

### PAH NEWS PIX

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### CALENDAR

- **SME Annual Meeting and Exhibit**  
February 28–March 2, 2005  
Salt Palace Convention Center  
Salt Lake City, Utah  
email: [sme@smenet.org](mailto:sme@smenet.org)  
Visit us at Booth 1002
- **PDAC 2005 International Convention**  
March 6–9, 2005  
Metro Toronto Convention Centre  
Toronto, Ontario, Canada  
email: [info@pdac.ca](mailto:info@pdac.ca)  
Visit us at Booth 312
- **Asia Mining Congress 2005**  
March 21–24, 2005  
The Oriental Hotel  
Singapore, Singapore  
email: [joan.ong@terrapinn.com](mailto:joan.ong@terrapinn.com)
- **Mining World Russia 2005**  
April 5–8, 2005  
World Trade Center  
Moscow, Russia  
email: [oleg.netchaev@miningworld-russia.com](mailto:oleg.netchaev@miningworld-russia.com)

## Mining Agreements and Royalties

The mining industry is once again riding high due to an across the board increase in metal prices. Landowners (individuals or companies) and mining companies are heavily involved in deal making to develop their mineral properties. After all, the goal of successfully negotiating a mining agreement is to provide maximum benefit to all parties.

The intent of this paper is to describe the various mining royalty agreements and the economic implications with respect to project development. Royalty arrangements represent an operating cost and can substantially influence project economics.

Mineral exploration is a high-risk activity and the cost can be substantial. While there is never an assurance that a commercially exploitable deposit will result, projects usually require long lead times where returns may not be realized for years. This is why small companies or individuals turn to larger, more integrated firms to develop their property. Likewise, larger firms, even with significant financial resources, turn to smaller companies or individuals who may control a property with significant mineral potential, to avoid the long lead times in mineral exploration.

Whether negotiations occur between individual landowners or governments of

mineral-rich countries, mineral agreements can be divided into two main groups: exploration agreements and production agreements.

### Exploration Agreements

The structure of the exploration agreement depends on each party's degree of sophistication, knowledge of the mineral property and tax regimes under which the negotiations are taking place. Generally the landowner (lessor) requires some form of upfront payment from the mining company (lessee), which allows the interested corporation to explore the property for a certain period of time. Depending on the aforementioned items, mining agreements can vary widely at this stage.

In negotiating exploration agreements the lessor wishes to maintain as much control and ownership as possible, minimize expenditures and limit risk exposure. The lessor generally requires the mining company to meet certain commitments or milestones to insure the property is explored and evaluated in a timely manner.

The mining company is interested in putting money in the property's exploration effort rather than making the

■ **OSM PROPOSED NEW RULES FOR OWNERSHIP, MANAGEMENT**

The mining industry is one step closer to ending a fifteen year-old battle between the Office of Surface Mining (OSM) and the National Mining Association (NMA) over ownership and management issues. OSM Reclamation and Enforcement has proposed new rules designed to ensure that the agency will not have actual approval of major acquisitions and management changes by coal companies. The new rules clarifies that the Surface Mining Control and Reclamation Act requirement which states that OSM sign off on any transfers or sales of coal mine permits does not apply to such business transactions. In 2001 the NMA filed a lawsuit over OSM's interpretations of who is liable for a specific violation. OSM wanted to include individuals who had no direct control over a mine that was in violation while the NMA wanted those directly responsible for management of a mine to be liable. OSM will accept public comment on the proposal of these new rules through March 27.

■ **PHILIPPINE COURTS ALLOW UNRESTRICTED FOREIGN OWNERSHIP**

A recent court decision in the Philippines is hoping to start a rebirth of exploration and mine development in that country. The court decision now allows for unrestricted foreign ownership of mines. As a result of this decision the Mines and Geoscience Bureau in the Philippines is estimating US\$6 billion in mining investment by 2010. Approximately 23 mining projects are planned, including the Rapu gold project of Australian Junior Lafayette Mining.

■ **NEW JORC CODE RELEASED**

The new version of the JORC Code was released in December 2004. Changes include:

- The recognition of overseas professional organizations (ROPO) to satisfy Competent Person requirements (previously the Competent Person had to be a member of AusIMM or AIG).
- The requirement for a Competent Person to be responsible for reporting Exploration Results.
- Revised coal reporting, including reference to a supplemental coal reporting document
- Revised diamond reporting.
- Guideline on level of study expected for Ore Reserves

lessor wealthy. The mining company wants to spend the least amount of money possible to evaluate the property's mineral potential, knowing that the chances against developing a mineral property are quite large; estimates indicate that about 1 in 1,000 exploration deposits lead to a viable operation.

During negotiations of exploration agreements, mining companies need to know what economic limits the project holds in order to gauge the negotiation. The negotiator needs to know what level of royalty expenses the project can withstand before it becomes marginal or uneconomic.

If the lessor is too demanding at this stage of the negotiation, the mining company may decide it is not worth the effort to continue discussions.

The lessor's payment requirements or exploration commitments may be so onerous as to condemn the property's economics before the mining company has a chance to start exploration. On the other hand, a property owner who is aware of and accepts the technical uncertainties associated with project development will probably take less upfront money in order to share in the profits from future production.

It is common to include the effects of taxes in project evaluations. This allows one to rank projects in terms of their net after-tax return on investment. While there are several reasons to include the effects of taxes in project evaluations, the most important is to ensure comparability between projects. As more companies perform exploration in various parts of the world, the mix of foreign and domestic projects will be

subject to different tax rules and rates. Analyzing these projects on an after tax rate-of-return basis avoids ambiguity by comparing projects on an equal basis.

Tax treatment of royalty (leasing) expenditures vary from country to country. For properties in the United States, payments made during the exploration stage must be recovered by depletion deductions over the life of the project. The only option for the lessor is to treat the royalty payment as ordinary income and pay taxes according to their appropriate tax bracket.

Although this paper discusses the after tax implications of royalty agreements, it is done primarily with regard to corporations. Individual tax scenarios vary so much that it would be beyond the scope of this paper to address all those cases. Individual landowners would need to seek the advice of qualified attorneys and accountants specializing in mineral agreements in order to determine their specific tax situation.

In regard to exploration agreements, there are no terms that have particularly favorable tax advantages for either party. For companies, royalty payments are no more than out-of-pocket expenses, which require recapture from future allowances. The lessor receives royalty income with no particular tax advantages, treating the income as ordinary income.

When negotiating mining agreements, consider that exploration royalties are generally offset against production royalties should the project go into production. Depending on the

landowner's risk tolerance and tenor of the deposit, both the mining company and the landowner may be financially better off by constructing their agreement around production royalties and minimizing the exploration royalties.

While exploration agreements are generally not going to be structured for the sole purpose of minimizing taxes, agreements should be negotiated to maximize information gathering on behalf of the project. Should the project move on to the next stage of development, both parties will reap the benefits. It is at this stage where the more complicated and financially rewarding mining agreements occur.

### Production Agreements

Production agreements can take the form of a sale, lease or joint venture arrangement. The sale of the property does not include royalties because the mining company is purchasing the mineral interest from the other party. The joint venture arrangement takes on an entirely different type of mineral interest. Usually the joint venture partner is required to spend a certain level of funds in order to earn an interest, or share, in the project. This discussion only considers the various lease agreements.

Lease agreements consist of net smelter return (NSR), net proceeds and net profits interest royalties. Royalty payments based on net profits interest deduct mine operating costs and are generally avoided because of differences in accounting, particularly for non-cash charges and taxes. Inclusion of these items adds to the complexity of the agreement, often

requiring litigation to be resolved. Net profits interest royalties are not considered in this paper.

NSR royalty is based on the gross revenue received by the mine less costs incurred subsequent to concentrating, which includes smelting, refining, marketing, transportation, and insurance. Usually no provision is made for deducting direct mine operating costs. The NSR royalty is simple and straight forward to administer.

Landowners generally prefer the NSR royalty to avoid the detail and negotiations associated with net proceeds or net profits royalties. While the NSR is easy for mining companies to administer, NSR royalties are paid to the landowner **whether or not the project makes a profit.**

Net proceeds is a more general term that has no established accounting definition, allowing significant flexibility when negotiating agreements. In general, net proceeds refers to the net amount from revenue received by the mine less direct operating costs, which includes mining, milling, ongoing reclamation, general and administrative costs. Additional charges, such as offsite overhead fees, taxes, in-house cost of equity financing and replacement capital, will require negotiation.

Net proceeds royalty agreements are usually structured such that the operator will be able to recoup capital expenditures prior to royalty payments being made. Capital costs typically include mine development, mine/mill plant and equipment, working capital, and replacement capital. This allows the mine to gain a healthier cash flow

### ■ MINING INDUSTRY ZERO TOLERANCE ON BRIBERY

Several mining companies are lending their support for a zero-tolerance policy towards bribery and the development of a practical and effective implementation program. Sixty-two companies have signed the Partnership Against Corruption Principles, which are derived from Transparency International's Business Principles for Countering Bribery and in partnership with the Basel Institute on Governance. The companies have pledged either to implement anti-bribery and anti-corruption practices based on the Partnership Against Corruption Principles or will use them to improve their own existing programs. The principals address political contributions, charitable contributions and sponsorships, and gifts, hospitalities and expenses. It also calls for the elimination of facilitation payments or small payments made to expedite the performance of routine action to which the business is entitled. The principals were announced at the World Economic Forum in Davos, Switzerland in January.

### Minerals Corner—

#### **Kaemmererite (Fe, Mg)<sub>3</sub>Fe<sub>3</sub>AlSi<sub>3</sub>O<sub>10</sub>(OH)<sub>8</sub>, Iron Magnesium Aluminum Silicate Hydroxide**

*Kaemmererite, also spelled kammererite, is the chromium rich variety of clinocllore. Clinocllore is a part of a large group of minerals called chlorites. While most chlorites have a green color as a result of iron and magnesium ions, kaemmererite has only small amounts of chromium in its structure. Crimson red is the most common color of kaemmererite but it can also be found in lavender. Kaemmererite's crystals are similar to erythrite, which are usually thin platy crystal aggregates. But erythrite's crystals are more pointed and have acute angles, which are lacking on kaemmererite's crystals. This mineral is found in Lancaster, County, Pennsylvania and California, USA; and Guleman, Turkey. Kaemmererite's only use is as a mineral specimen.*

position and pay royalties when profits are actually being recognized. In addition, a provision can be made to carry forward a net operating loss to offset net proceeds payments in future years. This provision reduces the total net proceeds royalty that the lessor would otherwise have received.

Although the net proceeds royalty agreement is very flexible and can be tailored to fit any project, they are extremely complicated to negotiate. Many areas of dispute may arise, and the administrative burden, renegotiation or legal expenses may offset the benefits. However, depending on the sophistication of the landowner and the degree of risk tolerance, this type of royalty agreement might be to both party's advantage. Should the risks tend to the upside, each group's wealth may significantly improve.

NSR royalties can vary from a low of one percent to a high of 15 percent (if multiple property owners are involved) and typically range from two to six percent. Net proceeds royalties vary from 10 to 35 percent, depending on the agreement terms and number of landowners involved, and typically range from 15 to 30 percent.

Based on previous work conducted by the author, one can equate the economic tradeoffs between NSR royalties and net proceeds royalties. The results of this work indicate that, based on after-tax net present value analysis, one percentage point of NSR is equivalent to 3.5 percentage points of net proceeds royalty. Results further indicate that the equivalency is consistent regardless of size or type of mine. If the landowner desires to indulge in the higher-risk potential of the project yet maintain the simplicity of the NSR royalty, one could do so by applying the equivalency guideline.

Although, the net proceeds royalty is more advantageous to the mining company because profitability is taken into account, most companies prefer the NSR royalty because it is far less of an administrative burden, even though royalties are paid regardless of profit.

One cannot discuss royalties without noting the impact royalties have on project economics and mineral reserves. Royalties, no matter what type, represent a direct operating cost to the project. Thus, royalties have the direct impact of raising the

cutoff grade, which in turn reduces the project's mineral reserve. Royalties that are too high can make the project uneconomic, forcing the company not to develop the property.

Although most countries have enacted legislation governing their mining sector, most companies negotiate some form of mineral agreement with that government prior to conducting exploration or developing mineral properties, particularly in regard to taxes and royalties. However, governments have been securing a larger portion of project revenues by applying additional taxes and royalties on mineral projects within their borders. As the country's mineral wealth becomes established, these countries are in a strong position to change tax laws or royalties as they wish. While it is their sovereign right to make changes benefiting their country, doing so may jeopardize their reputation and force investors to explore for and develop mineral properties elsewhere.

*This month's article was provided by Don Tschabrun, Principal Mining Engineer don.tschabrun@pincock.com*



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