PwC Australia Africa Practice
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Two steps forward, one step back

The African tax landscape

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Contents

Introduction

Africa is changing. The political environment has stabilised, meaning sovereign risk attached to investment in Africa has reduced. The timing of this improvement is ideal – coinciding with the resurgence of the mining sector, which has been a key driver of economic growth on the continent.

Despite the challenges the mining industry has faced in recent years, increasing commodity prices, the levels of global investment pouring back into resource projects, and the market rebound for mining services companies, shows positivity has clearly returned to the sector.

Against this increasingly positive backdrop, opportunities abound for African countries to capitalise on this market environment and attract the capital to develop the resources of their continent. However, we are seeing African governments increasingly looking for larger returns from mining operations in their country through increased taxes, royalties and/or increased free-carry stakes in the mines themselves.

Whilst African governments are grappling with the challenges of a lagging fiscal return to current positive market conditions, are they really taking ***"two steps forward and one step back"?***

As outlined in PwC's *Overtaxed?* publication from 2015, governments and mining companies need to work closely together to achieve a common goal of opening new mines. Greater economic activity is clearly in everyone's best interests – new mines developed, foreign direct investment, creation of jobs and the opportunity to generate profits from Africa's vast mineral wealth. A deposit left unmined is of no value to either the host government and its people or the miner who has right of access to it.

The question is – how do African countries capitalise on the positive market conditions to strike the right balance between tax and revenue measures, while still allowing sufficient return on the capital invested by miners to allow these investment to occur in the first place?

In this publication, we analyse this conundrum. We look at what has changed since 2015 and outline some potential alternative considerations with a view to ensuring a "win-win" scenario for both mining companies and governments.

The African tax landscape

As we did in *Overtaxed?* two years ago, we have performed an economic analysis of a standard gold mine operating under the same conditions, with the same assumed capital and operating costs, across four different African countries, being Tanzania, Namibia, Ghana and Egypt. We added Egypt this year due to its different approach to "taxing" mining companies and to contrast its fiscal regime with the more traditional royalty and income tax structure. We selected these countries as they have a tradition of mining and to demonstrate the impact of different fiscal regimes on the decision making of a mining company – specifically the decision on whether to invest in the development and construction of a new mine.

To ensure our analysis is focused on the tax regimes, we have normalised all other factors. In this publication, we have changed some of our model assumptions from 2015, however, our gold mine modelled continues to assume the same operating conditions, grade and metallurgy in each country. We have assumed the same capital and operating costs, including those for energy consumption. We removed the impact of any limitations in access to skilled labour and critical infrastructure, along with the availability of parts and contractors. As such we tested the current taxation regime and the impact this has on both the decision to build the mine and the income generated by the government and company over the operating life of the mine.

We have also updated our modelling analysis to reflect changes in the tax regimes of the three consistent countries modelled from our 2015 publication being Ghana, Tanzania and Namibia.

Introduction (con't)

Key findings

Table 1: 2017 IRR and total government revenue generated by country

Country	Project IRR (%)	Would the mine be developed?	Government revenue generated ($m)	IRR Trend since 2015
Ghana	24.2%	Maybe	487	↓
Tanzania	18.3%	✘	700	↓
Namibia	25.3%	✔	435	↓
Egypt	20.0%	✘	580	–

Source: PwC Analysis

What can been seen from our analysis is that Namibia continues to be the only country which generates a sufficient Internal Rate of Return (IRR) to allow a clear decision for the mine to go ahead – this is even so despite the introduction of a 1% export levy since 2015. The current fiscal regime makes the project marginal in Ghana where the IRR threshold is just below the target threshold of 25%, whereas significant changes to the tax regime in Tanzania has resulted in Tanzania having an IRR of just 18.3% which would mean there would be no viable project in Tanzania. Egypt (on the face of it) also has an IRR below the required investment threshold of 25%.

Therefore, while the Namibian tax take may at first glance appear lower than the other countries, it is the only country that is highly likely to receive any taxation revenue at all. Namibia has maintained its status as the most attractive destination of our sample countries for foreign mining investment capital.

For Namibia, this means the generation of government revenues of US$435 million over the life of the mine and foreign direct investment of US$200 million spent constructing the mine. Over the life of its operations expenditure of $1.1 billion and sustaining capital of $150 million are spent in country. The mine has ongoing employment of 1,100 people.

Backwards step

This analysis shows that by changing the tax regimes in Ghana, Tanzania and Namibia from 2015 to 2017, these governments have sought to increase their share of the mining pie. Tanzania's recent changes, allowing the government to take a much higher stake in the mine, have had a hugely detrimental effect. These changes ultimately impact the IRRs achieved by mining companies and may determine whether the project goes ahead at all.

As another example of changing tax regimes, we have modelled Egypt.

Ordinarily, Egypt has a standard taxation regime, but this is often replaced by a Production Sharing Contract (PSC). This is a bespoke arrangement between the Egyptian government and the miner where the miner agrees to operate and fund a project while the government obtains a share of the profits earned on the project. PSCs are common in the global oil and gas industry, but not so common in global mining. Whilst our initial modelling of a typical Egyptian PSC arrangement results in a below target threshold IRR, in this paper we demonstrate that if simple changes are made to the terms of such a PSC arrangement, we would see more economically viable returns for the miner and government.

This paper is designed to stimulate further discussion on the economic levers African governments and the mining sector should pull in order to maximise the potential of their mining industry. We believe our modelling demonstrates a win-win scenario for miners and governments is possible – generating income for both parties by finding the right balance between return to the country and return to the miner.

Ben Gargett
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Stability and certainty

There are many factors a company takes into account when deciding where and when to allocate their scarce capital to a mining project. Each company, even the most junior explorers, typically have more than one project on which they could expend their effort and hard earned funds. Even those with a flagship asset, which appears well ahead of other investment alternatives within a company, will make decisions on whether or not to continue to allocate funds to the project.

Undoubtedly the mineral prospectively of a country plays a large part in the initial selection process, with those countries assessed as having the greatest mineral potential benefiting. However, beyond mineral endowment, there are many other factors, which can be influenced by governments that make a project or a country attractive as an investment destination.

While mineral deposits are not mobile, the capital which is allocated to fund construction of the assets certainly is. This capital will naturally be shifted by companies to projects which generate the best return and in jurisdictions which provide stability and certainty. Stability is critical as the return generated by the miner on the substantial upfront capital investment is typically generated over a number of years, decades in some cases. Certainty over right of tenure is also a must have for companies to allow them to spend the funds needed to find, prove up and construct an operating mine.

In our 2015 report *Overtaxed?*, we investigated one of the key factors – the taxation regime and fiscal settings of the government. While there are many factors taken into account when making decisions to allocate capital to potential projects, one core common factor is the return that the deployed capital will generate for its investors. Without a sufficient return all other settings become irrelevant because in most circumstances there will be no decision to mine. As a result, we analysed the impact of the taxation and fiscal regimes in four African countries with a history of mining to determine the impact on these regimes of the decision to mine.

In this 2017 report "*Two steps forward, one step back*", we have analysed the key tax changes that have occurred in each of Ghana, Tanzania and Namibia over the past two years, whilst also modelling a PSC type arrangement in Egypt.

In order to isolate the impact of the taxation regime, we have modelled the economic impact of each of the four countries' regimes on a gold mine, which we have standardised. We have equalised the grade, metallurgy, operating costs, production levels and construction times. We have assumed the same capital and operating costs and taken out any variability as a result of limitations in access to power and water. We have removed country specific input cost variables, such as regulated diesel fuel pricing, removed the impact of any limitations in access to skilled labour and critical infrastructure, along with the availability of parts and contractors.

Whilst in reality the cost of constructing and operating this gold mine in each country is likely to be significantly different due to many factors, these assumptions allow the modelling to examine the impact of each fiscal regime in isolation on the project economics and ultimate decision to mine.

PwC Gold

Our gold mine has the following key factors (all amounts are US$):

- Open pit mine, with processing plant on site to produce gold doray
- Exploration costs of $30 million have been incurred to date
- Four year permitting and approvals process, during which development costs of $150 million incurred to construct the mine and processing plant
- Production of 200,000 ounces p.a.
- Assumed real gold price of $1,275 per ounce
- Cash costs of $595 per ounce and All In Sustaining Costs (AISC) of $795
- The mine employs 1,100 local staff and 11 expatriates

Cash flows have been discounted to present value using an 8% discount rate.

Based on analysis performed across a number of mining companies, we have assumed a minimum required Internal Rate of Return (IRR) of 25%.

Refer Appendix A for a full list of assumptions used.

Changes in tax regimes since 2015

We received such signif cant inquiry following our 2015 publication **Overtaxed?** *that we decided to analyse the state of play in 2017.*

We have updated our previous modelling to reflect some changes which have occurred since 2015. Practically, this includes some macroeconomic factors which have become prevalent due to current market conditions such as:

- Decreasing cash and all in sustaining costs (AISC) to $595 and $795 respectively (2015: $699 and $957 respectively) reflecting the hard work done by miners to reduce operating costs and deflation in certain areas and;
- Gold price of $1,275 (2015: $1,175).

In relation to specific tax regime changes since 2015, we note that there has not been significant tax changes affecting the modelling in Ghana and Namibia, with the only main change of note being the introduction of a 1% export levy in Namibia.

Due to changes in current market conditions noted above and Namibia's 1% levy, the overall IRR for Ghana and Namibia have decreased slightly since 2015 as follows:

- Namibia 2017 IRR: 25.3% (2015: 26.7%).
- Ghana 2017 IRR 24.2% (2015: 25.0%).

In addition there have been changes in individual taxation and withholding tax rates in Ghana and Namibia. As these are equalised in our modelling, these have no impact the mine's IRR.

In contrast, there have been significant tax changes in Tanzania which has resulted in a significant decline in the IRR of our Tanzanian gold mine from 24.9% in 2015 to 18.5% in 2017. These changes are highlighted below.

Tanzania – two steps back

The Tanzanian government's decision to introduce significant tax changes in 2017 caused a state of flux amongst the many ASX listed Tanzanian focused mining companies, many of which went into trading halts whilst the impact of the new legislation was considered. This legislation was rushed through parliament and came without consultation with the industry.

In short, some of the key tax changes in Tanzania as relevant for this analysis included:

1. An increase in the royalty rate from 4% to 6%;
2. Tax depreciation of mining capital expenditure over 5 years (straight line) compared to previously 100% upfront in certain circumstances; and
3. The government minimum non-dilutive free carry interest to be set at 16%, with the government being entitled to free carry up to 50%.

These changes in Tanzania are significant and resulted in a marked negative impact on the share price of many of the ASX listed Tanzanian focused mining companies.

As highlighted in our 2015 *Overtaxed*? publication, governments rightly focus on the headline rates of corporate income tax and royalties, given the overall impact they have on their fiscal position. They also consider each taxation or other fiscal lever

they can pull in order to maximise their return from any given mining project. It is every government's sovereign right to levy whatever taxes and other charges they desire on the companies and individuals operating in the country.

However, care is needed to balance the return to the government/people through the levying of various taxes (whether named that or not) and the miners to ensure the return is sufficiently attractive to be able to obtain and subsequently commit the risk capital to develop the project. For while the mineral resource is not mobile, capital certainly is, and it will shift to the locations that are the most attractive around the world.

At a time when the mining industry has turned positive and with increased political stability in Africa as a whole, the timing of the Tanzanian tax changes may impede the recovery of the mining industry in that country. Other countries in Africa could be impacted by the flow-on effect in terms of market/sentiment of investing in Africa. The timing of such changes could not have come at a worse time, not dissimilar to the timing of the proposed Resource Super Profits Tax by the Australian Rudd government in 2010. Is this a sign of things to come? Is there an alternative approach?

Whilst African governments (such as Tanzania) are grappling with the challenges of a "lagging" fiscal return to current positive market conditions, is this an all too familiar story of "two steps forward and one step back"?

However, how do African countries capitalise on the current positive market conditions to strike the right balance between tax and revenue measures such that they generate what is seen to be a fair return for their people from the consumption of the country's mineral wealth, while still allowing sufficient return on the capital invested by miners to allow the investment to occur in the first place?

In order to help answer this question, we sought to analyse whether other tax regimes in Africa may provide a viable solution, such as the Production Sharing Contracts (PSC) often seen in Egypt.

Dividing up the pie

Mining is a long-term game. Substantial capital is placed at risk and invested up-front, with the goal of generating returns over a number of years, in many cases decades. The mining industry is cyclical and over the course of an average mine's life it is likely to experience the whole cycle, from booming highs to desperate lows. The cycle is driven by supply and/or demand variations which lead to volatility in the price at which products are able to be sold to customers.

The key decision point for a mining company is whether or not to develop the mine. Until this point the expenditure is lower and performed in stages as exploration progresses. Once development has been approved, a significant amount of money is spent to construct the mine, associated processing facilities and ancillary items, including infrastructure.

Throughout the process for assessing the viability of a mining project, ahead of a development decision, the miner and host country government will be in close contact over many factors, including licencing, operating conditions, local content, taxes and incentives. The culmination of these negotiations drives the decision to develop the mine. It is at this stage that the government can have the most impact on the project, either positively or negatively.

Is there a project?

Table 2 below shows the profits and cash flows generated by the miners along with the taxation and other revenue provided to the government, over the life of the PwC Gold mine.

Our gold mine generated cumulative free cash flows (to the miner) of $256 million in Tanzania, $469 million in Ghana, $521 million in Namibia and $377 million in Egypt. All of these are on an undiscounted basis. They are also only generated if the mine is actually developed – without the development decision the government revenue is nil, as is the cash flow generated by the miner.

Table 2: Returns generated by country

Country	Cash flows generated for mining company ($ million)	Government revenue generated ($ million)
Tanzania	256	700
Ghana	469	487
Namibia	521	435
Egypt	376	580

Source: PwC analysis

For the PwC gold mine, Namibia is the only one of the four countries analysed where it is clear that the mine would be developed and the government would receive revenues and the associated economic development.

Figure 2 on page 10 shows the total profits generated from the mine over its operating life, allocated between those which are paid to government and those which are retained by the mining company. It can be seen that in Tanzania 73% of the total project profits are paid to government and 61% in Egypt – a burden which was sufficiently high that it prevents the mine generating sufficient returns. In the other two countries the government share of the pie is between 46 – 51%.

Either way this is a large portion of the profits, given the government typically does not take on the capital risk. The company is left to gain sufficient return on its capital invested from less than half of the profits generated by the mine.

Sharing the returns

Table 3 to the right shows the composition of government revenue and miner profits generated across the four countries studied in 2017. Despite having the highest corporate income tax rate (and therefore income tax cash flow), the Namibian government's total project cash flow is less than the other countries, and hence the miner's IRR is the highest. This illustrates that royalty rates and government free-carry/profit shares are a significant driver of project outcomes. As such, it is not surprising that these are the two main items on which the Tanzanian government has focussed on changing. In particular, we note that these items have the most significant impact on the PSC project cash flow in Egypt.

What drives the outcome?

There are only so many profits and so much cash flow generated by a mining project. If the government takes too much, there is insufficient left for the miner to generate a commercial return. It is the miner who is bearing 100% of the capital and operating risk of the project. The miner's capital is mobile and decisions are made in the allocation of this capital on a regular basis. Further than that however, the decision may well be out of the hands of the miner and in the hands of those who finance such projects.

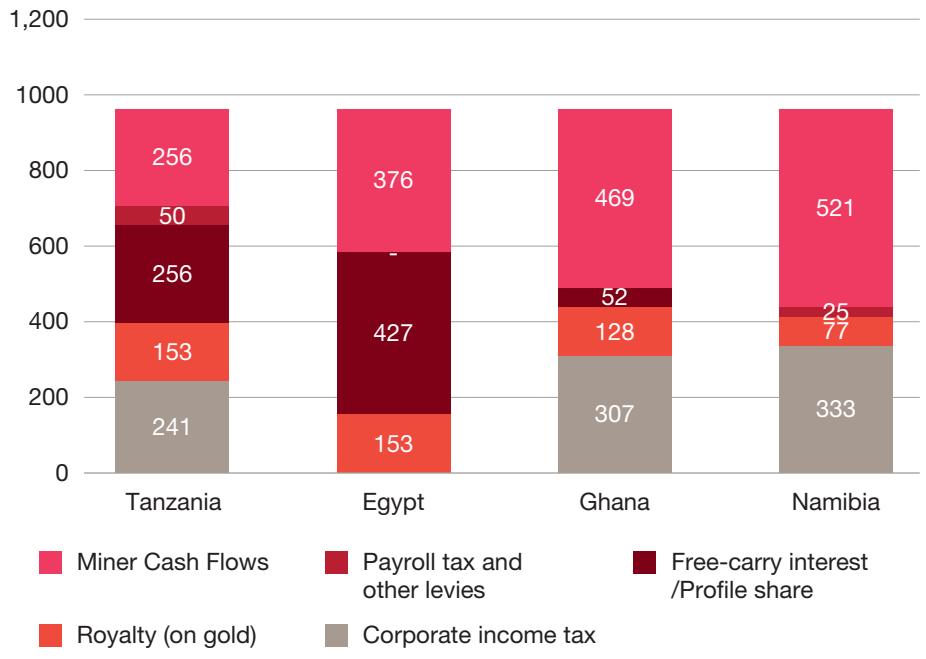
For the countries other than Namibia, these calculated government revenues may well be a theoretical exercise only. For their government, a slightly smaller share of the pie is better than a larger share of a pie that never eventuates.

Undoubtedly there are new mining projects being approved and developed in each of these four countries. The challenge is that the project must be that much better – and grade is only one factor – for the project economics to work for the miner in Egypt, Tanzania and Ghana. Each country has high grade projects like this which will typically get developed under any scenario. However naturally, the higher the grade, the rarer these projects are. Therefore over time fewer projects would get developed as only the best meet the required IRR to allow development.

Table 3: 2017 revenue mix based on project cash flows

	Government cash flows						
Project cash flows (US$m)	Corporate income tax	Royalty (on gold)	Free-carry interest/ Profit share	Payroll tax and other levies	Total government cashflows	Miner cash flows	Total
Tanzania	241	153	256	50	700	256	956
Egypt	-	153	427	-	580	376	956
Ghana	307	128	52	-	487	469	956
Namibia	333	77	-	25	435	521	956

Figure 1: Project cash flows by type



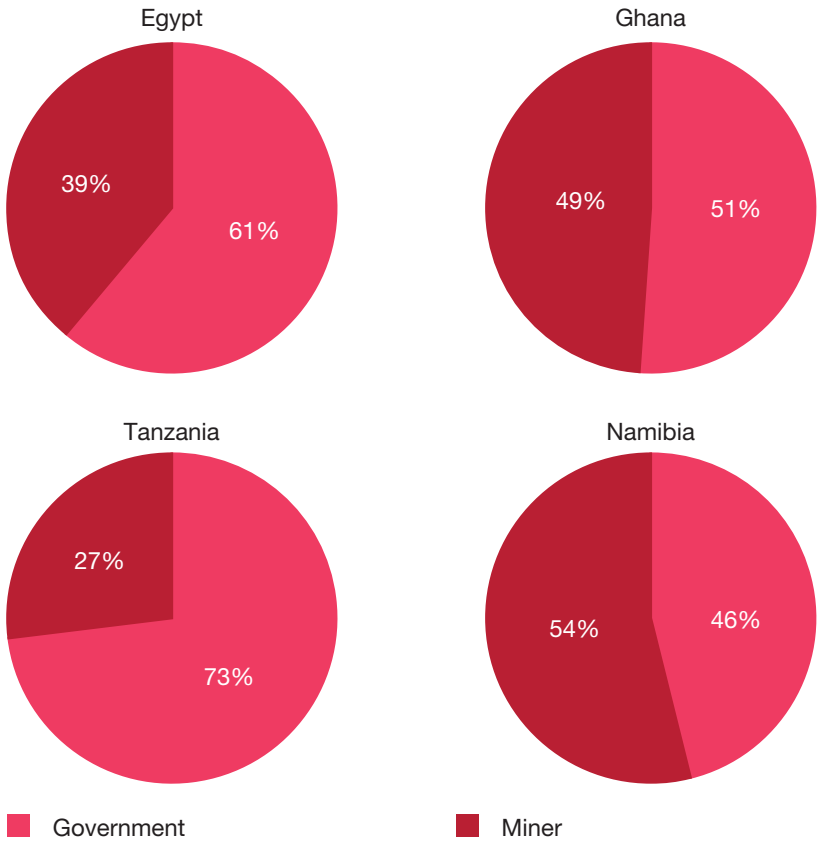
Dividing up the pie (con't)

Working together

Working together collaboratively, the government and the mining company can achieve a better outcome for all. While at times it can appear that the two parties are on opposite sides of the fence, there is no reason why government and company cannot sit alongside each other to drive improvements that provide benefits for both parties.

For example, if government can work together with a miner to help them reduce costs, it will generate a higher level of profitability and therefore return a share of this through higher income taxes and potential expansion of the operations. One example of this is power costs, which are a significant proportion of any mining venture. Any reduction in power costs, say through connection to grid power rather than running of diesel plants, is highly likely to generate a return to the miner. This return is shared by the government. For any ideas the outcomes must be win-win, not only to the benefit of the miner or the government.

Figure 2: Project cash flow allocation



Are PSCs a viable alternative?

We have applied the case study on the PwC gold mine to the tax system in Egypt, which is potentially quite different in structure to that of the other countries in this report. Following the successful move into Egypt by Centamin Limited, Australian miner Resolute Mining Limited recently won a tender to acquire prospective ground in Egypt.

Typically, the Egyptian government enters into a Production Sharing Contract (PSC) with a miner whereby the miner agrees to operate and fund a project, while rather than extracting royalties and income tax the government instead is entitled to a share of the profits earned by the project.

The main features of the Egyptian PSC system are as follows:

- The Egyptian government is entitled to a production share (normally referred to as a "profit share") determined on a contract by contract basis of typically between 40% – 50%;
- The miner is entitled to recover operating and capital costs before any profit is allocated. This recovery is normally limited to a percentage of revenue between 60% – 90%, depending on expected operating margins plus an allowance for capital costs recovery;
- No corporate income tax is payable on the miner's share of profits; and
- No withholding taxes on interest and dividends are chargeable.

It is important to note that the terms of the PSCs vary from contract to contract and are individually negotiated. Hence the terms noted above are guidelines based on recently observed PSCs.

When negotiating, the government typically takes into account a number of factors such as the quality and quantity of the gold deposits, the cost of developing the project and remoteness of the project relative to existing infrastructure. In order to encourage development of infrastructure in undeveloped areas, the government tends to provide more favourable terms for projects located in such areas.

We have applied the same key project assumptions to a typical Egyptian PSC in order to assess how well this compares to the other African jurisdictions examined.

In addition to the key project assumptions, we have adopted the following Egypt-specific assumptions:

- A royalty rate of 6%;
- A cost recovery rate of 72.5%; and
- A 50:50 profit share between the miner and the Egyptian government.

As shown on the IRR table earlier, the PwC gold project under this Egyptian PSC system, using the assumptions noted above, results in an IRR of just 20.0%.

We however note that these results would differ substantially if a different set assumptions relating to profit share, recovery and royalty rates was applied through the contract negotiations or through legislation.

In order to assess the range of outcomes that could be attained at different PSC terms, we have performed a sensitivity analysis of the IRR to different levels of cost recovery rates and profit share ratios.

This is shown on the table below:

Table 4: 2017 Egyptian IRR based on different revenue recovery rates and profit share percentages

Project IRR at various assumptions

		Recovery rate (% of revenue)				
		60.0%	72.5%	80.0%	90.0%	100.0%
Profit share (government)	50.0%	16.7%	***20.0%***	20.5%	20.7%	20.9%
	40.0%	20.1%	22.5%	22.9%	23.2%	23.3%
	30.0%	23.1%	24.8%	25.1%	25.3%	25.4%
	20.0%	25.8%	26.9%	27.2%	27.3%	27.3%

Source: PwC Analysis

Table 4 above shows that the project IRR can range from a low of 16.7% to a high of 27.3% given our adopted key assumptions.

Are PSCs a viable alternative? (con't)

It is therefore important to ensure that optimal PSC terms are agreed between the government and miner to ensure that sustainable rates of returns of returns can be earned.

We have also performed scenario analysis to show what the IRR would be at a low gold price and to reinforce the impact that PSC terms can have on project returns. These scenarios are based on a low gold price environment ($980/oz) and show what the IRR would be at various percentages of profit share, royalty and recovery rates. Specifically, Table 5 below shows that in a certain (low) gold price environment, more favourable PSC terms will be required to earn a modest IRR.

This is shown below:

Table 5: 2017 Egyptian IRR based on a low gold price and different PSC terms

Project IRR under various scenarios assuming a gold price of $980/oz

	Current scenario	Scenario 1	Scenario 2	Scenario 3
Royalty rate	6.0%	5.0%	4.0%	3.0%
Recovery rate	72.5%	80.0%	90.0%	100.0%
Miner profit share	50.0%	60.0%	70.0%	80.0%
IRR	**-0.4%**	**7.8%**	**11.8%**	**14.0%**

Source: PwC Analysis

Project IRR summary

Whilst our base case gold mine for the Egyptian PSC model shows that the project does not generate sufficient returns for investment (given an IRR of 20%), what can be seen from the above is that to the extent more favourable PSC terms can be agreed to with the Egyptian government (such as a higher revenue recovery rate and/or lower profit share) this could make investing in Egyptian projects favourable.

What the PSC model does achieve is alignment of interests between the host government and the miner as both parties are interested in the operating profit of the mine.

PSC Summary

The outcomes above clearly indicate that in the current environment, flexibility is critical in relation to obtaining a "win-win" scenario for both miners and governments. Further, it appears that material (and poorly timed) tax changes such as those introduced in Tanzania can have a significantly negative impact on the ability of a country (due to the reluctance of miners investment appetite) to attract capital for mining projects.

This begs the question, is a PSC type arrangement (as seen in countries like Egypt) more flexible than standard tax regimes seen in Africa such that governments and miners can strike the right balance of return on investment for each party?

Conclusion

In conclusion, what to make of the PwC analysis set out in this report?

As each project is different, and given commodity pricing can be volatile, it appears that flexibility in relation to the way in which returns on a project are allocated between miners and governments is critical. The PSC type arrangement (if structured appropriately) seem to provide a possible alternative to allow for such flexibility.

A challenge to both miners and governments – are you willing to work together collaboratively to understand project specific economics in order to build a flexible arrangement to allocate returns from a project appropriately? As the saying goes, one size doesn't fit all…

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Appendix A
Information on tax regimes

In compiling the above analysis, we have utilised taxation summaries on each of Tanzania, Namibia, Ghana and Egypt, prepared by various sources. Only local taxes have been included due to variations in host country and other taxes as a result of different corporate structures. The key taxes and associated assumptions are contained in the tables:

Tax Type	Ghana	Tanzania	Namibia	Egypt
Corporate income tax	35%	30%	37.5%	22.5%
Royalty rate on gold	5%	6%	3%	6%
Income tax rates – local employees	17%	28%	21%	23%
Income tax rates – expatriate employees	20%	30%	21%	23%
Dividends to government (government free carry)	10%	24%*	0%	0%*

*subject to negotiation

Rates of Tax Amortisation	Amortisation rate
Ghana	20%
Tanzania	20%
Namibia	33%
Egypt	20%

Other Assumptions

Assumption	Details of Assumption
Value-added tax (VAT)	All mining companies are assumed to be either exempt or able to receive a refund for VAT, and therefore the net effect is assumed to be zero.
Withholding taxes	Withholding taxes are assumed to be already included in costs (including payee taxes) and that the analysis excludes repatriation of profits and funding to shareholders.
Customs and excise duties payable on inputs	Customs and excise duties payable on inputs are assumed to be already included in costs.
Other tax assumptions	In many countries taxes can be varied, such as through the provision of tax holidays in the mining development agreement. We have assumed no variation from the statutory rates. We have not allowed for repatriation taxes. Australian corporate tax has not been modelled.

Appendix B
Key Project Assumptions

Life of Mine	
Exploration	Before Commencement
Development (inc. permitting and licence approval)	4 years
Production	10 years
Closure and rehabilitation	1 year
Production	
Yearly (oz/per annum)	200,000
Capital expenditure ($m)	
Exploration	30
Mine development and construction ($m)	150
Sustaining capital ($m per annum)	15
Closure and rehabilitation ($m)	20
Gold Price ($/oz)	
Real price (held constant year on year)	1,275
Costs ($/oz)	
Cash cost	595
All In Sustaining Costs	795
Discount Rate	
Rate used to discount future cash flows	8%
Benchmark IRR	
Minimum IRR required for positive investment decision	25%
Employment	
Local employees	1,100
Expatriate employees per mine	11
Local employees salary (annual $)	25,549
Expatriate employees salary (annual $)	122,900
Dividend Payout Ratio	
Average % of profits paid as dividend	27%

Note – all amounts in US$ unless otherwise stated.

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