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ALLANGRAY

6 September 2013

The Committee Secretary
The Parliamentary Committee on Mineral Resources
P O Box 15
Cape Town
8000

Attention: Ms Ayanda Boss

Dear Ms Boss

SUBMISSION BY ALLAN GRAY PTY LIMITED ON THE MINERAL AND PETROLEUM RESOURCES DEVELOPMENT AMENDMENT BILL [B15-2013]

Allan Gray Limited acting on behalf of its clients is a significant investor in South African equities and bonds. We are concerned that the proposed Amendment Bill will have an adverse effect on the South African economy as a whole at a time when global business conditions are turning adverse. Accordingly we have prepared the attached submission which we hope the Committee will consider when reviewing this legislation.

If there are any issues you wish to raise in regard to this submission please contact me on 021-415-2314.

Yours sincerely

A A McGREGOR

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Submission by Allan Gray Pty Limited On The Mineral and Petroleum Resources Development Amendment Bill [B15-2013]

1. **Mining is a key driver of the South African Economy**
Allan Gray Limited makes this submission as a significant investor in South African bonds and equities, including mining companies. We make these investments on behalf of our clients which include pension funds and private individuals. We act as an intermediary transforming the savings of South Africans into ownership of the economy. While the proposed legislation directly affects mining, our major concern is that it will have an adverse impact on the economy as a whole. South African economic growth is mainly driven by exports, predominantly commodities. The prosperity of the past decade was made possible by the fact that exports grew more than three-fold from $31 bn in 2001 to $98 bn in 2011, due to abnormally high commodity prices triggered by rapid growth in China. This growth in exports made possible a big rise in personal disposable income and a substantial increase in government spending. Unfortunately, it looks as if this commodity boom is coming to an end and the South African economy is now facing increasing headwinds.

   In this environment it is critical that government policy and legislation be supportive of the mining sector which is the country's principle generator of exports.

2. **Much of the South African mining industry is unprofitable**
It is important to recognise that in South Africa mining no longer generates massive profits. After providing for capital spending, neither gold nor platinum has been profitable for the past five years. Rising electricity prices have made the ferroalloy industry at best marginal. Iron ore exporters are still enjoying windfall profits, but with large increases in capacity coming on stream in Brazil and Australia, competition will drive down iron ore prices and profits to more normal levels.

   This deterioration in profitability is a global phenomenon, which is unlikely to change soon. It should be regarded as a return to normal after a period of exceptionally high returns. The mining industry no longer has the financial resources to undertake marginal or doubtful projects. Rather it will focus on the limited number of ventures which may generate high returns. Unfortunately, given the depletion of our resource base by over 140 years of active mining, few of these projects are located in South Africa.

   This does not mean that mining cannot continue to be an important contributor to the economy. However, companies will have to be flexible and skilful to make acceptable returns on capital deployed. South Africa failed to take full advantage of the minerals boom because it lacked an enabling environment. High prices masked this lost opportunity. Now that we have entered a period of lower prices, the consequences of a difficult operating environment will become increasingly apparent. In an environment of high prices mining companies can afford to pay the costs imposed by an unfavourable regulatory regime. When prices are low they cannot carry these costs. Investment will decline and production will fall, with adverse consequences for the economy as a whole.

3. **The proposed legislation will deter investment**
The major criticism of the proposed legislation is that much of it will act as a disincentive to investment, at a time when the global investment climate for the resource sector has turned adverse. In particular the ubiquitous extension of ministerial discretion will create an environment of uncertainty which will discourage investment.

Section 26 on beneficiation could have significant unintended consequences. The simple reality is that the domestic beneficiation of South African resources does occur where it is viable. Generally, beneficiation projects which should have been built have been built. There have also been several major beneficiation projects which have been financial disasters, for example Colombus Stainless Steel, Saldanha Steel and Hulamin.

The proposed amendment to section 26 eliminates the concept of <u>economical</u> beneficiation. There is an implicit threat that beneficiation will become a process whereby mineral producers subsidise domestic manufacturers. When prices are high this policy might seem to work. However in normal times, as probably lie ahead of us, miners will need all their revenues to earn an adequate return. The possibility that mining ventures will be subject to such imposts, means that the hurdle rate for new investment will be increased. More marginal projects will not proceed.

Giving the Minister arbitrary powers to license exports is a threat to mining company's ability to maximize revenues. A critical issue for investors is whether a venture is sustainable in bad times. Mining companies must have the freedom to maximize their export revenues when margins are under pressure. A second issue is whether in times of exceptionally high prices, a fair share of the windfall gains accrues to the shareholders. The promise of windfall gains makes investors willing to accept sub optimal returns in normal times. The uncertainty created by the proposed legislation, by allowing arbitrary intervention by government, erodes the certainty that is required to sustain investment.

4. **Specific problems should be subject to specific and not general legislation**
Recently export controls have been proposed to solve problems in ferrochrome and electricity generation. Ferrochrome offers an interesting insight into the economics of mineral beneficiation. China is the world's largest stainless steel consumer and therefore the largest consumer of ferrochrome. Its ferroalloy industry has grown rapidly at a time when South Africa, which historically was the lowest cost producer, has been constrained by electricity shortages. In creating industry dominance in ferrochrome, China's access to markets has proved far more important than access to raw materials which in the last resort are always fungible. It is uncertain whether proposals regarding restricting chrome exports to keep South Africa's ferrochrome producers in business will work. However, if such an arrangement is deemed appropriate it is better to have specific legislation to handle this problem rather than give the Minister blanket powers to intervene in all mineral exports. The same arguments would apply if it is deemed appropriate to restrict coal exports to ensure Eskom has sufficient coal supplies. Otherwise legislating to address problems in coal and ferrochrome may have the unintended consequence of creating uncertainty which will reduce investment throughout the mining industry.

5. **The offshore oil sector**

The criticisms set out above also apply to the offshore oil industry. Exploration for and development of offshore oil and gas require a combination of considerable technical skills and large financial resources. Few, if any, South African institutions are able to play a meaningful role in this sector. Despite record oil prices the international oil industry has proved disappointing for investors because the capital cost of sustaining production has become so large.

South Africa is a frontier oil play where the risks are high. Unless South Africa can produce a competitive framework underpinned by certainty there will be little chance of getting significant investment from the international oil companies. They can invest their scarce resources elsewhere. A significant offshore hydrocarbon discovery could have a transforming impact on the South African economy. Legislation should be crafted to promote such a discovery.

6. **Unintended consequences**

Our understanding is that after asking for comment from the mining and oil companies this legislation is being pushed forward, ignoring industry inputs. This is concerning. Such input represents the view of the companies which will make the decision whether or not to deploy scarce capital in South Africa. To ignore their concerns could well accelerate the decline of South Africa's resource industry, which will have damaging consequences for the economy as a whole.

A A McGREGOR
6 September 2013