Creating an attractive investment environment

Chile and Minera Escondida S.A.

1. Introduction

Creating the right conditions to attract private investment requires a comprehensive approach involving a range of instruments and actors. Precepts 3 and 4 of the Natural Resource Charter provides advice on what countries can do to attract this investment ranging from good contracting principles to a flexible but stable fiscal system. From a starting point of little foreign investment, and international perceptions of political risk, Chile has done relatively well in this regard. This case study describes its efforts to build an investment environment that resulted in the establishment of Escondida, a large privately-owned copper mining company, in the country.

Background of the Investment

As explained in Precept [x], extractive industries have a fundamental tendency towards expropriation of private property by governments. This characteristic of extractive industries is likely to reduce the propensity of private investors to invest in countries with poorly perceived legal structures. In 1972, Chile became another example of this expropriation risk where two companies, Kennecott and Anaconda, were taken by the government.[1]

When the internal political scenario changed in Chile, the new government had to adopt a highly competitive tax and regulatory framework to attract foreign investment, given the traumatic nature of the previous expropriation process. It is in this context that one must understand the Decree Law 600 (DL600), the law that regulates large scale foreign direct investment in Chile.

Escondida was the first new major mining project to start in Chile after nationalization occurred in the 1970s. Before operations started in 1990, the only significant foreign private investment in Chile had been the acquisition of the Disputada mine by Exxon in 1978 and the purchase of Mantos Blancos in 1980 by Anglo American; however, these cases differed in that they involved buying an already productive mine and not developing one from the early exploration process.

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[1] Moran (1973) gives a detailed account of how the two major mining companies at that time, Kennecott and Anaconda, faced the increased political pressure: using joint-ventures with the government.

2. The Investment Process

Investment Regulation

The cornerstone of foreign investment in Chile has been the DL600 law. Enacted in 1974, this law gives foreign companies that invest more than 50 million dollars the opportunity to opt-in a tax and regulatory stability framework, where the initial tax and norms at the time of the investment cannot be changed for 20 years. In compensation for these conditions, the company is subject to a different tax regime on remittances, which are taxed at 42 per cent[2] instead of the general 35 per cent. In both cases, standard corporate taxes that have been already paid are deducted from this remittance tax. Alternatively, companies have the alternative to opt-out from this framework once, and be subject to the normal 35 per cent rate.[3]

The policy therefore allows companies to 'buy' fiscal and regulatory stability in the form of higher tax rates. The DL600 guarantees that the financial assumptions used initially are going to be maintained at least until the bulk of the investment has been recouped: this includes not only taxes but also accounting principles valid at the time of investment, like accelerated appreciation.

Strategies used by investors to minimize risk

As one of the first major investments in Chile's new regulatory framework, the ownership structure of Escondida reflected the desire to minimize political risks by the investors. An ad-hoc consortium was founded between BHP Billiton, Rio Tinto and JECO Corporation (an investment vehicle controlled by Mitsubishi); the ownership structure also included the International Finance Corporation (IFC), part of the World Bank, to provide further guarantees of stability (see below).

Corporate Structure of the Investment

In principle, joint ventures, like the consortium that invested in Escondida can be desirable for governments and investors alike, as they:

- ***Decrease the risk for individual partners.*** By being able to undertake a bigger investment with less capital commitment. It also allows smaller companies with some specific technological advantage to participate as junior partners in a major mining project.
- ***Decrease the risk for governments.*** A joint venture increases coordination costs between investors, which is desirable if the government wants to lower tax avoidance. Abuse of transfer pricing, for example, becomes more difficult as investors need to coordinate on

2 Before 1993 it was 49.5 per cent.
3 For more information, see Government of Chile (2010).

pricing gaps between real and declared costs to transfer wealth in adequate proportion to each investor's participation.

- ***Political risk decreases if the partners come from different jurisdictions.*** If the ownership and contract structure is diversified geographically it becomes more difficult to unbundle it. This should lower the perceived political risk and make investment more attractive in case contracts want to be derogated.

However, in the case of Escondida, it is not clear to which extent it was advantageous for the country to have a consortium. The existence of a senior partner (BHP Billiton) to whom all production was directed for commercialization implies that there has not been an increase in coordination costs for the owners as a government could wish, for this reason it should be better to have multiple investors of equal size, so that tax avoidance measures are more difficult to coordinate.

Role of International Donor Organisations

As has been seen above, the World Bank entered directly into the ownership of Escondida through the IFC, but its involvement in the investment extended further. In the aftermath of the expropriations from the early 1970s, World Bank's Multilateral Investment Guarantee Agency (MIGA) played a pivotal role providing political risk insurance to major investments.

The fact that the Chilean government received funding from the World Bank for development projects implied that the Bank had more leverage to settle any dispute related to the mine, which in the end lowered the cost of insurance provided by MIGA.

Moreover, when Escondida's investment project materialised, the foreign investment regulation (DL600) had been in place for more than 14 years. This made investors more confident on the long term sustainability of the legal framework.

The costs of the policies in place

As was seen above, Chilean government had to wait for more than a decade until it started receiving substantial tax income from the operations. This was a consequence of:

- Accelerated depreciation allowances in mining;
- The ability to carry forward losses indefinitely; and
- Up to 2001, the ability for companies to return funds equivalent to the original invested capital without being subject to tax.

This situation was sustainable in part due to the absence of local communities that could have been affected by the operations of Escondida, save distant communities that resented the use of the scarce water by the mining operation. Low copper prices during the 1990s also helped to mitigate any public pressure on receiving taxes from these mining companies.

Fiscal capacity to implement the policies

As important as having the appropriate legal structure to attract investment is the capacity to enforce the legislation that is in place. In the case of Chile, several loopholes have been exploited in the past by companies to minimize their tax burden. These have been completely legal, but have departed from the spirit of the law, thus decreasing the tax captured by the state.

The simplest and commonest of them has been the abuse of leveraging. As mentioned before, remittances are subject to a tax of 35 per cent[4] (minus corresponding corporate taxes that have been paid), but debt payments only pay a four per cent tax surcharge. In consequence, until 2001 mining companies showed extremely large debt to capital ratios, up to 81 and 50 in two cases[5]. Such high ratios led the authorities to believe that mining companies were avoiding taxes, so that from 2001 onwards the debt to capital ratio was capped to 3, debt payments above that are now treated as capital remittances.

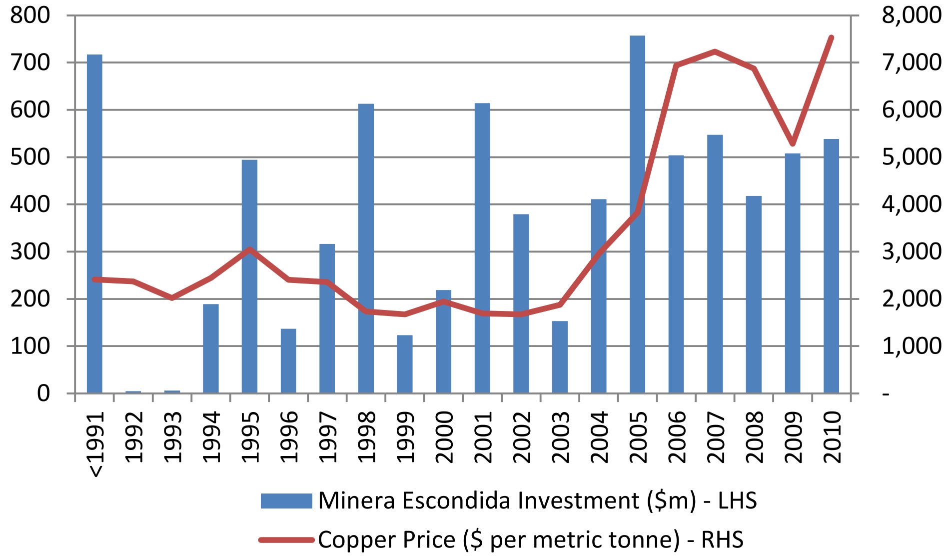
There are some problems that persist, and that the state, despite having strong institutions still has not been able to fully correct, among them are transfer pricing abuses (see Precept 3 for an explanation of this problem) and i**ncentives for re-investment.** As profits get taxed at the full 35 per cent rate only when they are sent back to the parent company there are incentives to use the mining company as a platform for overseas investment, thus delaying further the payment of taxes.

3. Results

Following the pattern of most large-scale mining projects, Escondida had a large upfront investment, which started in August 1988, until the start of operations at the end of 1990. In the graph below shows how the total annual investment has evolved.

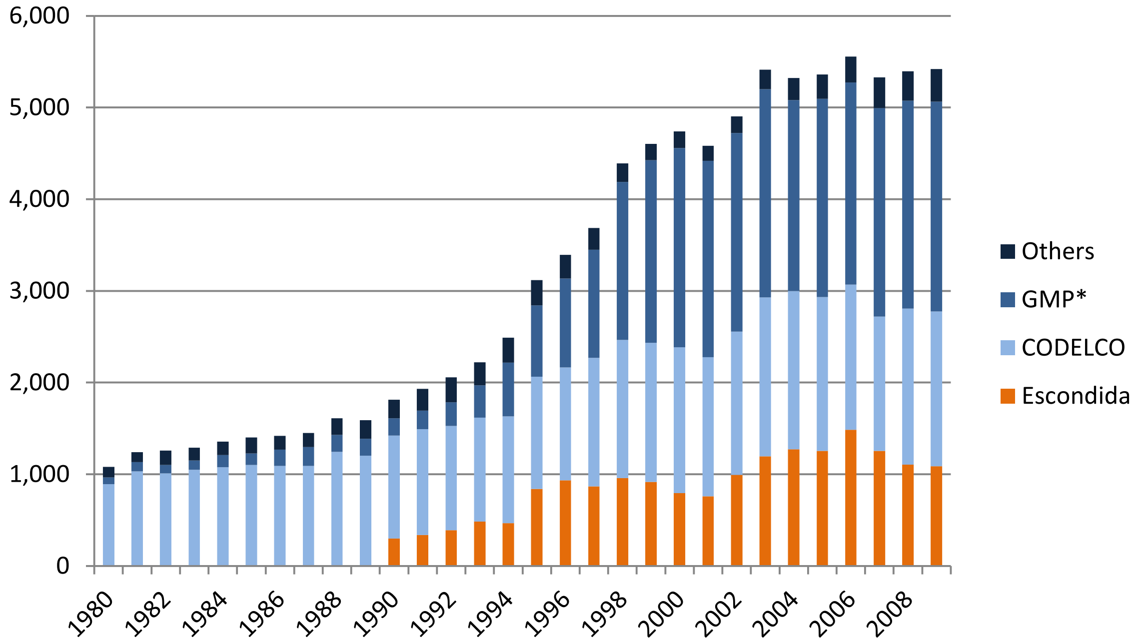
Figure 1 Escondida's annual investment and copper price

4 Strictly speaking, the tax rate for companies subject to the tax stability law (DL600) is 42.5 per cent, however mining companies usually renounce the stability pact, as they are able to do once, before sending remittances to corporate headquarters.
5 See González Castillo (2004) and Senate of Chile (2004a).



Source: Escondida (2011) and COCHILCO

Operational investment in the mines has increased after the surge in prices from 2004 onwards, which has been reflected in that extraction levels have remained higher than it was seen in the previous decade. In the graph below we can see the evolution of Escondida's production figures compared with Chile's total.

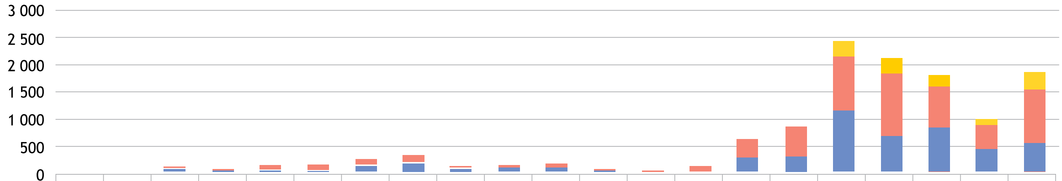


Benefits for Chile

Tax receipts for the operation were quite low throughout the first decade of operations, and increased –together with copper prices– during last decade as can be seen in the graph below.

Taxes Paid Since the Beginning of Operations

US$ Millions



	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Mining Tax	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	269	292	179	116	299
Corporate Profit Tax	0	3	46	36	91	111	112	143	32	50	68	17	19	88	314	532	1.015	1.119	735	427	844
Foreign Dividend Tax	0	0	82	35	48	44	141	188	87	115	114	66	20	30	303	329	1.148	715	867	471	698

Source: Minera Escondida (2011)

Escondida has been the largest private investment project in the country, totalling a cumulative investment of $7,648 million dollars up to December 2010[6]. It provides the country with almost 3% of the annual GDP of the country and also with 40% of the growth from the province. Almost 36% of the employment in Antofagasta province is related to the operations of the mine[7], though by the end of 2010 there were only 3,640 employees working directly in the company together with the equivalent to 5,926 full time workers as external contractors.

4. Summary of recommendations

Tax invariability and political risk

Tax invariability conditions were instrumental for the start of Escondida. However, these pacts tend to linger for too long after the reason for their creation has already superseded.

In the case of Chile, the DL600 was created in a context where the country was in dire need of foreign capital; but these very favourable conditions for investment become less accepted as the country became more stable.[8] Investors demand a lower return for their investment in other competitive areas of the economy, and so there is a widening gap between the market rate of return and the returns obtained through economic rents by mining companies. For this reason, and with hindsight, it would be advisable to condition the derogation of tax invariability clauses to the attainment of certain sovereign risks status by the host country. In that way there can be an escape clause for governments when the economic rents that mining companies receive are no longer justified due to increase stability in the host country.

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8 See Osmundsen (2010) for a discussion on the limits society puts on the taxation of petroleum and minerals.

Role of external committees to resolve disputes.

It is impossible to write a contract that foresees every single scenario, for that reason a desirable taxation regime should consist of a simple and clear framework where the purpose of the law and its taxes are clearly stated. In addition to this, the norm should settle appropriate arbitrage mechanisms to correct different interpretation of the laws. This is to prevent companies from shielding on the fact that tax stability agreements prevent any modification to the letter of the law even if the declared objective of the law is being bypassed[9]. For this reason, the establishment mutually agreed independent committees can help to maintain mutual confidence between the government and investors.

A final word

Mining companies' executives act on the best interest of their shareholders, which sometimes may differ from the interest of the host country. For that reason it is necessary to have the adequate mechanisms to resolve disputes in good faith.

Moreover, adequate simplicity and transparency are key: even the best taxation regime is going to be worthless if the tax authority has no capacity to implement it properly. In these past twenty years since Escondida has been operating the government has been able to learn how to deal with large scale investment in mining. Sometimes it is necessary to forego some of the measures that would make an investment more attractive to take into account the state's limitations to implement them. In the end, confidence in the rule of law is necessary to attract long-term investment, and the perception of fairness in the law among the host country allows regulation to remain stable in time.

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9 González Castillo (2004) discusses about companies acting in 'bad faith' or 'legal fraud' while abiding strictly to the letter of the law, and the harmful effect this has on the attitude of the government towards businesses.

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