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CONFLICT RESOLUTION BETWEEN GOVERNMENT AND INVESTORS IN TERMS OF NON-COMMERCIAL RISKS IN MINING INDUSTRY

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CHAPTER ONE

INTRODUCTION

I.I. BACKGROUND TO THE PROBLEM

The global mining industry has undergone profound structural reforms over the last decade. The Foreign Direct Investment (FDI) has increased during the same period as a consequence of more favourable investment conditions in many countries, partly as a result of the change in foreign investment regimes (Otto, 2002). The need to increase export income pounded the motivation for host countries to attract foreign mineral sector investment and involvement. Now, governments' attention has increasingly turned to the growth of FDI in the mining industry in the near term as well as in the medium term. The growth will provide many opportunities for investments around the world.

However, there is an ongoing international debate on the inability of some countries to attract FDI. It was noticed that many countries with attractive endowment of mineral resources still experience problems in creating a stable environment to investment (World Bank, 2000).

During a survey carried out in the USA (American International Group, 2000), a special committee of advisors from some institutions completed a questionnaire to better understand the inability of some countries to attract FDI. The result of the survey was that the developing region offered to foreign investors an environment with opportunities and a variety of risks and uncertainties that include geological, political, commercial and infrastructural aspects. Many countries from the developing world are

perceived by investors to have environments that pose the highest levels of non-commercial risks anywhere in the world, (World Bank, 2000). Those risks include some factors which increase non-commercial risks with impact on commercial risks by increasing operating and capital costs, said Mistry and Olesen (Olesen, 2002). The factors reduce the cash flow of the project and as a result mineral sector investment by foreign investors has been slowed or impeded by political instability.

Achieving the greatest return on investment for the minimum of risk remains the motive of investors and the profitability of investments is of essential interest to foreign investors. Developing regions have suffered from the continuing absence of effective measures at the global level for dealing with political instability. For this reason, a large number of investors prefer countries which are perceived to have lower risks. A good example of political risk has been the Zimbabwe's situation or over land redistribution (Marawanyika, 2004). This conflict has introduced a dangerous process of institutional disintegration from what was previously an efficient state. The recent events have under mined the contribution of foreign investors to the economic growth in this country. The lesson of Zimbabwe is that the principle of sovereignty is meaningless when it is divorced from principles of democracy (World Markets Research Centre, WMRC 2001).

In identifying the most attractive investment alternative the stability of the host country represents one of the important factors to be considered. Any national government is firmly committed to provide investors with a stable framework, which removes uncertainty and minimises risks that might impede investment.

Though the developing world recognizes the important role of FDI in stimulating national economic growth and increasing global competitiveness, it lacks an internationally recognised accounting

framework to meet the need of the mining industry in foreign investment regimes. The issue of political risk is specific to developing regions. The ravage of debt, instability and globalisation have made developing regions, if anything, even more fragile and thus more important than it was a generation ago, said Thoung (Thoung, 2002).

Assessing the effects of globalisation on developing region's economies, it is argued that certain aspects of current international trade regime, FDI for example, create opportunities for the developing world to play a more prominent role in the world in mining sector.

The recent increase in global demand for investment flows, the mining industry's situation in some developing countries does not reflect the level required to complete internationally. This gives opportunity for research activities. Similarly, it is hoped that the research effort can contribute in some way to a productive and fruitful resolution of problems in mineral industries.

I. 2. RESEARCH APPROACH

The research approach project comprises:

1.2.1 Previous research

There is extensive literature concerning the inability of some countries with rich endowment of mineral resources to create an environment that enables foreign participation in mineral development. The flow of private foreign investment in some developing countries has been much lower compared to others have relied on mineral resources as the basis for economic development such as Chile, Peru and Mexico. The flow remains

well below the level required to stimulate strong development. FDI inflows do not reflect the investment opportunities that developing countries offer to the mining sector (Willem, 2003).

To ascertain whether such a view has any basis in reality, significant research relating to the perception of non-commercial risk' factors were analysed. The following brief review of past research is therefore limited to the understanding of the lack of growth in order to consider the existing evidence for the mining industry in the developing world.

At one extreme the Regulation of Mineral Enterprises: A Global Perspective on Economics, Laws and Policy (Rocky Mountain Mineral Law Foundation 2000), under the direction of Otto and Cordes, had undertaken study in global perspective on Economics, Law and Policy issues. The authors analysed the most critical issues in the regulation of minerals industry in the context of strategic decision-making. The analysis focused on the major topics of international investment's factors such political or policy risk. The following paragraph shows the importance of the issues: **"***International mineral investment must always account for a variety of risks and uncertainties generally categorized as geological, commercial and political. Their identification, measurement, assessment and mitigation are integral parts of the risk-reward equation that defines each investment. Geological and commercial risks are assessed and accounted for initially in feasibility studies and financing agreements. They are periodically re-evaluated and the results incorporated into operational decisions at the mine. The burden of these risks is typically shared by governments and investors and allocated through the project's fiscal or taxation regime. Only investors and their financial backers perceive policy risks as a threat to investments. Governments, however, share the consequences of this perceived threat***"** (Otto, 2002, pp. 58). Then they explored ways in which investors attempt to mitigate or transfer policy risk in business. Particular attention is given to mechanisms to avoid disputes such as renegotiation

and stabilization of investment agreements. The book contributed to a better understanding of the efforts of host countries and investors in mining industry to improve the decision-making processes through consultations based on mutual respect. The objective is to find solutions for the conflicts that currently affect this sector.

At the other end the debate, the Pacific Islands organised a forum in 2003 titled “a Forum Economic Ministers Meeting”. The forum presented some key economic issues considered by investors when they want to invest. The forum found that country-risk’s factors are an important basis for investment decisions and they are useful both to investors and Governments. Paragraph from the background clearly summarises the forum: **”***When investors are seeking a suitable investment in a country in which to invest their funds, one of the factors they consider is the likelihood of getting their money back in accordance with the terms in which they invested in that country***”** (Suva, 2003. pp.11)

Aylward (1995) completed a study entitled “*Criteria Influencing International Mining Investment*”. He focused on the criteria such as economic, political, technical and financial and the conditions underlying those criteria to change. Aylward developed a calculating framework to evaluate the impact of criteria on the performance of a mining project in different countries and the work also provided the means of measuring the range of impact of various criteria on a mining investment. He also investigated to the most significant event impacting on the global political and economic landscape over the past decade. Based on this work, Aylward drew several significant conclusions as follows:

1^{o} There were numerous criteria which investors and financiers give priority when making investment decisions.

2^{0} The stability and transparency of political, legislative and administrative structures were the most important issues.

3^0 Underlying those factors cited as being particularly important were security of tenure, the ability to repatriate capital and income, the overall level of taxation and other duties

4^0 The more technical criteria such as deposit grade and size, operating costs and development capital expenditure to self-financing were considered obvious and a pre-requisite to the successful development of a mining project.

On balance, the most important component should be the stability of political of the operating and investment over time. This point is an important issue for this study.

Other research efforts are also worth mentioning. Cawood (1999), from the abstract of his work, noted that**"** *There is a strong relationship between the success in attracting investment and the attractiveness of a country's investment rules. These investment rules impact on the returns investors will receive for risking their capital***"** (Cawood, 1999. pp. 5). Cawood established a competitive mineral investment framework and found that the reason for the lack of growth in the South African mining sector has been the fact that South African's country offers an unfavourable investment environment to private foreign mineral investors. Economics and political factors caused many of these failures to benefit from large mineral endowment. The other countries such as Chile, Argentina, Mexico and Brazil offer a more favourable investment environment for foreign investment. The policies adopted by those countries were instrumental in simulating mining investment. He concluded that a higher discount rate must be applied to cash flows in the developing countries in order to accommodate the higher risk factor, while countries from the developed world could effort to levy higher taxes because of the negligible risk factor.

A 2003 World Bank document by William (William, 1997) wrote that many countries from developing region have had less access to capital markets, due to a global decline in lending, increased uncertainty among investors, and reduced willingness to assume risk. The report noted that the developing countries now suffering from a global economic downturn. The result of developing countries' political in removing restrictions to FDI entry and improving standard of treatment of foreign affiliates has been mixed. Opening has not, in many cases, led to magnitude of FDI inflows that many developing countries expected, in one side. Even when inflows rose, the development benefits of FDI were often below expectations, in the other side. A possible explanation is that, despite the liberalization, prospective mineral investors may have found the investment environment risky or deficient. To promote the foreign direct investment, the World Bank Group worked closely with other agencies such as the Multilateral Investment Guarantee Agency (MIGA) by developing innovative ways to help the developing countries.

The paper by Tony and Almas (2003) from United Nations University (UNU/WIDER) contained an important discussion on the new global determinants of FDI flows to developing countries. By using the most recent statistics, the analysis was based on a large number of countries. The paper found that the distribution of FDI is highly unequal and many developing countries face major difficulties in attracting foreign investors. Furthermore, due to the temporal patterns of FDI, liberalisation, privatisation, GDP growth and openness might not be sufficient statistics for the unobserved FDI behavioural differences across countries. Variables other than traditional determinants should be retained. The results support or confirm many of the findings of previous research in the area. In particular that openness, privatisation and liberalization have a positive impact on FDI flows and more important, the level of risk affects FDI negatively.

Latin America has sought to take advantage offered by foreign investors. In contrast, with exception of some developing countries, the developing region attracts small part of foreign investors in mining.

In the survey conducted by the Fraser Institute (1998), a neo-liberal think tank based in Canada, 280 mining companies were asked to rate mining region across North America on mineral potential and public policy issues, including taxation, regulatory consistency and land-use policies. Laura Jones, the institute's director of environmental studies and survey coordinator, advocated another option **"***Exploration investment is a key indicator of the future health of the mining industry***"**. She admitted that many countries in the region have favourable mining potential that could easily compete with others countries around the world to attract investment. However, unfavourable public policies, around the region, increasingly threaten exploration (Laura, 2001).

A further basic reason for the disappointing performance of some developing countries with rich mineral endowed of natural resources to match the growth of the more advanced but mineral deficient countries is becoming apparent in contemporary economic literature. The report of the Investor Relations Business by Thomson (2004), investigated the news and strategies for financial communications professionals. **"***It's clear that the high level of proposals indicates that investors continue to be active regarding where they put their money. They have kept pace with regulations over the past few years, and we'll see more next year***"** (Thomson, 2004).

Other parties to the debate include a wide range of experts groups who have provided a foundation in which to better understand the philosophies influencing the current mineral investment environment. A range of qualitative and quantitative factors of risk have been combined and diverse risk rating agencies use different methods to determine country or

country risk. For example, a permanent panel of ± 105 experts around the world present a risk index which measures a country's business environment against measures such as Political Risk Index (PRI), Operations Risk Index (ORI), and Repatriation Factor (R Factor) developed by BERI (Business Environment Risk Intelligence) since 1980. The objective of these indices is to gauge the climate for foreign business, to create a multicomponent system with flexibility to weigh key factors, to provide data of risk measures, and to estimate country's capacity and willingness for private foreign companies (Stephen, 2004).

The concept of Political Risk Rating (PRR) has also been developed by the Political Risk Service Group (The PRS group, 1999 - 2005). The aim of political risk rating is to provide a means of assessing the political stability of the countries on a comparable basis. This was done by assigning risk points to a pre-set group of factors, termed non-commercial risk component. They include the more significant factors of non-commercial risk which investors face in host countries. One advantage of the political risk rating model is that it allows investors to make their own risk assessments based on this model or to modify the model to meet their specific requirements. They provide a benchmark used by the mining industry and financial institutions (Jones, 2004). These indices rating present a significant problem. A country may appear to present a secure haven for investments on the basis of an acceptable level of risk in terms of political risk rating. However, these numbers give no indications of how stable that assessed situation is-i.e. to what degree the risk assessment might vary. They provide useful insights but not definitive insights and they must be integrated into the investor's project type (Otto, 2002).

To measure this stability or instability, the concept of Risk Stability has been introduced. The risk stability of an individual country represents the volatility or stability of risk for a given country.

A different approach to measuring country risk may be contained in the global debt markets by comparing the interest rates in different countries. This should give an indication of the market's confidence in the structures supporting the investment. This gives opportunities for further research, and has considered important as the basis of the research undertaken in this report comprised the consideration (or situation) in some developing countries which are participants in current mining industry with a view to anticipating improved relating to future FDI prospects. My attempt to develop the issues of political risk in the present study is therefore partly based on the results of previous and ongoing study by other researches in this concept.

I.3 OBJECTIVE OF THIS RESEARCH

For the need of global mining industry, the developing countries provide immense opportunities for investment. The coming years are also given opportunities to countries commodities-dependent economics around the world to growth their economy by improving the environment for business.

Against the inability of some developing countries to attract foreign direct investment, research effort continued to develop innovative ways to help mining industry to meet the rising demand of investment. Research effort also sustained to develop strategies to minimise the action of governments to unilaterally change the content of agreements. Rather to consider industry-specific factors, this study is mainly concerned with host-country determinants as factors influencing international mining investment, and non-commercial risk is of particular relevant to the theme of this research project.

The purpose of the research project is, to explore in more detail the impact of non-commercial risks as cause of the inability of some countries to

attract FDI. Secondly, to devise a framework to stimulate the performance of a mining project in different countries. The simulation framework must be flexible. A range of representative factors could be introduced in the simulation, drawn from the mining codes of some representative countries. Those countries could be selected a comparable basis.
It is hoped that the approach may contribute in some way to a resolution of conflict between government and investors, particularly in the developing world. Anticipating improved FDI prospects during 2004-2007, is of particular importance to the theme of this research project.

1.4 IMPORTANCE OF STUDY

As the mining industry continues to expand, there are a number of continuing and new issues that the industry must continually deal with if it is to remain viable.

States through the globe are unanimous of the vital contribution of capital from foreign investors to their economies. Increasing number of investors in the mining industry could secure a source of foreign exchange earning to resolve some problems faced by developing countries. Criteria will need to be meeting to attract foreign investors. Among the most significant criteria to be addressed are those related with decision-making process, the environmental issues, the image of mining industry, and those relating to investment climate.

Dealing with the issue of non-commercial risk in a comprehensive new ways to build sustainable high-performing businesses on a global scale has been a major preoccupation**.** Researchers consulting worked with governments, mining companies and World Bank to find and implement solutions to these challenges across many criteria dimensions.

Substantial progress has been made until now, while other challenges remain.

Countries from developing countries still have an extensive mineral endowment, despite the environment risk that they present to investors. The approaches developed in this study provide a fresh perspective on the investment climate on developing world. This can be a good method for regulating an economic growth to ensure that developing nations involve the global industry. By identifying those criteria sensitive to the ongoing project, it will be easier to meet the challenge in need with the expansion of mining industry for the global economy.

1.5 LAYOUT OF RESEARCH

The plan of the study is as fallows. Chapter 2 examines the importance of foreign direct investment (FDI) in the global economy and in the mining industry over the last ten years, partly as a consequence of more favourable investment conditions in many countries around the world. Throughout the rest of the volume the determinants of FDI flows are specified.

Chapter 3 provides the concept of non-commercial risk. The chapter first review the notion of risks in mining investment, and identify risks faced by investors in developing countries. Various non-commercial risk ratings used in the literature were reviewed in this section. Chapter 4 focus on the selection of attractive developing countries[1.1]. An economic analysis of the ten selected countries is given in Chapter 5.

Chapter 6 focuses on non-commercial risk. The non-commercial risk for the ten selected countries is determined. Using 10 factors of non-commercial risk, the overall non-commercial risk is calculated for the ten

countries. Conflicts resolution between host governments and foreign investors is furnished in Chapter 7. A comparison of non-commercial risk ratings for ten selected developing countries, compiled by foreign direct investment inflows in 2001-2003, is given in Chapter 8. Some concluding remarks are presented in this Chapter.

[1.1]Developing region is relating to countries in which capital needed to industrialize is in short supply, not progressing and developing as fast as others, as in economic and social aspects, Developing region includes least-developed countries, landlocked and transit developing countries and small island developing countries, (Houghton Mifflin Company. The American Heritage. Dictionary of the English Language, Fourth Edition, 2000, 2004).