



Political risk in the mining sector: Understanding and mitigating the perils

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Oruro, Bolivia sits on the High Andean Plain 180 km southeast of La Paz. As the sun rose over this bucolic community of miners on February 9, 2007, soldiers of the Bolivian Army were amassing at a nearby tin smelter. The formation of approximately two-hundred troops descended upon the smelter to seize it from its owner, a European mining company. The smelter's workers, who opposed the expropriation of the facility, stood behind the chained gate in a futile effort to block the soldiers. By midday, Bolivian President Evo Morales had arrived on the scene. He stood in front of a banner that read "Nationalized" and declared that the smelter was now the property of the government.¹

While the details of this actual event may appear sensational, government nationalization of mining assets is not unusual. In fact, a recent report on the mining and metals industry by Ernst & Young cited resource nationalism as the biggest risk that mining companies face today, ahead of other risks such as capital costs and price volatility. The report states, "Resource nationalism continues to be the number one risk facing mining and metals companies as governments go beyond taxation in seeking a greater take from the sector. The uncertainty and destruction of value caused by sudden changes in policy by the governments of resource-rich nations cannot be understated."²

Operating in challenging environments

The growing global demand for metals means that mining companies cannot shy away from challenging operating environments. A recent United Nations study forecasts an increase of as much as 1,000 percent in the use of metals in the coming years due to rapid growth in the emerging economies of Asia, Africa and Latin America.³ Unlike other industries such as manufacturing, mining companies have limited ability to decide where to undertake projects. Simply put, miners have to go where the resources are, even if it means operating in challenging political or security environments.

For example, the Democratic Republic of the Congo has seen a number of expropriations and investor disputes in recent years, and it was ranked 181 out of 185 countries in the 2013 World Bank Doing Business Report.⁴ However, the country holds 50 percent of the world's reserves of cobalt, which is a critical component of batteries used in cellphones, laptops and electric vehicles. Mining companies will increasingly look to develop projects in challenging markets as demand for non-ferrous and precious metals, as well as rare earth elements, increases. Therefore, it is not only important for mining companies to be fully aware of the political risks that they face, but they should also understand what causes these risks and, of course, how these perils can be mitigated.

Causes of resource nationalism

There are many theories on what causes governments to pursue policies of resource nationalism. Some studies demonstrate that periods of high commodity prices are correlated with increased expropriation of assets and investment disputes. For example, a recent Chatham House study on the political economy of natural resources states, "The propensity of a government to expropriate or intervene is often closely linked to resource prices. The recent upsurge in disputes and expropriations is reminiscent of earlier waves that also corresponded with periods of high resource prices. Compulsory nationalization

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1. Tin Soldiers. February 15, 2007. The Economist (www.economist.com/node/8706221)

2. Ernst & Young. "Business Risks Facing Mining and Metals 2012 – 2013", Pg. 11. ([www.ey.com/Publication/vwLUAssets/Business-risk-facing-mining-and-metals-2012-2013/\\$FILE/Business-risk-facing-mining-and-metals-2012-2013.pdf](http://www.ey.com/Publication/vwLUAssets/Business-risk-facing-mining-and-metals-2012-2013/$FILE/Business-risk-facing-mining-and-metals-2012-2013.pdf))

3. United Nations Environment Programme. "Environmental Risks and Challenges of Anthropogenic Metals Flows and Cycles." April 2013. (www.unep.org/resourcepanel/Portals/24102/PDFs/Environmental_Challenges%20Metals-Full_Report_150dpi.pdf)

4. United States Department of State. 2013 Investment Climate Statement – Democratic Republic of the Congo. April 2013. (www.state.gov/e/eb/rls/othr/ics/2013/204623.htm)

or the assumption of a controlling interest, the confiscation of foreign-owned assets, windfall profit taxes and similar measures can therefore be expected to become more common in an era of high resource prices.”⁵

Alternatively, lower commodity prices have also led to instances of nationalization where commodity-dependent governments have sought to maintain a certain level of income in the face of falling prices. This risk is particularly acute when there is a precipitous drop in prices and governments are suddenly faced with the challenge of meeting expansive budgets in the face of dwindling revenues.⁶

Mitigation strategies

There are a number of ways to help mitigate the wide array of political risks that are inherent in any mining project.

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A clear understanding by all parties of the rights and obligations that are granted under the concession agreement and associated licenses is essential. All efforts should be made to ensure that the host government has reasonable expectations of the anticipated revenue from the project. There are many examples of investment disputes or forced contract renegotiations that were precipitated by a government’s disappointment with the amount of royalties that it was receiving for a project. In many of these cases, reliance on inaccurate production estimates and price forecasts was at the root of the problem.

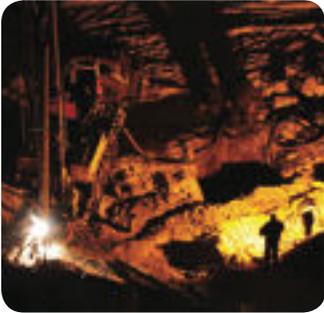
Because mining concessions are usually granted by a federal government ministry or agency, it is critical that the local government and the local community are also aware of the rights that are granted to the company and that they are vested in the project. Natural resource projects are rife with sensitive issues ranging from local land rights to social, labor, and environmental considerations. A project that operates in a challenging political or security environment is far more likely to be successful if the local community benefits from the project. Many investment disputes have originated with grievances from the local community, which in turn created problems with the regional or federal government. If the project agreements do not allocate any revenue sharing to the local community, then the project will certainly come under increased pressure to provide education, health and social programs to the community.

Corporate social responsibility programs — such as educational, social and environmental initiatives — not only create a lasting positive impact on the community, but can also be an effective way to mitigate project disputes. One study states that the success of corporate responsibility programs, “is measured in terms of what doesn’t happen rather than what does; the absence of local tensions, of time spent in dispute or litigation, and of not having to absorb the costs of regulatory impositions which were unplanned and unbudgeted.”⁷ A company that implements responsible social and environmental policies and adheres to recognized standards, such as the Equator Principles and the World Bank Environmental, Health and Safety Guidelines, might not only help reduce the political risks that it faces at the project level, but it will also find it easier to attract lenders and political risk insurers who will only participate in socially responsible projects.

5. Lee, B. et al., 2012. Resource Futures (London: Chatham House) http://www.chathamhouse.org/sites/default/files/public/Research/Energy,%20Environment%20and%20Development/1212_resourcesfutures.pdf. See also, Joffé, G. et al., 2009. Expropriation of Oil and Gas Investments: Historical, Legal and Economic Perspectives in a New Age of Resource Nationalism, *World Energy Law & Business*, Vol. 2, No. 1, pp. 3–23.

6. Young, R., Devine, R. Expropriation – A Very Real Risk. April 6, 2009. *Energy Risk* (www.risk.net/energy-risk/feature/1523570/expropriation-a-real-risk)

7. Humphreys, D., A business perspective on community relations in mining. *Resources Policy*, 2000. pp. 127–131



Employment opportunities are the most obvious benefit to the local community, yet mining companies should consult with local community leaders while staffing their projects. A company can help reduce problems with the community by being mindful of local cultural sensitivities. For example, during a mine site visit in the Democratic Republic of the Congo, this author witnessed firsthand the tension that can be created when part of a mine's workforce believes that a certain tribe or ethnicity has been favored in the hiring process or assignment of specific tasks.

The threat of political violence

Mining projects in challenging locations often face risks stemming from political violence, including regional conflicts, civil wars and localized violence specifically directed toward the project. The impact of political violence on a mining project can range from damage and destruction of assets to the inability to continue operations and possibly the forced abandonment of the project in its entirety. In recent years, a number of mining projects have experienced violence-related issues in many countries, including the Solomon Islands, Kyrgyzstan and Peru, among others.

It is noteworthy that a number of new deposits have been discovered in West Africa and several large-scale mining operations are coming on-line in that part of the world despite recent and on-going political turmoil in Sierra Leone, Liberia, Cote d'Ivoire, Guinea and other countries in the region. The Simandou Range in southeastern Guinea could become the largest combined iron-ore mine and infrastructure project ever developed in Africa. Income from the project could more than double the GDP of Guinea, if the project can overcome significant political hurdles.

It is also important to consider that episodes of political violence can lead to expropriation or forced contract renegotiation, as it is not unusual for a new government in a politically unstable part of the world to reexamine the revenue-generating projects in the country, particularly when a new government is starved for cash after a long conflict.

The dollar revenues from a mining project can be an alluring target for a government that is experiencing prolonged current account deficits and downward pressure on its currency. While the proceeds from a mining project are usually collected in dollar-denominated off-shore accounts, there have been instances where a host government has abrogated the right to sell production and maintain project-related accounts off-shore.

For example, Argentina ordered oil & gas and mining companies to cash-in all of their project-related export revenue on the local foreign-exchange market in a move to protect dwindling currency reserves.⁸ Apart from the problems that such actions pose to a company's cash flow management, it can also expose a company to increased taxation, as well as the risk of currency devaluation.

Political risk insurance solutions

While a company can mitigate risk through prudent and responsible project management, even the best-managed projects can be vulnerable to political risks. This is why many international mining companies utilize political risk insurance to protect their balance sheets. Political risk insurance can also make it easier to attract investors and lenders to a project. Mining companies have turned to the political risk market to protect

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8. Fitch downgrades Argentina Oil Companies Following Central Bank Dollar Move. October 29, 2011. MercoPress (www.en.mercopress.com/2011/10/29/fitch-downgrades-argentine-oil-companies-following-central-bank-dollar-move)

their assets and to secure lending for many decades, and an array of coverages that can be tailored to suit the specific needs of each project are available.

- **Expropriation coverage** offers protection in the event of confiscation, expropriation, nationalization and other acts by a host government that deprive the company of its fundamental rights to its venture, mined material, equipment or other assets. “Creeping expropriation,” a series of acts that ultimately have an expropriatory effect can be included as well. Selective discrimination, forced divestiture, and losses arising from breach of contract by the host government or the non-honoring of a government payment obligation under an off-take agreement or other commercial arrangement can also be covered.
- **Political violence coverage** offers protection against the damage or destruction of assets resulting from events such as war, revolution, insurrection, civil unrest, terrorism and sabotage. Coverage for business interruption is also available, as well as the forced abandonment of a project due to political violence.
- **Currency inconvertibility and non-transferability coverage** protects against the inability to convert local proceeds to hard currency and repatriate the currency. An element of this coverage that is particularly relevant to the mining industry is the protection that it provides against government decrees that force the company to bring project-related revenues back onshore to local accounts.

Political risk insurance policies can include any combination of relevant political risk coverages on a single policy and they can be manuscripted to meet the specific needs of each project. Coverage terms are available for up to fifteen years or longer, which is important for mining companies that are undertaking long-term projects and want to make sure that their assets are protected for the duration of the investment. It is also important to note that political risk coverage is non-cancelable and the premium rates are fixed for the duration of the coverage, therefore a company can lock in coverage for the entire length of their investment.

Conclusion

“As the global demand for minerals continues to grow and industrialized country mineral reserves dwindle, many mining companies will be forced to seek revenues in countries that present difficult political and security operating environments.”

As the global demand for minerals continues to grow and industrialized country mineral reserves dwindle, many mining companies will be forced to seek revenues in countries that present difficult political and security operating environments. While prudent management practices can help mitigate some risks, the nature of extractive projects and the difficult countries in which many of them operate result in heightened exposure to political risk for the mining industry. Fortunately, there is a large and stable political risk insurance market where companies can protect their assets against risks related to expropriation, political violence and currency inconvertibility.

About the author: Jim Thomas manages Zurich's political risk and structured credit underwriting in the United States, Canada and Latin America. In his 13 years with Zurich, Mr. Thomas has underwritten political risk coverage on numerous mining projects throughout the world and he is a frequent speaker on topics relating to political risk mitigation strategies.

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