2007.

The National Treasury prepared an estimate of the level of royalty rates in terms of the final bill for a number of different EBIT/gross sales ratios. These expected rates are provided in Table 7.1 in Chapter 7. Statistics SA (2008) indicated that EBIT could be expected to vary between 20% and 30% based on historical experience. The expected royalty rates for this EBIT range varied between 2% and 4%. In 2003 Cawood indicated that internationally competitive royalty regimes levied royalties at rates of between 0% and 3%, with an average rate of 1.8%. These competitive rates were however applied to a net smelter return tax base, which is lower than the gross sales value in the final bill. The

expected royalty rates are therefore higher than those deemed as competitive by Cawood. The level of royalty is expected to remain contentious and the implications thereof are only likely to become evident once the MPRRA comes into effect. This aspect is therefore one that warrants further research. Issues to be considered with regards to the level of the royalty rate are discussed in Chapter 7.

### **6.1.2. Royalty base**

The third draft bill proposed the use of gross sales less processing cost as the royalty base. The review of this royalty base however indicated that the definition of the point beyond which true beneficiation occurs would be difficult to identify in practice. It was furthermore noted that allocation of costs in an integrated beneficiation process may prove to be challenging.

The final bill returned to a gross sales value royalty base. The revised royalty base was described in section 6. Section 6(1) provided that the gross sales value of a refined mineral resource that is disposed of that in the condition described in Schedule 1 was the amount received or accrued to the extractor. The section also provided guidance on how the value should be determined in certain extraordinary circumstances when an actual sales value was not available. Section 6(2) contained similar provisions for unrefined minerals. Section 6(3) stated that the gross sales value should be determined without regarding an amount that was received or that accrued in respect of transport, insurance or handling after the mineral was brought to the condition specified in the relevant schedule to the final bill. When the gross sales value cannot be quantified section 6(4) determined that the arm's length value that would have been received had the minerals been transferred in the condition as set out in the schedules to the final bill.

The National Treasury (2008) provided the complexities posed by the introduction of the point beyond which a mineral was in its initial readily saleable condition as one of the main reasons for the return to gross sales value as a royalty base. Beneficiation was promoted by this final bill by providing separate royalty rates for refined and unrefined minerals. The question whether beneficiation should be taken into account in the royalty rate or the

royalty base remains one of debate. This issue has been included as an area that requires further research in Chapter 7.

### **6.1.3. Credit for bad debts**

The credit allowed for bad debts that appeared in the third draft bill was not included in the final bill for the reasons stated in the discussion of the third draft in 5.1.3.

## **6.2. RELIEF PROVISIONS**

As discussed in Chapter 5, the third draft bill contained a small mining business relief provision and a fiscal guarantee as its two main relief provisions. Role-players in the industry were of the opinion that the small mining business relief measure could discourage growth in the industry. The fiscal guarantee was criticised for being too wide as well as for its possible impact on the extent of future amendments required to the MPRRA to counteract its effect. The third draft bill also included an exemption from the royalty for sampling activities.

The final bill retained the small mining business relief and sampling exemption from the third draft bill. The concerns raised in the review in 5.2.1 remained relevant to this final bill. The final bill replaced the fiscal guarantee in the third draft bill with a fiscal stability agreement provision. The final bill introduced rollover relief provisions as well as transitional provisions to the MPRRB.

### **6.2.1. Fiscal stability agreements**

The principles of fiscal stability agreement provisions in the final bill were similar to the provisions relating the fiscal guarantees in the third draft bill. The only exception was that the fiscal stability agreement could only pertain to the provisions of section 4 (royalty rate formula) as opposed to the whole charging provision and relief measures as it was proposed in the previous draft bill. According to the Revenue Watch Institute (2008) the fiscal stability agreement in the final bill provided the State with more flexibility to make

marginal changes should it be required to do so than guarantee agreements that were proposed in the third draft bill.

### **6.2.2. Rollover relief**

Section 9 of the final bill provided a rollover relief when mineral resources were transferred as part of a going concern. In this case the transfer would not be deemed to be a disposal and the acquirer was deemed to have extracted the mineral resources.

### **6.2.3. Transitional provisions**

Commentators expressed concerns over the previous three versions of the draft bills because certain existing royalty and similar payments would have resulted in a double royalty on the extraction of mineral resources.

The final bill introduced transitional provisions to take lease-, royalty- or similar payments to the State in terms of an old order right or OP26 right as consideration for the removal or disposal of a mineral or petroleum into account in the royalty payable in accordance with the MPRRB. In terms of the transitional credits provision the above mentioned payments must be deducted from the royalty in recognition of the fact that the State had already been compensated for the mineral extracted.

The transitional credit provision did however not make provision for the deduction of payments made in respect of community royalties that remained payable in terms of Item 11 of the Second Schedule of the MPRDA or payments in terms of the Precious Metals Act that were still payable in terms of item 9(7) of the same schedule of the MPRDA. In his address to Parliament the Minister of Finance urged mining companies to negotiate with communities to convert these royalties into equity interests to contribute to empowerment in this manner. The National Treasury (2008) furthermore commented that the payments in terms of the Precious Metal Act constituted dividends rather than royalties because it stemmed from ownership interests. In the National Treasury's opinion these payments would therefore not result in a double royalty.

### **6.3. ANTI-AVOIDANCE PROVISIONS**

The anti-avoidance provisions of the final bill retained the core of the anti-avoidance provisions of the third draft bill. As stated in the review of the anti-avoidance provisions of the third draft bill in Chapter 5 these provisions were of a general nature. The SARS had previously experienced difficulties in applying general income tax avoidance rules. The issues experienced with applying general income tax avoidance rules could possibly also be experienced when applying the mineral royalty avoidance provisions, even though avoidance schemes are likely to be more limited than those implemented to avoid income tax.

### **6.4. SUMMARY OF THE PROVISIONS OF THE FINAL MPRRB AND MPRA**

The final bill proposed a mineral royalty based on a royalty base of gross sales value. The royalty would be determined by a royalty rate that is based on the profitability of the extractor. This royalty rate would be subject to a certain minimum rate. The royalty will promote beneficiation of minerals by providing a lower royalty rate for refined minerals than for unrefined minerals. The acknowledgement of the capital intensive nature though the use of EBIT as a profit indicator was welcomed by private mining companies. The average expected royalty rates that the National Treasury (2008) published in its media statement however remained higher than the internationally competitive rates suggested by Cawood in 2003. The question as to whether beneficiation would be addressed most effectively in the royalty rate or in the royalty base remained a point of debate.

Relief from the royalties would be available to small mining businesses. Commentators remained of the view that the provision could discourage expansion because of its hard cut off nature. Mineral extractors can enter into agreements to fix the royalty rate formula that will be used to determine their royalties. The National Revenue Watch (2008) was of the opinion that this provision provided the State with more flexibility that would result in a more stable royalty regime. Certain payments of amounts to the State are allowed as deductions from the royalty.

The National Treasury (2008) concluded in its media statement for the final bill that it considered the revised royalty regime to be investor friendly and that it should be relatively easy to administer. It was also of the opinion that it would ensure that the fiscus received a fair share of tax revenue. The final draft of the MPRRB was enacted on 24 November 2008 as South Africa's first Mineral and Petroleum Resources Royalty Act.

Despite the National Treasury's positive view of the MPRRA, the review in this chapter and the preceding three chapters identified certain contentious issues in the MPRRA that could necessitate future amendments to the act. These contentious issues are discussed as areas for further research detail Chapter 7.

## **CHAPTER SEVEN: SIGNIFICANT ASPECTS OF THE MPRRA THAT REQUIRE FURTHER RESEARCH**

In Chapters 3 to 6 the process followed by the National Treasury to develop the MPRRA, South Africa's first mining royalty legislation was reviewed. The Democratic Alliance (2008), South Africa's official opposition party at the time when the final bill was tabled in Parliament, commented that the process followed by the National Treasury was a thorough and transparent process of deliberations and public hearings, to assure the legitimacy and credibility of the Bills submitted to Parliament.

The mining industry nevertheless remained cautious with regards to the potential impact of the new legislation. The spokesperson of Anglo American was quoted in an article in the Sowetan newspaper on 27 August 2008 saying: "It is our hope that government retains an open mind on royalties given the large cost increases in key prices like labour, steel and oil that the industry is dealing with. There are, however a number of technical issues, which Anglo will be addressing, as a member of the Chamber of Mines, through further discussion with National Treasury." In the same article Nick Holland of Goldfields shared a similar view when he stated: "We hope that the authorities will re-evaluate the situation if royalties prove to be too onerous, given the cost pressures facing all mining companies." All commentators were not optimistic about the legislation. Lizel Oberholzer, from the law firm Bowman Gilfillan, expressed the opinion that the legislation was aimed at marginal mines and that the fluctuating royalties would eventually deter investment in the article. These views of the mining industry indicated that there were a number of contentious issues that were included in the MPRRA. The full implications of the new legislation would only be apparent in the South African mining industry when the MPRRA becomes effective.

An indication of the potential impact of the MPRRA (the Act) came in the form of the announcement of the delay in the implementation of the Act until March 2010 by the Minister of Finance (National Treasury, 2009:18). The reasons for this was to combat to the effect of the economic slowdown on the mining industry and the prevent job losses in the industry. The estimated impact of the 10 month delay of the implementation of the

MPRRA was estimated to be R1,8 billion savings in royalties for mineral extracting companies.

This chapter focuses on significant issues that were identified during the review of the development process which were included in the MPRRA and remain debatable. These issues could prove to be detrimental to the mining industry once the Act becomes effective and would therefore warrant further research. This research can contribute to future development and amendment of the MPRRA.

The two main issues that were identified are firstly the overall level of the imposed royalty and secondly the promotion of downstream beneficiation in the mechanics of the royalty equation. It should however be kept in mind that the issues are concurrent and cannot be viewed in isolation without considering the other. The level of royalty is affected by the royalty base as well as the royalty rate mechanism. Downstream beneficiation could in turn be promoted in either the royalty base or the royalty rate.

## **7.1. LEVEL OF ROYALTIES LEVIED**

The level of the royalty to be levied in terms of the MPRRA is determined by the royalty base and the royalty rate. The MPRRA provides a profit-based formula driven royalty rate. Separate formulas exist for refined and unrefined mineral resources. The rates determined using this formula should be applied to the gross sales value of the mineral resources transferred as a royalty base to calculate the royalty that will be levied.

### **7.1.1. The issue identified**

Throughout the process of the development of the MPRRA the level of royalty had been a point of contention between the private mining companies and the State representatives. On the one hand, the private mining companies expressed concern that the proposed royalties could be too onerous for the industry taking into account amongst others the increasing direct costs and BEE compliance costs (SAMDA (2003)). On the other hand trade unions (COSATU (2008)) and the Revenue Watch Institute (2008) suggested that

the total level of royalty was not sufficient to achieve the objectives of the MPRDA and therefore not in accordance with the spirit of the MPRDA.

Cawood conducted a study in 2003 to determine the range of royalty rates that were used to levy royalties in developing countries that he identified as attractive mining investment destinations using a competitive investment framework. Cawood (2003) justified the selection of these countries by stating that since 2002 Anglo American had actively explored investment opportunities in each of them. The conclusion of this analysis indicated that the average royalty was levied at a rate of 1.8% (with a maximum of 3%) in these countries. Cawood (2003) noted that the rates indicated by the study were applied to a net smelter value (gross sales value less beneficiation costs).

The media statement by National Treasury (2008) that accompanied the final bill provided the following table of expected royalty rates to be applied to the gross sales value, at the indicated levels of profitability for refined and unrefined mineral resources respectively:

<b>EBIT</b>	<b>Refined Minerals</b>	<b>Unrefined Minerals</b>
<b>%</b>	<b>%</b>	<b>%</b>
0	0.5	0.5
10	1.3	1.6
15	1.7	2.2
20	2.1	2.7
25	2.5	3.3
30	2.9	3.8
40	3.7	4.9
50	4.5	6.1
56	5.0	6.7
58.5	5.2	7.0

**Table 7.1: Royalty percentage rates for a range of EBITs (with 100% capital expensing)**  
(Source: Media Statement by National Treasury (2008))

This table illustrated the fact that the royalty rate formula could lead to capped rates as high as 5% for refined minerals and 7% for unrefined minerals respectively. These rates are three to four times higher than the average royalty rate indicated by the competitive investment framework study that was performed by Cawood (2003). In addition to this, these anticipated rates are to be applied to a royalty base of gross sales values which is

likely to be significantly higher than a net smelter return that was suggested by competitive investment framework.

In times of economic prosperity the rates determined in terms of the MPRRA may well be uncompetitive when compared to other developing countries such as Peru, Brazil, Argentina, Chile and Mexico. Cawood (2003) however warned that the fiscal package as a whole should be assessed before an opinion could be formed regarding the competitiveness of a fiscal mining regime. In times of difficult economic conditions, South Africa could however be an attractive mining investment location. Difficult economic conditions are however likely to reduce the extent of potential investment during these times.

### **7.1.2. Area for further research**

At the time of enactment of the MPRRA the mining industry was cautious as to the potential impact that the new legislation could have on the industry. It is difficult to accurately predict the level of royalty that will be levied in terms of the Act because of the number of variables that affect it. These variables include future costs, economic conditions and commodity prices.

The level of royalty will impact on a number of decision making processes and the achievements of objectives. The royalties collected will be used to achieve social and economic objectives, especially those described in the MPRDA. Secondly, the level of royalty will impact on the decision making processes of private mining companies. These decisions are likely include mineral project feasibility studies, decisions as to whether exploration activities should be carried on in South Africa, production decisions relating to the cut-off grade of ore reserves as well as cost management. The mining royalties will be a semi-variable cost that affects all cost calculations and estimates used to evaluate and manage mining projects. These royalties are furthermore likely to play a significant role in the economic viability of BEE companies and projects in the sector. Decisions taken by private mining companies will directly influence employment in the mining industry. The economic behaviour of the private mining sector will impact on the national GDP over the long run. Lastly, the level of royalty will directly impact on the investment attractiveness of

South Africa in the international market. Given the impact of the royalties on the mining sector is it of critical importance to levy mineral royalties at a level that is acceptable to all stakeholders in the industry.

It is recommended that a comprehensive analysis of the impact of the level of implemented royalty on each of the relevant decision makers be performed. This analysis should be from a theoretical perspective as well as a practical perspective once the MPRRA has been effective for a sufficient period of time to observe its impact on the decision making of mining industry.

## **7.2. THE PROMOTION OF DOWNSTREAM BENEFICIATION IN THE MECHANICS OF THE ROYALTY EQUATION**

Otto *et al.* (2006) defined a mineral royalty as compensation for the depletion of a non-renewable mineral resource paid to the owner of the non-renewable mineral resources. Because the royalty compensates the owner of the non-renewable mineral resource for the fact that the mineral resource has been depleted, the royalty should not be affected by the further actions by the extractor after a mineral resource has been extracted.

As early as the release of the first draft bill, Cawood (2003) identified the controversial issue that the royalty levied on a refined mineral resource in terms of the MPRRB was not necessarily equal to the royalty levied on an unrefined mineral resource. The Department of Minerals and Energy stated in the Mineral and Mining Policy (1998) that the promotion of downstream beneficiation and adding of value to mineral resources extracted was a national priority when it is economically feasible. Cawood (2003) observed that an increase in the royalty solely as a result of further processing of the mineral resource (adding value to the minerals extracted) would discourage further processing.

The legislators completely ignored the impact of downstream beneficiation in the first draft bill. In subsequent versions of the bill beneficiation was taken into account by providing different royalty rates for refined and unrefined mineral resources or by allowing a deduction for beneficiation costs from the royalty base. The second draft bill provided refined mineral rates for certain mineral resources that were equal to half the rate for

unrefined minerals. This method of promoting beneficiation would only be successful if further processing increased the gross sales value of the mineral resources by less than 100%. The third draft of the bill returned to a single royalty rate for refined and unrefined mineral resources but allowed a deduction for all beneficiation costs incurred after the point at which a mineral resource was in its initially saleable condition from the gross sales value (to arrive at a form of net smelter value as a royalty base). Allocation of costs to activities before and after this point proved to be a major concern in the mining industry, especially for extractors with integrated processing activities.

The final bill removed the deduction of beneficiation costs from the royalty base and provided separate royalty rate formulas for refined and unrefined mineral resources. The difference between the two formulas was in the requirement that the profitability factor (EBIT) had to be determined separately for each formula to reflect the difference in profitability between refined and unrefined minerals. Furthermore, the B-value in the formula was different for refined minerals (12.5) and unrefined minerals (9). The impact of the B-value on the formula is that an increase in the B-value will result in a decrease in the royalty rate. This implied that as long as the increase in the gross sales value of minerals as a result of further processing was less than 38% (12.5 divided by 9) the extractor would be incentivised to process mineral resources further. Any increase in the gross sales value that exceeds 38% would result in a higher royalty being payable if the mineral resource is refined.

The analysis in the previous paragraph assumed that EBIT will remain unchanged even when the mineral resource is refined. The benefit provided by a higher B-value when a mineral is refined could further decrease or even make the use of two formulas ineffective in achieving a consistent royalty if the EBIT of refined mineral resources is higher than the EBIT of unrefined mineral resources. The expected rates provided by National Treasury in table 7.1 illustrate this issue. If it is assumed that a mineral in its unrefined form is extracted at an EBIT ratio of 30%, the expected royalty rate is equal to 3.8%. If the same mineral resource is processed further and as a result of the beneficiation the EBIT for refined mineral resources increases to 40% the royalty on the refined mineral resource would be levied at a rate of 3.7%. The gross sales value of the refined mineral resource is however expected to be significantly higher than the unrefined mineral resource leading to

a significantly higher royalty. In this case beneficiation would be discouraged by a significantly higher royalty on the refined mineral resource.

### **7.2.1. The issue identified**

It is questionable whether the royalty mechanism in the MPRRA will result in the same royalty irrespective of whether a mineral resource has been refined or not. It can therefore be questioned whether the current legislation will effectively promote downstream beneficiation.

The opinion of important role-players and commentators on this matter varied throughout the development of the legislation. Cawood (2003) recommended a net smelter return as a royalty base as a solution to the problem. The third draft bill allowed a deduction for all processing costs incurred after the point beyond the mineral resource was in its initially saleable condition. Comments published by the National Treasury in the Response document (2008) to the third draft bill indicated that the definition of the point beyond which beneficiation would take place as well as the allocation of costs to activities prior to and after this point proved to be more complex than initially expected. The Chamber of Mines (2008) summarised the concerns with this approach by stating that the point beyond which beneficiation require extensive regulations to determine this point for each mineral resource and could also result in transfer pricing issues.

The use of different royalty rates is possibly easier to administer from the perspective of the tax authorities than a net smelter return royalty base. The use of different royalty rates for refined and unrefined mineral resources however posed its own challenges. Any processing that does not satisfy the definition of a refined mineral resource is disregarded because the term refined must be defined in order to determine when the refined mineral resource royalty rate could be applied. In addition to this it has been discussed earlier that the use of B-values and lower royalty rates does not necessarily provide sufficient benefit to downstream beneficiation to arrive at a royalty that is similar to that of an unrefined mineral.

The Revenue Watch Institute (2008) suggested that other methods of determining mine-mouth values of minerals as a royalty base should be investigated.

### **7.2.2. Area for further research**

The legislator opted for the option to provide different royalty rates for refined and unrefined mineral resources in the MPRRA. The rate for refined minerals provides a higher B-value. This results in a lower royalty rate. This lower royalty rate provides an incentive to promote downstream beneficiation.

The jumping to and from the various alternatives available in the four draft versions of the MPRRB indicated the uncertainty and difficulty in achieving a balance between administrative considerations of the act, the beneficiation objective in the Department of Minerals and Energy's policies on mining and minerals, economic behaviour of private mining companies and the responsibilities of the government to manage the depletion of the nation's mineral resource wealth in its capacity as custodian thereof.

Further research opportunities exist to assess and compare the royalties charged on refined and unrefined mineral resources and their impact on beneficiation activities once the Act has been effective for a period of time. This research could also take into account practical challenges faced with the provisions of the MPRRA relating to beneficiation promotion. The practices implemented and problems experienced in other countries in this regard should also be investigated further.

## CHAPTER EIGHT: SUMMARY OF FINDINGS

As stated in 1.2 it was the objectives of this study to to analyse the development of the MPRRA to gain an understanding of the issues that were given consideration during the development process as well as to identify provisions of the MPRRA that may require improvement in future and would therefore justify further research, based on the understanding of the development process.

The study concludes with a summary of the main areas of consideration during the development of the mineral royalty regime and a summary of the areas of the MPRRA that would require further research.

### 8.1. DEVELOPMENT OF A MINERAL ROYALTY REGIME

On 24 November 2008 the MPRRA was enacted. This Act, which was developed by the National Treasury and the Department of Minerals and Energy, imposes a royalty on the extraction of mineral and petroleum resources in South Africa. This legislation originated from the provisions of the MPRDA which stated that the State as Custodian of the nation's mineral resources may levy any fee or considerations in respect of these resources.

The process to develop the MPRRA took approximately 5 years and 4 draft versions of the MPRRB. During this period extensive consultations were held between the legislators and various role-players in the mining industry. Each draft version of the MPRRB contained a charging provision, relief provision(s) and anti-avoidance rules. The administrative aspects of the proposed legislation were contained in the bill, up to the third draft when it was detached into a separate document. The review in Chapters 3 to 6 focussed on the charging provisions, relief provisions and anti-avoidance provisions rather than the administrative provisions.

The charging provision proved to be the most contentious of the three components of the bill. The first draft bill proposed that published values and prescribed royalty rates for different categories of minerals should be used to determine the royalty payable to the

State. Commentators however noted that this approach did not take into account the ability of mining companies to pay this royalty and also had potentially onerous administrative consequences. The first draft bill completely ignored the impact of downstream beneficiation on the royalty. The second draft bill revised the charging provision and stated that the royalty would be based on the gross sales value of the mineral transferred multiplied by a prescribed royalty rate for various categories of minerals. Lower royalty rates were provided for certain minerals if the minerals were in a refined form to promote further processing of these minerals. Cawood (2006) questioned whether separate royalty rates for refined and unrefined minerals effectively promoted downstream beneficiation. The third draft bill introduced sweeping changes as the royalty base was reduced from the gross sales value to a net smelter return type of value which was equal to gross sales value less beneficiation costs beyond the point at which the mineral resource is in its initially saleable condition. The royalty rates were determined in terms of a single formula for all minerals. This formula took into account the profitability of the extracting company but could potentially lead to a zero royalty in times of economic difficulty. The Chamber of Mines (2008) indicated that it could prove to be challenging to determine the point beyond which a mineral resource is in its initially saleable condition in practice. The final bill returned to a gross sales value royalty base and separate royalty rates for refined and unrefined minerals. This bill introduced minimum and maximum royalty rates.

During the evolution of the relief provisions in the bill these provisions underwent complete changes from draft to draft even though it was not as controversial as the charging provision. Certain amendments were consequential changes resulting from changes to the charging provision. The first draft bill provided exemptions from the royalties available at the discretion of the Ministers of Finance and Minerals and Energy as well as an option to fix the royalty rates at a rate higher than the rate proposed in that draft version of the bill. Cawood (2003) was of the opinion that the marginal mine relief at the discretion of the Minister of Minerals and Energy was too subjective. He was also of the opinion that the fiscal stabilisation clause would have sent a negative message to investors regarding future rate increases. The second draft bill replaced the exemption available at the discretion of the Ministers with an objective marginal mine relief. Many commentators were of the opinion that the application of the relief was too narrow. The fiscal stabilisation clause was amended to fix the rate at the proposed royalty rate rather than a higher rate.

The second draft of the bill introduced a small mining relief to aid start-up of mining activities and small scale mining companies. The third draft removed the marginal mine relief provision as its royalty rate formula provided automatic relief based on the profitability of the mineral extractor. The small mining relief was amended to be a hard cut-off relief rather than a relief measure available to all small mines. It was noted that a hard cut-off relief provision could discourage expansion if the thresholds were not regularly reviewed. The fiscal stability clause evolved into a fiscal agreement clause whereby the provisions of the act could be guaranteed in the third draft. The guaranteed provisions were reduced to include only the rate formulas in the final draft. The National Revenue Watch (2008) was of the opinion that this guarantee provided the State with flexibility if changes to the royalty regime were required.

The anti-avoidance provisions had to follow the movements of the charging provision as the charging provision evolved. Initially the draft bill only focussed mainly on avoidance between connected persons using transfer prices to manipulate the royalties payable. These provisions changed to become general anti-avoidance provisions which applied to all transactions and addressed could be used to address all types of avoidance issues.

Even though the royalty regime that was enacted in the MPRRA had progressed a long way from the initially proposed regime, the mining industry had fears that the royalties may be too onerous for the industry to bear. Uncertainty existed as to the exact impact of the regime because of the number of variables involved in determining the royalties to be imposed.

## **8.2. ISSUES FOR FURTHER RESEARCH IDENTIFIED**

The uncertainty and caution of the mining industry stemmed from a number of aspects that were included in the MPRRA. Even though these aspects were thoroughly discussed and considered, legislators had to take a view and include these views in the provisions of the MPRRA. Further research should be performed on certain aspects of the MPRRA. The two main issues identified in this study are firstly the level of the royalty that will be levied and secondly the promotion of downstream beneficiation by the royalty equation.

Throughout the development of the royalty charging provisions, the level of royalty has been a major point of contention. The level of royalty depends on the tax base as well as the royalty rates. Cawood (2003) indicated that a study of competitive international royalty regimes levied a royalty of between 0% and 3%. The final royalty rates in terms of the MPRAA will range from 0.5% up to 7%. The MPRRA levies royalties on a gross sales basis as opposed to a net smelter base that was suggested in the study conducted by Cawood in 2003. The impact of the level of royalties on investment in the South African mining industry, the decisions taken by private mining companies and the government in achieving its social and economic objectives is an area that would require further research.

A further aspect of the MPRRA that could require amendment in future based on the effectiveness of the current provisions once it is implemented is the consideration of beneficiation when determining the royalty payable. The ideal royalty should not be affected by activities after extraction of the minerals because the royalty merely compensates the owner of a non-renewable resource for the depletion of the resource. The royalty should therefore be constant irrespective of whether the mineral has been processed further or not. If the minerals are processed further the gross sales value increases. This would result in a higher royalty when the gross sales value is used as a royalty base. This increase in royalty can be countered by using a net smelter value royalty base, by providing a lower royalty rate for refined minerals than for unrefined minerals or by using another method of determining the value of the mineral at the mine-mouth. An area for further research exists to determine the most appropriate method to promote downstream beneficiation in the royalty equation in the South African mining industry.

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## APPENDIX A – FIRST DRAFT BILL ROYALTY RATES

### Substance Classification and Royalty Rates

Group	Substance	Royalty Rates %
1	Salt, sand, stone, sandstone, late, gravel, clay, concrete, mortar, plaster, brick, dolorite, limestone, shale, gypsum, limestone, perlite, and phosphate rock extracted by a mineral extractor outside of the exemption described under section 12.	1
2	Oil and gas: natural gas and natural gas condensate petroleum crude offshore production where the water depths are deeper than 500 meters.	1
3	Alumino-silicates (andalusite, sillimanite, kyanite), asbestos, ammonium sulphate, barytes, zirconium oxide uranium oxide, kaolin, talk, magnesite, mica, silica, sulphur, sodium sulphite, mineral pigment, pyrophyllite, dimension stone (granite, norite), and perlite.	1
4	Anthracite and bituminous coal (low ash and steam)	2
5	Antimony, copper, iron, manganese, lead, zinc, cobalt, nickel, silicon, tin, and vermiculite.	2
6	Oil and gas: natural gas and natural gas condensate petroleum crude onshore and offshore production where the water depths are shallower than 500 meters.	3
7	Gold, silver, vanadium, chromite, and titanium dioxide (Ilmenite, rutile).	3
8	Platinum group metals: platinum, paladium, rhodium, iridium, ruthenium, and osmium.	4
9	Amethyst, quartz (smoky quartz, citrine, rose quartz), cryptocrystalline quartz (jasper, opal), or chalcedony (blue lace agate, moss agate, onyx, rainbow chalcedony), tiger's eye, blue asbestos (crocidolite), beryl (emeralds, aquamarine, morganite, heliodor), chrysoberyl (cat's eye, alexandrite), corundum (rubies, sapphires), garnet (jade, hydrogrossular, spessartine), lolite, kyanite, sodalite, sugilite (royal lavulite or royal azel), tourmaline, verdite (serpentine), and topaz.	5
10	Unpolished natural diamonds	8

(Source: Schedule to the Mineral and Petroleum Royalty Bill (2003))

## APPENDIX B – SECOND DRAFT BILL ROYALTY RATES

### Minerals with a Single Rate

Group	Minerals	Rate %
1	Unpolished natural diamond (gem and industrial), crystalline quartz (smokey quartz, citrine, rose quartz, amethyst, rock crystal), cryptocrystalline quartz (jasper, opal), chalcedony (blue lace agate, moss agate, onyx, rainbow chalcedony), chalcedonic replacements (silicified wood, tigers-eye), blue asbestos (crocodolite), beryl (emeralds, aquamarine, morganite, heliodor, goshenite, bixbite), chrysoberyl (cat's eye, alexandrite), corundum (rubies, sapphires), garnet (almandine, pyrope, almandine-pyrope, grossular, spessartine, uvarovite), lolite, kyanite, sodalite, sugilite (royal lavulite, royal azel), tourmaline, verdite (serpentine), topaz, copper minerals (azurite, malachite, chrysocolla), enstatite, epidote, feldspar group (moonstone, amazonite) and spinel.	5
2	Andalusite, asbestos, vermiculite, sillimanite, kieselguhr, calcite, granite, marble and siltstone.	1
3	Feldspar, fluorspar, barytes, gypsum, magnesite, mineral pigment, sulphur, silica, sillimanite, talc, slate, shale, attapulgitite, bentonite, flint clays, kaolin and fire clay.	0.5
4	Limestone, lime and dolomite, phosphate rock, salt, quartzite, schist, plastic clays, fire clay (construction grades), kaolin (construction grades) aggregate and sand.	0

### Minerals with Unrefined and Refined Rates

Group	Minerals	Unrefined rate %	Refined rate %
5	Platinum Group Metals (platinum, palladium, rhodium, iridium, ruthenium and osmium).	6	3
6	Chrome, manganese, silicon, vanadium, iron, cobalt, copper, nickel, lead, zinc, antimony and tin.	4	2
7	Ilmenite, rutile and zircon	3	1.5
8	Gold and silver	3	1.5

### Energy

Group	Mineral	Specification	Rate %
9	Coal.	Above 15% Ash content	1
		Below 15% Ash content	3
10	Hydrocarbon fuel (oil and gas).	Mining in water deeper than 500 m	1.5
		Mining in water shallower than 500 m	3
11	Uranium.	Oxide (yellow cake) and Uranium Hexafluoride	1.5
		Uranium concentrate	3

(Source: Schedule to Mineral and Petroleum Resources Royalty Bill (2006))