RAID
Rights & Accountability in Development

Democratic Republic of the Congo

Key Mining Contracts in Katanga: The economic argument for renegotiation

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Executive Summary

"Any legitimate balanced review of what we're up to will be very favourably considered…"

(Arthur Ditto, President and Chief Executive Officer, Katanga Mining Limited)

This report is intended to make a constructive contribution to the current debate about the fairness of the mining contracts in the Democratic Republic of Congo (DRC), in particular key joint venture agreements between the state-owned La Générale des Carrières et des Mines (Gécamines) and private companies, which were all signed and approved during the period of the Transitional Government. Following the elections in the DRC, the new government, with encouragement from the World Bank and IMF, has announced its intention of reviewing past mining contracts.

After 30 years of the Mobutu dictatorship and more than 15 years of war and transition, the needs of the Congolese population are immense, as was noted in the recent NGO Memorandum, *Public-Private Partnerships in the DRC's mining sector: Development, good governance and the struggle against corruption.*

It is apparent that for the Congolese economy to be rebuilt and for government revenues to increase to a level where social programmes can begin to address the problems caused by extreme poverty, then not only must the mining sector be revitalised, but it must be done in such a way that both the state and the private sector benefits equitably from the wealth generated.

The new Mining Code, which came into force with World Bank support in 2002, was supposed to ensure full transparency and a fair distribution of revenues among Government, mining companies and affected communities.

But in mid-2005, the Transitional Government approved three joint venture contracts between Gécamines and a number of foreign private companies: Kinross Forest Ltd (now Katanga Mining Ltd), Global Enterprises Limited (GEC - now Nikanor Plc) and a consortium formed by Phelps Dodge Corporation and a subsidiary of the Lundin Group called Tenke Mining Corporation.[1] These joint venture agreements concern between 50 and 75 per cent of the DRC's copper and cobalt reserves and form an important part

[1] The reader is advised to consult the full report for references.

of Katanga's industrial capacity. There was great disquiet about way these deals had been negotiated, signed and approved with a total lack of transparency, either on the basis of a flawed or non-existent international tendering process.

Economic Model

In view of the controversy surrounding these contracts, RAID invited Pierre Ratcliffe, an independent mining expert, with extensive experience of conducting evaluations around the world on behalf of the European Investment Bank, to examine and model key economic aspects of one of the projects, the Kamoto project by way of illustration. The intention is to assess whether the right balance has been struck between the financial rewards accruing to the private companies and the stake in the assets and level of control retained by Gécamines.

By way of illustration, an economic analysis was undertaken of one of the contracts, Katanga Mining Limited's (KML) Kamoto project. The report provides an assessment, based on available information, of the distribution of the financial benefits between KML as the private partner and Gécamines.[2] The analysis considers the following questions:

- The level of returns generated by the project, comparing this to the accepted norms for similar mining ventures.

- The stake in the joint venture company retained by Gécamines and whether or not this minority holding fairly reflects the contribution of the state-owned company to the project

- Whether or not, based on modelling realistic scenarios concerning metal prices, the call for the renegotiation of the joint venture contracts is justified on economic grounds.

- The extent to which the DRC Government benefits from revenue streams – taxes and royalties – generated by the project.

The object of modelling the returns and worth generated for each of the project partners at Kamoto is to obtain an independent assessment of the fairness or otherwise of the joint venture agreement. Considerable care has been taken to avoid using base data that would result in overstating the case for renegotiation in favour of Gécamines.

The data is used to present a possible model for the renegotiation of Gécamines' joint venture agreements: the other key Katanga contracts should be subject to a similar transparent analysis, whether conducted by the World Bank, the DRC Government or the companies themselves.

To estimate the value and the feasibility of a project and to be able to decide whether to invest or not, companies calculate the Internal Rate of Return (IRR). The IRR is the rate of interest that renders the initial capital cost equal to future revenues. In other words, a company must compare how much capital it has invested in a project with the revenue that it expects to receive back from a project. IRRs of mining projects are typically fairly low, between 12 -15 per cent because they involve a long time lag (20 years), high levels of risk in prices of minerals, and technical risks related to mining, ore processing and metallurgy.

[2] The approach used in the economic modelling is rigorous and the methodology and workings are available in full: <http://kamotominingproject.blogspot.com>.

Conclusions

- KCC, Gécamines and KML appear to have underestimated the long-term copper price (1.10$/lb instead of 1.52$/lb) and the cobalt price (10$/lb instead of 15$/lb) when compared with prices based on real historical data.

- Hence, the IRR for the project is significantly increased to 76.9%, which compared to a 12% opportunity cost of capital, leaves a margin of 64.9% to the project sponsors.

- However, KML, as the private partner, captures a disproportionate amount of these returns because the 25% stake in the project owned by Gécamines under the existing agreement does not reflect the true value of its contribution to the project.

- It is a matter of serious concern that the considerable value of the assets – the reserves of copper and cobalt and the plant and equipment – brought to the project by Gécamines have never been properly assessed. Comments by the KML's CEO suggest that, when compared to a greenfield site, and after taking into consideration the cost of refurbishment, these assets are worth in the region of $570 million.

- Modelling the worth of the Kamoto project using realistic metal prices produces a net present value to KML of $716.5 million and to Gécamines of $351.2 million. Not only is the NPV accruing to Gécamines worth considerably less than the value of the assets it has contributed to the project, but the state owned company receives a disproportionately low percentage of the value created – less than half that received by KML.

- The imbalance in the distribution of the benefits from the Kamoto project can be redressed either by an up-front payment to Gécamines or through an increase in its equity stake in the project.

- An improved deal for Gécamines will not, of course, adversely affect many of these wider benefits: job creation, social expenditure, revenue streams from taxation and royalties.

- The purpose of this report is to stimulate debate on the distribution of the economic benefits and costs of the joint venture agreements based upon a credible model to analyse a number of realistic scenarios. It should be emphasized that other parties – the World Bank, the DRC government, the companies themselves – are free to run, and, indeed, encouraged to run, their own rigorous and transparent models or to model scenarios other than those presented here.

Recommendations

There currently appears to be the political space for the renegotiation, where necessary, of joint venture contracts that are genuinely disadvantageous to Gécamines or the Congolese state. In the light of this, and in the light of the current analysis, RAID recommends that:

- This or a similarly rigorous model should be run for the other joint venture projects, including with Nikanor and with Tenke Mining/Phelps Dodge, to establish whether or not there is an equitable distribution of the project benefits between the parties. Nothing precludes the private companies, Gécamines, the World Bank or the Ministry of Mines from carrying out such an analysis. The results of such an analysis should be made public.

- Given that one of the most important variables is the price of copper and cobalt, the base rate should be set by an independent expert, possibly the World Bank.

- The returns and value of the Kamoto project should be re-modelled, taking into consideration the improved production figures and reduced costs.

- The value of the assets that Gécamines brings to each of the joint venture projects should be properly audited.

- Based on the current modelling exercise, the terms of the existing KCC Joint Venture Agreement should be renegotiated so that they more equitably reflect Gécamines contribution to the project. Either the latter's equity stake should be increased or KML should make an up-front payment made to the state owned mining company.

- Based on the results from an equivalent model, the other joint venture projects, including those with Nikanor and with Tenke Mining/Phelps Dodge, should be reviewed to determine the relative distribution of the project benefits between the parties to establish whether these are commensurate with their respective contributions.

- Clearly, there is a need for a much wider review that should include the equally problematic contracts related to gold, diamonds and other minerals. For this reason the Congolese Government's announcement that it will review all mining contracts is welcome with the proviso that:

    i) it is not simply an exercise designed to impose arbitrary and additional levies on private companies and,

    ii) that the Government, given the past failure to establish a credible independent and functioning commission to validate mining titles, to show its good faith, accepts the help of an international body of experts, nominated by the World Bank, to conduct the review.