South African Mining Development Association

Submission to the Portfolio Committee on Trade and Industry re: Transfer Pricing and Transformation within the Mining Industry

3 September 2014

South African Mining Development Association

- The South African Mining Development Association was started in 2000 as the Junior Mining Initiative by South African junior and black economic empowerment (BEE) mining investors.
- While the founders' initial impetus was to present a united response to government on the Minerals Bill, the need for a strong, permanent lobby, representative of the interests of junior mining companies on several fronts, soon became apparent.
- The need for and support of such a body was confirmed subsequently by research conducted by the Minerals and Energy Policy Centre (MEPC).
- In the research conducted by the MECP on the junior Mining sector the following definition of junior mining companies was concluded. e.g
- Junior Miners are companies with an Asset base of R50 million to R7 billion.
- Above R7 billion are the majors.
- Below R50 million are Small Scale miners.
- Below the small scale miners are the Artisanal miners.

South African Mining Development Association

Vision
- SAMDA's vision is to be the vehicle for the development of a vibrant and sustainable junior mining sector which contributes towards the growth and prosperity of the mining industry.

Mission
- to create an enabling environment for raising finance;
- developing technical and other skills;
- practicing responsible environmental management and sustainable development; and
- the maintenance of standards of good practice in the junior mining sector

To Lobby;
- government;
- organised labour; and
- other stakeholders and institutions
- to promote mutual understanding
- to encourage local and international investment
- to conduct research to understand the sectors needs
- to promote beneficiation
- to build African and global alliances
- and to facilitate the transformation of the mining industry by promoting emerging junior mining operations and those who are historically disadvantaged.

What is transfer pricing?

- The term ‘transfer pricing’ is used to describe arrangements involving the transfer of goods or services, at an artificial price, (usually lower) in order to transfer income from one business to an associated business in a different tax jurisdiction which is often lower
- Some producer companies sell the companies commodities to its marketing divisions at lower than market related prices.
- This results in the exportation of profits to the tax haven off shore accounts and the declaration of low profits and the payment of low tax in the country where the commodity is being produced and exported from. In this case a loss to South Africa
- As Transfer Pricing regulating are tightened in South Africa, more sophisticated forms are developed, such as abuse of Advanced Pricing Agreements

Some ways to Transfer Price

- Under reporting of commodity prices, in favour of contract pricing or recommended pricing;
- Non-reporting of full range of products sold;
- Inflated expenditure used to reduce profits locally;
- Thin-capitalisation;
- Transfer between two South African based companies which are connected but the transfer is towards the company carrying an assessed loss which is used to reduce prices; and
- Exchange rate misreporting

Impact on the mining Sector

- Outflows exceed local spend significantly;
- Pleading poverty;
- Projects committed to are underfunded because of a perceived loss of profitability;
- Commitments are scaled back and delayed;
- BBBEEE partners to mining companies are robbed of profits and so dividend which would go towards paying re-paying loans and funding products leading to cancelled BBBEEE deals.

Mining Contribution to the SA Economy

The Mining Sector has a Direct and Indirect contribution to the whole economy as demonstrated below:

- 17% of GDP (direct and indirect);
- 38% of merchandise exports (primary and beneficiated mineral exports)
- 19% of private sector investment
- 11.9% of total investment in the economy
- 50% of volume of Transnet’s rail and ports
- 16% of formal sector employment (direct and indirect)
- 94% of electricity generation via coal power plants
- 40% of electricity demand
- 37% of country’s liqued fuels via coal

TRANSFER PRICING HAS A DETREMENTAL EFFECT ON CHARTER COMPLIANCY IMPLEMENTATION

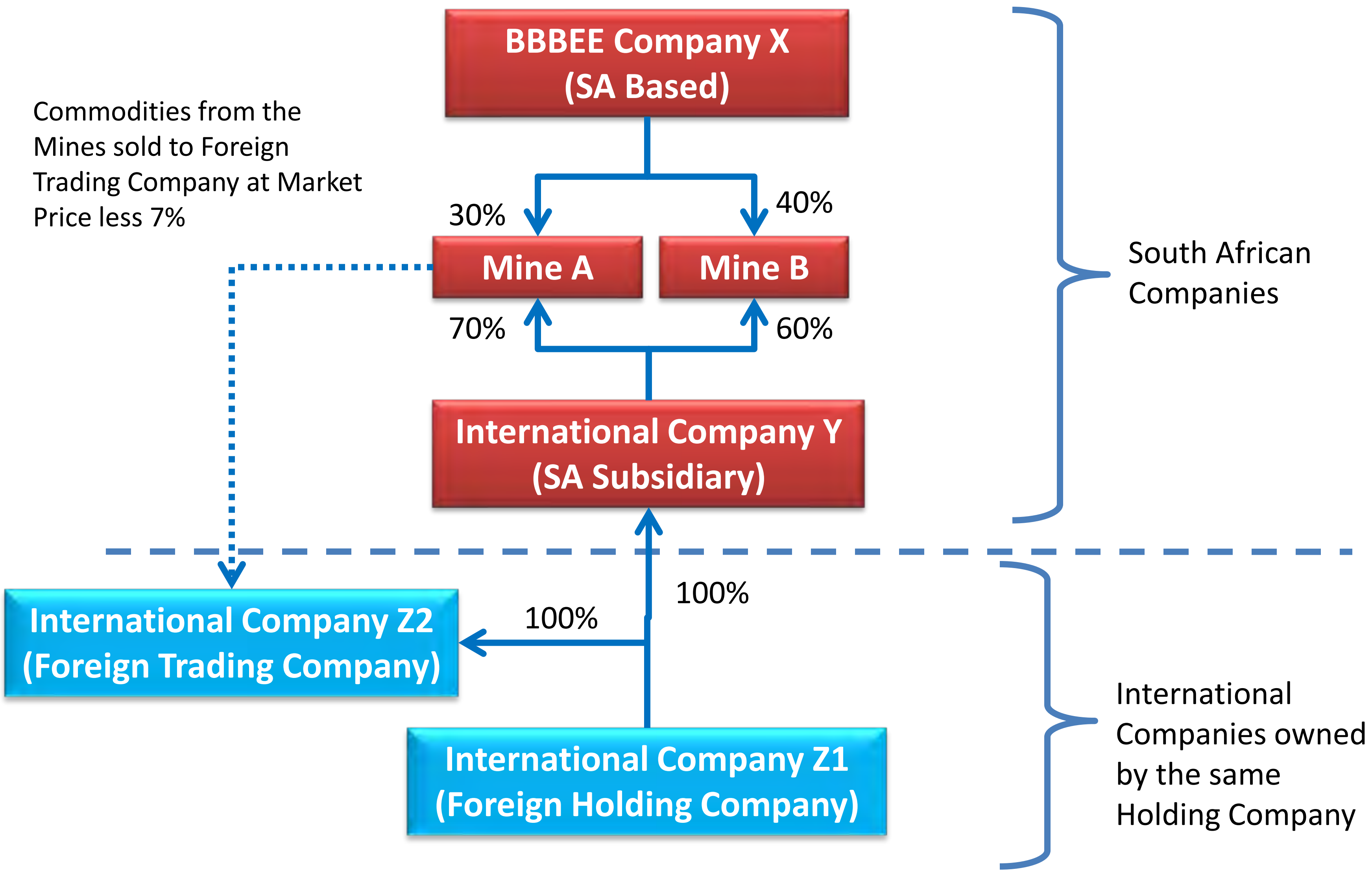
IN SECTION 100 (2)a OF THE MINERALS AND PETROLEUM RESOURCES DEVELOPMENT ACT, THE MINING CHARTER WAS CREATED as a historic charter for the transformation of the mining sector that would introduce elements of sustainable growth of the mining industry, with the intention to ensure transformation of the mining industry.

Below are the elements of the Mining Charter that are not being complied with by practicing transfer pricing. The following elements of the Mining Charter are being eroded and compromised and the 1 May 2014 charter compliancy requirements are not fulfilled:

- **Ownership - 26% equity participation by May 2014**
- **Procurement and Enterprise Development**
- **Beneficiation**
- **Employment Equity - 40% black managers by May 2014**
- **Human Resources Development – Skills Development Spend by May 2014 should be 5% of payroll**
- **Mine Community Development through Integrated Development Plans and Social and Labour Plan**
- **Housing and Living Conditions Requirements:**
  - To attain the occupancy rate of one person per room by 2014;
  - To upgrade or convert hostels into family units by 2014;
  - To promote home ownership.
- **Sustainable Development through:**
  - Environmental Management Plan
  - Rehabilitation
  - Waste Removal and Storage
  - Improve Health and Safety Performance

CASE STUDY IN MINING

Current Structure of Case Study



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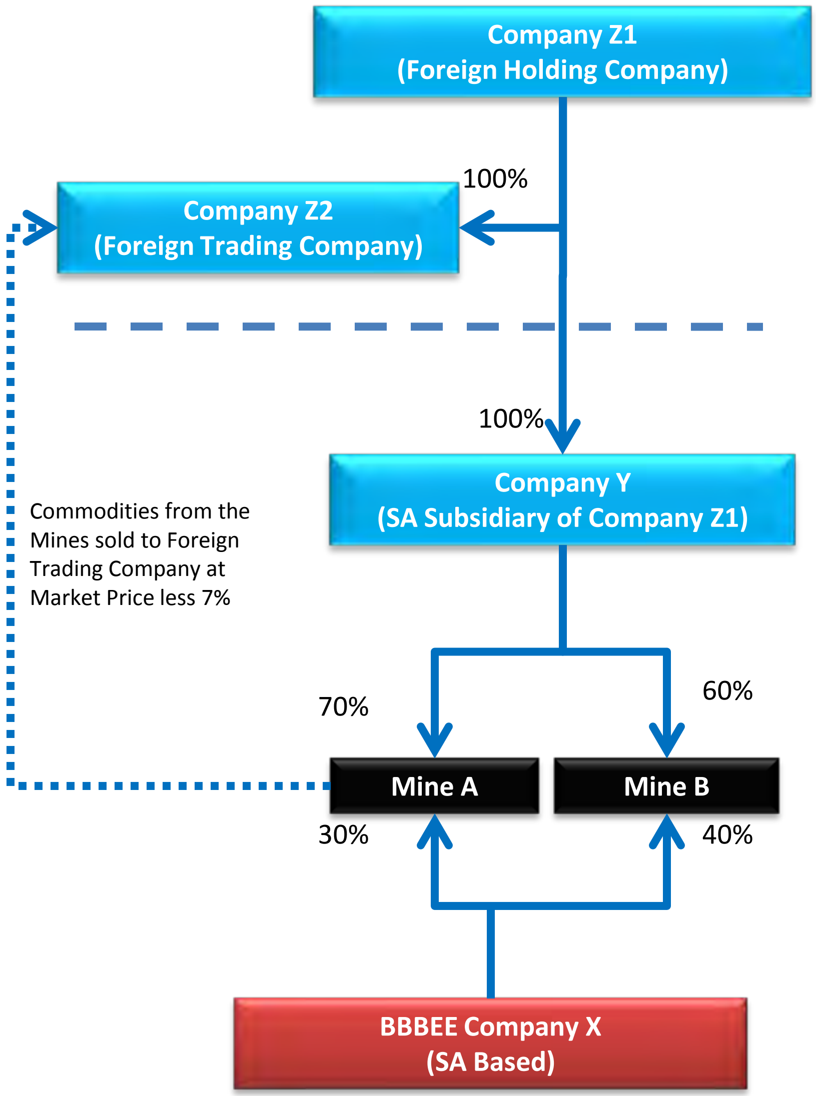

- A foreign Investor (Company Z1) invested in two mines in South Africa – Mine A and Mine B. The Foreign Investor created a local subsidiary (Company Y) in which the shares were held. The Foreign Investor also created an offshore Trading Company (Company Z2) to market the commodities from the two mines (Mine A and B).
- A BBBEE Company (Company X) became the BEE partner through purchasing of shares in Mine A and B. The BBBEEE company is not a shareholder in the Trading Company which is owned by the Foreign Company alone.
- Mine A and Mine B produce the same mineral.
- The mineral produced are priced by International buyers/traders and sellers at a South African harbour on a Free on Board (FOB) basis – thereby determining the "Spot Export Market Price" of the commodity. The buyers could inclu
- The Foreign Owned Trading Company (Company Z2) structured a marketing agreement with the two mines forcing them to sell their product at a 7% discount to the "Spot Export Market Price".
- By so doing the BBBEE company was forced to sell its commodity to its foreign Partner for 7% less than the market value eg. If the price of the commodity was R100 then the income was only R93 for the BBBEEE and not R100.
- The Trading Company (Company Z2) justified the payment of the 7% as a marketing commission payable for marketing and trading services rendered.

Transfer Pricing Audit Conducted by BBBEE Company

- This Marketing Arrangement left the mine with minimal profits most of the time.
- Over and above a discounted sale of commodity to its own Foreign Trading Company by its own mines, the Foreign Investor often sells the commodity to the end user at a higher price than the "Spot Market Price".
- Transfer Pricing occurs through the discounted price and the additional higher price.
- The lack of profit from the Mines made it impossible for the BBBEE Company X to repay its loans for acquiring the shares.
- An marketing audit was commissioned by the BBBEEE company to investigate this disproportionate income arrangement caused through transfer pricing.
- The final audit report was accepted as correct by the Foreign Holding Company (Company Z1) and Foreign Trading Company (Company Z2).
- Despite the fact that the report found that the Foreign Company should have only discounted the price at between 2% - 3% and not 7% thereby achieving an extra-ordinary profit of 4% , the Foreign Company continued with this practice
- eg. R100/t less 7% discount = R93/t but should have been R100/t less 3% discount = R97/t resulting in a R4/t extra-ordinary profit for the Foreign Trading Company.
- If the discount of the sale of the commodity to the Foreign Trading Company was between 2% - 3%, this would be able to cover all fixed and variable cost, including a reasonable returns associated with the risk of the activities conducted by the Foreign Trading Company.
- The calculation for this case study was therefore based on a profit differential of 4% in favour of the Foreign trading Company owned by the Foreign Partner.

Potential Transfer Price Impact

Platinum	7% Transfer Price	3% Transfer Price	Extra-ordinary Profits (4%)
If Mine A and B produced 5% of the Platinum Market	R212m per annum (US$1350 x R10 x 0.225mil ounces x7%)	R91m per annum (US$1350 x R10 x 0.225mil ounces x 3%)	R121m per annum
If all producers were doing transfer pricing (100% of the Platinum Market)	R4.24bil per annum (R212m/5%)	R1.82bil per annum (R112m/5%)	R2.42bil per annum (R121m/5%)
Potential tax loss for SARS			R677m per annum

Coal	7% Transfer Price	3% Transfer Price	Extra-ordinary Profits (4%)
If Mine A and B produced 5% of the Coal Market	R262m per annum (US$75 x R10 x 5mil x7%)	R112m per annum (US$75 x R10 x 5mil x 3%)	R150m per annum
If all producers were doing transfer pricing (100% of the Coal Market)	R5.25 bil per annum (R262m/5%)	R1.8bil per annum (R112m/5%)	R3bil per annum (R150m/5%)
Potential tax loss for SARS			R616m per annum

Recommendation

- The extent, type and impact of commodity price manipulation in the mining sector must be investigated by the regulator, the Department of Mineral Resources (DMR) and National Treasury to ensure that revenue that is destined for South African Stakeholders to the mining sector is not taken from them.
- The role of local and foreign marketing agents and their impact on the mining sector must be researched and better understood.
- The role and benefits of companies with primary listing off-shore must be researched and reviewed;
- The alignment of the Mining Charter with DTI's B-BBEE Codes of Good Practice has not been made despite the fact that the Mining Charter has a 2014 deadline to comply with.
- We suggest that the immediate alignment of the Mining Charter with DTI's B-BBEE Codes of Good Practice must be done as it is long overdue to adress transfer pricing and charter non-compliance by producers.
- Section26 (3) of the MPRDA states that any person who intends to beneficiate any mineral mined in the Republic outside the Republic may only do so after written notice and in consultation with the Minister.
- Section26 (3) of the MPRDA can be used to assist government in determining the true value of the commodities being transferred to the end user/consumer/beneficiator.