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Challenges for Australia in mining investment: lessons learned from mega-projects in small developing countries

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Challenges for Australia in mining investment: lessons learned from mega-projects in small developing countries

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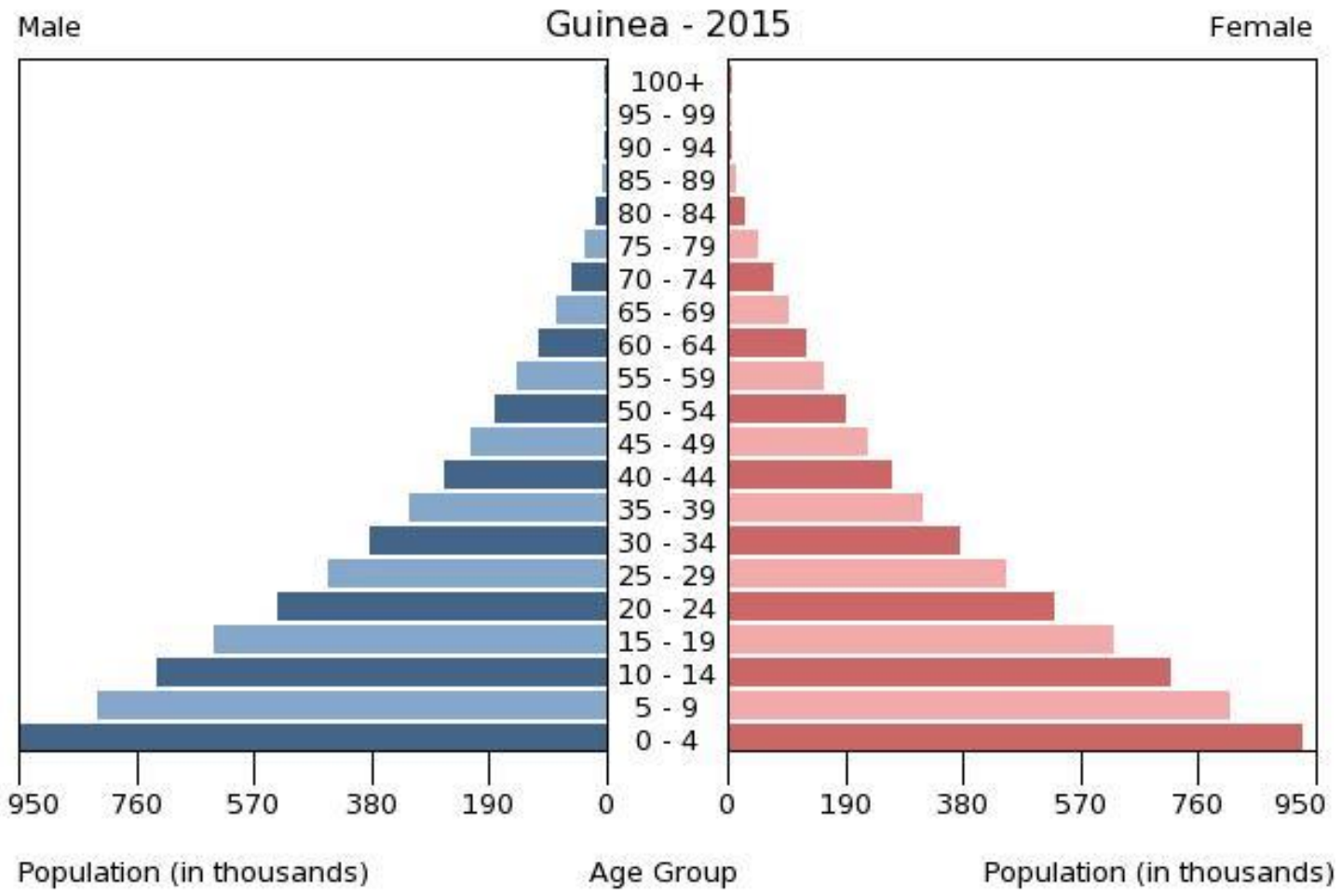
Guinea – country description

Located in West Africa
Population about 12m
87% Muslim
5 ethnic groups; 3 make up about 80% of population
French the national language
Dependency ratio 87%
Birth rate 18th highest in the world
37% urbanised
Literacy 30%
GDP per son (PPP) $1 300
Degree of risk of major infectious diseases: very high
Major producer of bauxite and alumina; producer of diamonds and gold; potential major iron ore producer

Nominal exchange rate

Guinea – population characteristics



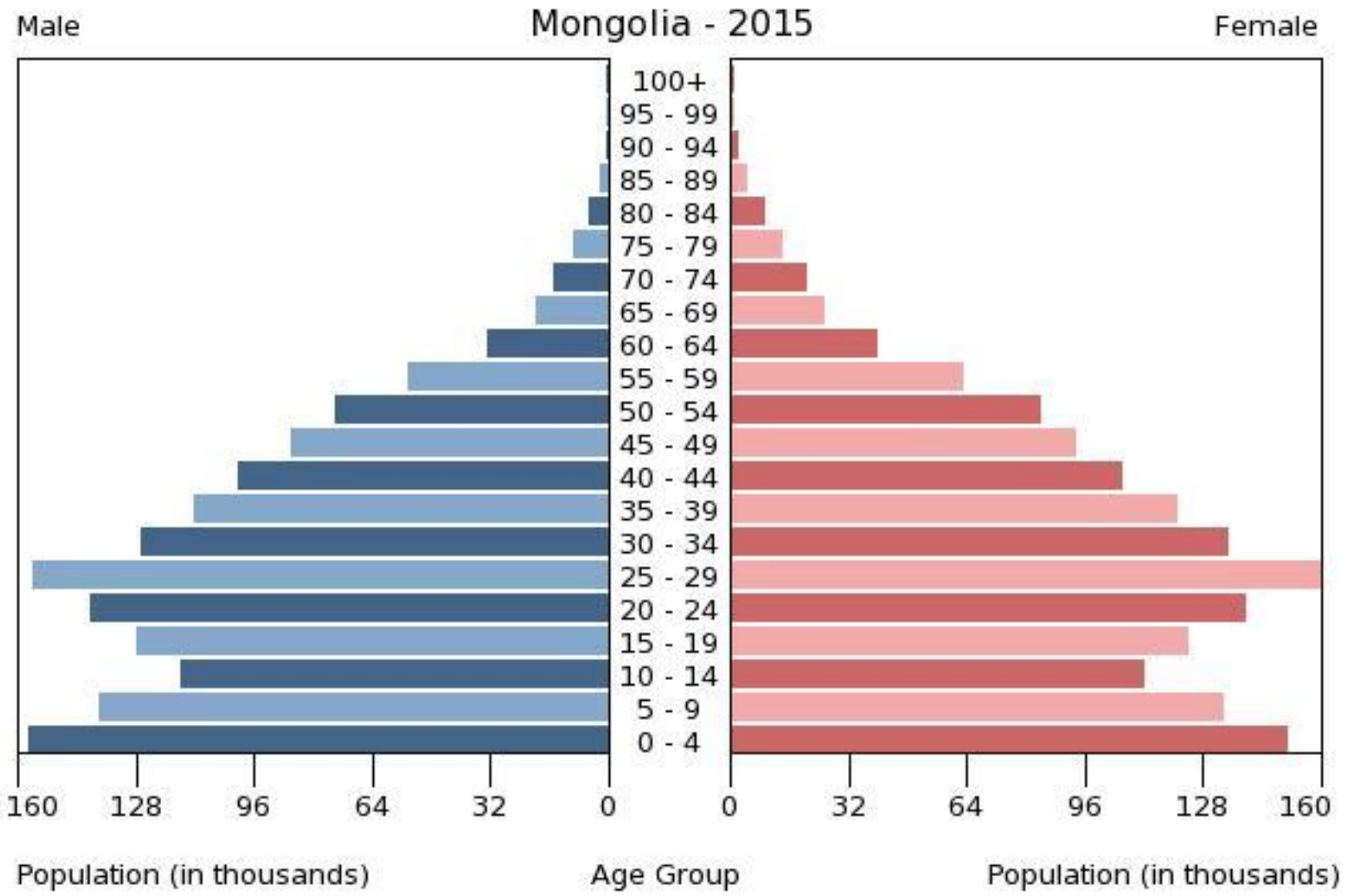
Simandou exploration site

Mongolia – country description

Located in North Asia
Population about 3m
53% Buddhist; 39% no religion
1 major ethnic group
Mongol the national language
Dependency ratio 48%
Birth rate 92nd highest in the world
72% urbanised
Literacy 98%
GDP per person (PPP) $11 900
Degree of risk of major infectious diseases: moderate/low
Major producer of copper; producer of coal and gold; potential major coal producer

Nominal exchange rate

Mongolia – population characteristics



Oyu Tolgoi mine site

Project characteristics that exacerbate friction between host govts and foreign developers

- Many project proponents consider sovereign risk to be exogenous
- But often their actions endogenise this risk
  - Short term incentive to ‘talk up’ the project at initiation of negotiations with government – heightens govt and local community expectations
  - Profession not blameless here – excessively high multiplier estimates from some studies
  - National govt usually ‘owns’ the resource but lacks capital to develop it – often earns equity in the project by foregoing dividends in the early stages and may also demand pre-payments of tax to be offset by even longer dividend deferments – result is growing timing gap between community expectations of returns and actual payments of dividends despite the ongoing successful operation of the project.
  - Typically skilled labour is in short supply and the project bids up wages in the local region – negative impact on traditional agriculture sector and unequql distribution of benefits between regions can lead to political tensions – made worse in jurisdictions like Peru where local authorities are allocated a large share of project returns – those regions with projects do much better than those without.
  - In the development phase the real exchange rate usually appreciates (relative to the reference case) putting further pressure on traditional sectors

System shock – project size relative to local economy and speed of development

- Proponents are usually driven by NPV calculations and the usual way to maximise NPV is to develop the project as quickly as possible – the ‘big bang’ approach
  - But this puts all sorts of strains on the local economy
  - Initial Dutch disease effect larger than otherwise might have been the case both because of the initial surge in FDI and because the first major development agreement is often taken as a ‘gating’ event by the frontier investment community
  - In Mongolia FDI rose by 168% in 2010 and a further 173% in 2011. In Guinea FDI increased by 824% in 2011
  - These projects may simply overwhelm the capacity of local officials expected to do the project approvals
  - At the time the engineering drawings for the concentrator were submitted for Oyu Tolgoi the Ministry was required to review more than 13 000 documents in the space of a few months – more than it had received in many years.
  - Any upfront payments made by the proponent (that are perhaps supposed to be used to develop needed infrastructure) simply add to the approval burden

Misaligned incentives, system shock and perceptions of ‘unfair’ share exacerbate conflicts between proponents and host governments

- What can be done?
- Carefully consider ownership structure up front to avoid later misalignment of incentives – perhaps it is better to concede more equity than to produce a shock that could delay later approvals for several years
- As much as possible avoid prepayments of tax to minimise economic and capacity shocks
- Consider staged development rather than the ‘big bang’

Final points

- Over the past 20 years the extractive industry has made major advances in its approach to environmental, health and safety issues.
- But few companies apply sufficient resources or make the necessary cultural and organisational changes necessary to ensure that the issues discussed above are fully understood from the board room to the operational level
- Major companies have dedicated teams who spend many person years addressing these issues
- But one false move by, perhaps, an ‘insensitive’ engineer in the field can set back a project with the local community for months or even years