

DRAFT ANALYSIS OF CHINA UNION CONTRACT FISCAL FRAMEWORK

Revenue Watch Institute¹ and Columbia University

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On January 19, 2009, China Union signed a 25-year Mineral Development Agreement with the Government of the Republic of Liberia for the exploration and mining of iron ore in the Bong Range of Liberia. The deal is reported to be the largest ever foreign investment in Liberia. The contract followed an international competitive bidding process (commencing with a general solicitation for bid proposals in January 2008), with China Union's bid having been accepted on December 8, 2008. The signed contract, however, reflects a deviation from the terms of China Union's original bid in consideration of the financial crisis (Recitals, F). Revenue Watch Institute and Columbia University have been unable to obtain copies of the general solicitation for bid proposals, original bidding documents or modified bidding documents and thus cannot make any assessment of these documents or the extent to which the signed contract constitutes a reduction in government revenues vis-à-vis the bid terms. We nevertheless highlight the following issues (and potential issues) that we think warrant close scrutiny by the legislature as it considers this contract. In light of the general analysis of this contract recently produced by Green Advocates and Global Witness,² we have focused our analysis largely on the fiscal framework created by the contract.

I. Renegotiation of bid terms

Tenders of mineral rights (if run properly) can enable governments to maximize their benefits from mining projects by pitting companies against each other in the bidding process and awarding mineral rights to the company offering the best overall deal. Where the terms of a winning bid are subsequently renegotiated, there is a risk that the benefits of awarding mineral rights through tender will disappear. While there may well be good reasons for renegotiating the terms of a winning bid, it is important to evaluate any such renegotiation vis-à-vis both the original winning bid as well as the losing bids from the original tender. China Union may have offered more in the original tender, but the second-place bidder may have been willing to offer more than China Union ultimately agreed.

As a separate point, we note that the time between the acceptance of the original bid (December 8, 2008) and the agreement of this contract reflecting the revised terms (January 19, 2009) seems remarkably short given the revenue at stake.

Questions for further analysis:

- As an initial matter, Schedule 6 and the original bid documents should be made available to allow informed analysis of the contract.

¹ The government of Liberia was advised in part by Joseph Bell and Lorraine Sostowski, partners of Hogan & Hartson LLP, working pro bono in conjunction with the International Senior Lawyers Project. Substantive responsibility for the agreement rests solely with the government of Liberia. Mr. Bell is also Chair of the Advisory Board of the Revenue Watch Institute. He has not reviewed or otherwise participated in the preparation of this report. The opinions expressed herein are solely those of the authors.

² Available at http://www.emansion.gov.lr/doc/global_witness_greenadvocates_memo.pdf.

- In what ways, specifically, does the fiscal regime elaborated in the contract differ from that under the original bid documents?
- Has the Government run a comparative analysis of the contract vis-à-vis the second-place bid from the original tender? How do the fiscal packages compare?
- Since being approached by China Union to renegotiate the original bid terms, has the Government approached any of the bidders from the initial tender to gauge their level of continued interest in the Bong Range?

II. Exemption from surtax on high yield projects

Section 14.3.b exempts China Union from payment of the surtax on high yield projects imposed by Sections 730-732 of Schedule 6 (the Government's "proposed fiscal regime for Mining"). We have been unable to obtain a copy of Schedule 6, and thus cannot comment on the precise nature of the exemption, though we expect that the surtax on high yield projects contained in Sections 730-732 is some version of a windfall tax or resource rent tax.

Resource rent taxes are designed to address the variability of mineral prices and mineral project profitability by providing a mechanism that automatically captures a greater share of the windfalls that often occur during cyclical upswings in the mineral sector. Given the current down cycle and financial crisis, projects are likely to be less profitable and such taxes are, accordingly, not likely to come into play until prices recover.

Thus, the current economic crisis appears to offer little reason for giving up this fiscal tool. When prices for iron ore recover (and they surely will over the course of this long-term project), Liberia will be unable to capture an increased share of those windfalls and may well face internal pressure to renegotiate for a fairer deal. Flexible fiscal mechanisms are designed to ensure an equitable distribution of benefits under different economic conditions³ and thus allow for more politically stable contracts. They are thus especially important where contracts are signed during down cycles.

Questions for further analysis:

- What was the rationale for offering an exemption from the surtax on high-yield projects?
- Has the Government run an analysis of the impact of this exemption? What price assumptions were used and how much lost revenue does the exemption represent?

III. Royalty

Section 15 of the contract establishes a variable rate royalty ranging from 3.25% to 4.5%. Given current price projections, the royalty rate would appear to be 3.25% under the contract.⁴ While,

³ In this regard, the Draft Mineral Policy of Liberia states that "... excess rents need to be equitably shared between the asset owner (Liberia) and the asset exploiter. The proposed new Liberia Revenue Code (LRC) should cater for this in a transparent and equitable manner."

⁴ The royalty rate under the contract is determined using prices received by Vale Mining Company, the largest producer of iron ore in the world. The royalty calculation sets the rate (between 3.25% and 4.5%) by reference to the spot price of ore for shipment from Brazil to China. In February/March 2008, Vale's reference price for shipments to China was reportedly \$118.98/ton, which would correspond to a 3.5% royalty under the formula in Section 15.1.b of the contract. Prices have fallen since that time, likely

as noted, we have not seen the bid documents, we note the royalty rate for iron ore produced under the Mittal contract is 4.5%. Thus, China Union's royalty would appear to be 1.25% lower (i.e., a 27.8% reduction in royalty receipts) than the rate established in the Mittal Agreement in the short term, and in the long term will be capped at the 4.5% paid by Mittal. Moreover, given prices seen near the peak of the commodities boom that ended around August 2008, it appears unlikely that the variable royalty rate mechanism would yield a rate of 4.5% (which is a reasonable rate in line with international standards) absent another historic boom in prices.⁵ To do so, prices would have to exceed \$150 per ton.

Another feature of the royalty calculation that could be cause for concern is that the deemed value of iron ore shipped from Liberia is determined by reference to the prices paid by China to Vale in Brazil. The past year has seen numerous reports that European iron ore customers have at times paid over 10% more than Chinese customers for similar quality ore.⁶ Liberia's interest should be in valuing its ore at the highest price the market would be willing to pay for it. The mechanism in Section 15.1, however, appears to allow Liberian iron ore to be valued at a discount, thereby reducing both royalty and tax payments.

Questions for further analysis:

- Could the Government provide historic data on Vale spot and contract prices, as well as its own projections for such prices in the short and long terms? How were the price points for the calculation of the royalty rate (i.e., \$100, \$125, and \$150 per metric ton) chosen?
- What is the difference in estimated royalty receipts under a 4.5% fixed royalty (as in Mittal) as applied to the China Union contract and the 3.25% to 4.5% variable royalty in the present agreement? What price assumptions did the Government use in making these calculations?
- Has the Government evaluated the revenue impacts of basing the royalty on sales prices between Vale and China as opposed to, e.g., sales between Vale (or other major iron ore producers) and European customers?
- Why did the Government agree to allow downward adjustment of the royalty rate (from the 4.5% agreed in Mittal) without also asking for a corresponding upward adjustment at high prices?

resulting in a 3.25% royalty at the outset of the contract. The rate determined according to Section 15.1.b is multiplied by the "reference price" to determine the royalty payment. The reference price is based on the annual contract price then in effect for shipments of ore from Brazil to China.

⁵ We note that the price thresholds used in the variable rate mechanism do not appear to be adjustable for inflation. Thus, it is possible that inflation (i.e., a nominal as opposed to a real increase in iron ore prices) might result in the highest royalty rate of 4.5% being reached sooner than expected. Whether this is an oversight or a deliberate feature of the contract is unclear. However, since it operates in the Government's favor, we would expect that China Union may seek revision to account for inflation.

⁶ See, e.g., "Vale wants higher Asian iron ore prices; impact in North America unclear", available at <http://www.purchasing.com/article/CA6603098.html>.

IV. Fiscal stabilization

Section 14.3.a provides stabilization of the income tax rate at 25%. While stabilization of fiscal terms is common in mineral contracts, we would argue that their use should be limited and, at a minimum, stabilization clauses should not operate as a “one-way street” allowing companies the benefits of tax rate reductions but shielding them from the cost of tax rate increases. Section 14.3(a) is such a one-way street.

Questions for further analysis:

- Explain the rationale for one-way tax rate stabilization.

V. Free equity

Section 9.22 of Liberia’s Minerals and Mining Law provides that the Government is to receive a 10-15% free equity stake in mining operations. While this feature potentially represents a material share of the Government’s receipts under any mining contract, no such interest is explicitly granted by the contract. While it is possible that Schedule 6 of the contract (which, again, we have not seen) includes language establishing a 10-15% equity stake, it seems unlikely that an item of such significance would be addressed solely in a Schedule and not in the body of the agreement.

Questions for further analysis:

- Was a 10-15% free equity stake for the Government included in the original bid terms for the Bong Range? If so, why was it dropped? If not, why not?
- What is the net present value of a 10-15% free equity stake given reasonable assumptions about the profitability of the mine over time?

VI. Ring-fencing

Section 14.6 of the contract allows China Union to offset profits on a project with established mineral potential (the Non-Goma Deposits Area) with losses on exploratory activity over distinct areas (the Goma Deposits Area, the Additional Concession Area, and the Contiguous Area). This is almost certain to reduce income tax receipts to the Government in the early years as the exploration costs related to the prospective areas will reduce taxable profits on the Non-Goma Deposits Area. While there can be valid reasons for allowing non-ring-fenced tax treatment, the presumption should be in favor of ring-fencing—especially where there is an urgent need for early revenues.

Questions for further analysis:

- What is the rationale for offering non-ring-fenced tax treatment of the separate mining licenses?
- How did the original bid materials address ring-fencing?

VII. Other fiscal exemptions and benefits accruing to China Union

Section 14.3 provides for several other exemptions from the general fiscal framework. While we have not seen Schedule 6 to the agreement and thus cannot be sure of the significance of those deviations, it is apparent from the contract itself that several of the exemptions are likely to prove material.

The 0% withholding tax on dividends for the first 12 years (Section 14.3.c) could potentially represent a significant loss of revenues, depending on the level of withholding provided by generally applicable law (we were unable to verify the withholding rate that would ordinarily obtain under Schedule 6 to the agreement). Similarly, the reduced withholding rates for interest and payments for services could represent material losses.

Import duties (Section 14.3.f) are exempted for 10 years, potentially leading to a substantial loss of revenues particularly in the early years of the project. Customs user fees (Section 14.3.g) are capped at \$400,000 per year for the first 10 years.

Several payment streams accruing to the Government, e.g., surface rent (Section 15.4), education funding (Section 11.3), annual social contributions (Section 8.2), “other support” (Section 16.5) appear not to be adjusted for inflation (though surface rent is increased from \$100,000/yr. to \$250,000/yr. after year 10). The lack of inflation adjustment means that these payment streams will effectively get smaller over the life of the contract.

The amount of land on which the company has rights has the potential to expand over time, from the initial concession area of 59,000 to an additional concession area of 94,000 more, and then, upon application not to be “unreasonably rejected by the Government,” additional contiguous areas (Sections 3.1 and 3.2). The company also has a right of first refusal to other minerals (e.g., not iron ore) that are discovered within the concession area (Section 3.3). These provisions have the potential to give the company access to a bigger geographic and economic pie than may be the original focus of attention on the mine.

Questions for further analysis:

- What is the fiscal impact of each of the special exemptions, reduced rates and capped payments over the life of the project? Which of these special terms was contemplated in the original bid?
- What is the rationale for not adjusting certain payment streams for inflation?
- What projections and assumptions about the potential value of additional minerals and contiguous areas fed into the decision to include priority rights to them in the contract?

VIII. Additional Observations

Our analysis has focused largely on aspects of the China Union contract’s fiscal framework that we believe merit close scrutiny. We would be remiss, however, to ignore the many positive aspects of the contract that have the potential to serve as valuable precedents for future agreements:

- The contract’s revenue disclosure and transparency provisions are by and large positive. We note, in particular: agreed compliance with LEITI (Section 17.5), general reporting requirements (Section 6.8), transparency in the budgeting and disbursements of social contributions (Section 8.2), and relatively limited confidentiality provisions (Section 32.1).
- Periodic review of the agreement (in line with the requirements of the mining law) is likely to make the contract more stable by providing a clear mechanism for revisiting the balance of equities in the case of substantial changes in circumstances (Section 30).
- Public disclosure of the contract itself (Section 33.9) is another positive feature of this contract that is all too often absent in extractive contracts.

ADDENDUM: DRAFT ANALYSIS OF CHINA UNION CONTRACT FISCAL FRAMEWORK
Revenue Watch Institute¹ and Columbia University

March 13, 2009

On February 25, 2009, RWI and Columbia University published their initial analysis of the iron ore contract between China Union and the Government of the Republic of Liberia (available at http://www.revenuewatch.org/images/RWI_Columbia_Draft_Analysis_of_China_Union_contract_fiscal_framework.pdf). Our analysis was qualified by the fact that we had not seen Schedule 6 (the proposed fiscal regime) or the original bid materials, both of which would appear to be necessary to a complete economic analysis of the contract. We understand that the parliament has now received copies of several Schedules annexed to the agreement, and we have also been provided additional documents. In particular, we have reviewed Schedule 6 and accordingly provide this addendum updating our previous analysis.²

- Section 701 of the proposed tax regime sets the tax rate at 30%, whereas the agreement stabilizes the rate at 25% (the Mittal contract sets the rate at 30%). We did not note this tax rate reduction in our earlier memo, but feel it requires attention from parliament. Some analysis of the revenue impact of this derogation from the general tax rate should be provided by the Government (we note also that we do not know what rate was set in the original bid documents; this will also be important information for the parliament to have). In a mining project of this size, it is not uncommon for income tax not to be paid until several years into the project life, as heavy up-front costs must first be recovered. Given this delay in the application of the income tax, we wonder whether a reduction in the tax rate is an appropriate response to the economic crisis (which was cited as the primary reason for the derogation from original bid terms). Though we cannot say this with great certainty absent detailed modeling of the project (not to mention perfect foresight with respect to the world economy), it seems very possible that the economic crisis will have ended before the income tax becomes a major source of revenue from this project. Thus, this concession by the Government seems poorly matched to the rationale behind it.
- As we surmised, Sections 730-732 of Schedule 6 indeed impose a resource revenue tax, from which China Union is exempted under the contract. Our analysis on this point is thus unchanged and the exemption from this tax remains a cause for concern and heightened scrutiny. Resource rent taxes are designed to address the variability of

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² We note that we have so far focused only on Schedule 6, the proposed fiscal regime for mining, and have not yet analyzed the other annexes to the agreement (including the report of the "Inspection Visit to the Bong Range Area and the Port of Monrovia", which may bear on the economic analysis).

mineral prices and mineral project profitability by providing a mechanism that automatically captures a greater share of the windfalls that often occur during cyclical upswings in the mineral sector. Given the current down cycle and financial crisis, projects are likely to be less profitable in the short term and such taxes are, accordingly, not likely to come into play until prices recover. Thus, the current economic crisis appears to offer little reason for giving up this fiscal tool.

- We noted in our initial analysis that the 0% withholding rate on dividends to nonresidents was likely significant, but did not know how significant it was because we had not seen Schedule 6. Schedule 6 provides for a 5% withholding rate on dividends to nonresidents. Thus, this exemption could represent a significant reduction in revenues to the Government.
- The surface rental on the 59,000 acre “initial concession area” and the 94,000 acre “additional concession area” is set at \$100,000/yr for the first 10 years and \$250,000/yr for the next 15 years. This works out to roughly \$0.65/acre for years 1-10 and \$1.63/acre for years 11-25 (these effective per-acre rates will be adjusted downward if any “Contiguous Areas” are added under Section 3.1 of the agreement and upward in the case of any areas being relinquished). Schedule 6, in contrast, calls for a surface rent for mining license contract areas of \$5.00/acre in years 1-10 and \$10.00/acre for years 11-25. Thus surface rent under the contract may be less than it would be under the proposed general law (we cannot state this with certainty as the surface rent for exploration under Schedule 6 is set at \$0.20/acre and the overall rent per acre will depend on the proportion of land under exploration and land being mined, which will change over time). Any discrepancy will presumably grow over time because, whereas Schedule 6 provides for an inflation adjustment to surface rentals (which will generally raise the level of payment each year), the agreement appears to override this.