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Mining in Africa – getting in sync with the cycle

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With one third of the world's mineral reserves and two thirds of the world's diamond production, Africa should have basked in the era of roaring commodity prices and booming optimism. Over the last decade, Africa's average annual growth rate was more than 5% making it the world's fastest growing continent. For years commodity prices have shaped Africa's economic growth, but of all continents, Africa was seen as the new frontier of the super cycle.

While some nations rode the boom – attracting investment in new mining projects and mining-related infrastructure and investing the proceeds prudently – questions can be asked as to why Africa missed out on this golden opportunity to benefit to the same extent as others did from the super cycle.

Africa didn't benefit sufficiently from the super cycle

Historically, mining in Africa has been viewed as a high risk affair - broadly characterised by higher capex costs required for infrastructure, underdeveloped regulatory regimes, a lack of transparency and bureaucracy causing project delays. Whether perceived or real, at the dawn of the super cycle these risks made many African mining nations a less attractive investment opportunity than other mineral-rich countries – such as Canada, Chile and Australia.

Take Simandou. Bloomberg estimates that its development could double the Guinean economy, yet almost two decades after Rio Tinto first explored the deposit, it remains undeveloped. A crucial factor is the significant infrastructure Rio Tinto must build before it can extract and export the riches of Africa's largest iron ore project, which requires a 650km railway through dense mountain forest to a specially constructed deep sea port. Project costs have escalated – estimated at $13 billion already. The project has also faced hurdles posed by changes to Guinean mining and fiscal regulation and the Ebola outbreak.

In December 2014, when iron ore prices were flying high (even if already down from their peak of $191 a tonne in February 2011) such mega-projects were still feasible. In little under five years, prices have fallen to below $40 a tonne – down approximately 70% from the peak. It took over two years, crucially right at the top of the cycle, to finalise and ratify the Investment Framework Agreement and associated conventions, which separated the mine and infrastructure projects and allowed the parties to seek new investors for the separate financing of the project's rail and port infrastructure.

Meanwhile, over in Western Australia's Pilbara, Rio Tinto, BHP Billiton and Fortescue approved massive expansions of iron ore production capacity, backed by a highly facilitative regulatory regime and supportive Australian state and federal governments. The spoils of those Pilbara expansions now flood the global market, contributing to the lower price of iron ore. The prospect of realising a massive African iron ore project like Simandou seems once again distant prospect.

Similar stories of delays and downed tools echo across Africa. A case in point is Sundance Resources' moth-balling of the Mbalam-Nabeba iron ore project in Cameroon. Falling prices signalled that the cost of constructing the deep sea port and 510km of rail infrastructure was not economically viable at that stage of the cycle.

With the benefit of hindsight some claim that some African nations were not sufficiently well-positioned at the dawn of the boom to take advantage of the opportunities presented by the commodities super cycle – they were behind and out of sync with the cycle.

How can African governments get in sync with the cycle?

Africa's high fixed costs for infrastructure will remain a barrier to investment at any stage of the cycle, but African governments should consider implementing certain reforms that will help to bring their nations in sync with the cycle.

African countries may look to their neighbours Côte d'Ivoire and Burkina Faso who have successfully implemented longer-term scenario planning into their statute books. Both countries incorporated the EITI principles into their revised mining legislation, with Côte d'Ivoire also introducing the Equator Principles and the Kimberly Process Certification Scheme into its new mining laws.

Another example is Mozambique which rose fifteen places to 133rd in The World Bank's annual 'Doing Business' report 2015/16. This reflects its government's focus on streamlining the construction licensing and work permit process. Measures such as these – which develop efficient systems and procedures – can only help to signal that a nation is "open for business"; ready and prepared for the uptick of the cycle.

Burkina Faso has now ensured that its gold royalties are indexed to gold prices. The interests of gold miners and the state are aligned – the country is viewed by investors as open for business. Like Australia's past Mineral Resources Tax (a.k.a. the "super profits tax"), Burkina Faso's treatment of gold royalties shows an understanding of the volatility of the market – and that mining laws and their associated fiscal regimes must work both at the top and the bottom of the cycle.

The discussion around fiscal reform looks to various potential tools to encourage the co-location of downstream activities from mining (such as the marketing of mine product and downstream processing) in the same country as the mine itself. Co-location of these activities could have the dual benefits of increasing economic growth through the top of the cycle and also reducing the 'naked' exposure of a host country to volatile commodity prices (as its tax take will be spread more evenly across the value chain). Amongst these potential tools, a current hot topic is transfer pricing rules (these rules regulate intro-group transactions within mining companies' corporate groups). Some critics argue that weak or poorly enforced transfer pricing rules have allowed mining companies to 'offshore' too much of the spoils of mining.

Bridgette Radebe, a prominent South African mining entrepreneur and President of the South African Mining Development Association, comments: *"The practice of shifting profits to tax havens, through the abuse of transfer pricing, deprives African governments of substantial revenues from their natural resources, which could be re-invested into their economies to significantly enhance domestic economic growth and development."*

Lessons can be learned from the depths of the cycle – the importance of balanced and well-aligned regulations is clear. Increased government 'takes' may make good economic and political sense while commodity prices are high, but in a downturn they significantly worsen the plight of struggling mining companies who must cut costs (read local jobs) to hang on by their finger nails.

But some question, when the window for attracting mining investment at the top of the cycle is so tight, should a country risk making wholesale changes to its regulatory regime at such time? Uncertain or untested legislation and questions over the rule of law may deter investment, but when is the best time to enact the required reforms?

Take Zambia – Africa's largest copper producer – which is one of two African countries (alongside Zimbabwe) that hiked its mineral royalties not once but twice in the past six years. The timing of these reforms has been called into question, arguably deterring greenfield investment and stalling expansions, even though copper (Zambia's principal mineral) held out longer than other commodities against the turn of the cycle.

Lessons – getting in sync

There is much to be positive about – many claim that the 'resource curse' is losing its grip on Africa. They point to the progress in updating Africa's mining laws to reflect improved corporate governance, transparency, sustainable mining and national beneficiation. But as the cycle rolls on there is also much to reflect on and still much to do.

Always with one eye on the cycle, African nations would be prudent to use this downturn to look again at their regulatory framework, mining procedures and infrastructure requirements. It is crucial that law makers recognise that to promote sustainable long-term mining investments, miners must be able to survive the lean times and require stability in the regulatory environment. Balanced mining laws are essential to avoid the economic and consequent political shocks that appear at each downturn – aligning the interests of investors and governments and ensuring that Africa is in sync with the cycle.

It is vital for mining companies to collaborate with African governments in this endeavour – sharing their deep knowledge of the market and cycle – to build a responsible and sustainable investment and fiscal regime, sufficiently flexible to meet the changing demands of mining projects throughout the cycle.

Like all relationships, the relationship between mining companies and host governments is most powerful when it is based on trust. Most mining companies now recognise that they must demonstrably add value beyond tax payments and royalties, and that permission to explore and develop is to be pursued no less vigorously than securing a social licence to operate by winning over stakeholders at all levels from local communities, the workforce and civil society.

Leading British lawyer Cherie Blair CBE, QC said:

"Investors, corporates and political leaders around the world are increasingly aware of the positive impacts that responsible business can have on the communities and environment they operate in. Mining companies, regardless of their size, can behave in a way that not only gives their shareholders a return, but also guarantees the long term success of their businesses and satisfies host governments, consumers and employees alike. Companies that stand for something are the ones that mark themselves out from the crowd. It is these mining companies that governments, investors nd other stakeholders will seek to support when times get challenging."

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White & Case will be hosting a very special event with Cherie Blair and Bridgette Radebe centred around how Africa's mining jurisdictions can position themselves to "Get in sync with the cycle" at this year's Mining Indaba in Cape Town on 9 February 2016 at 6 p.m. at the Westin Executive Restaurant. Please **RSVP** if you would like to attend.

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