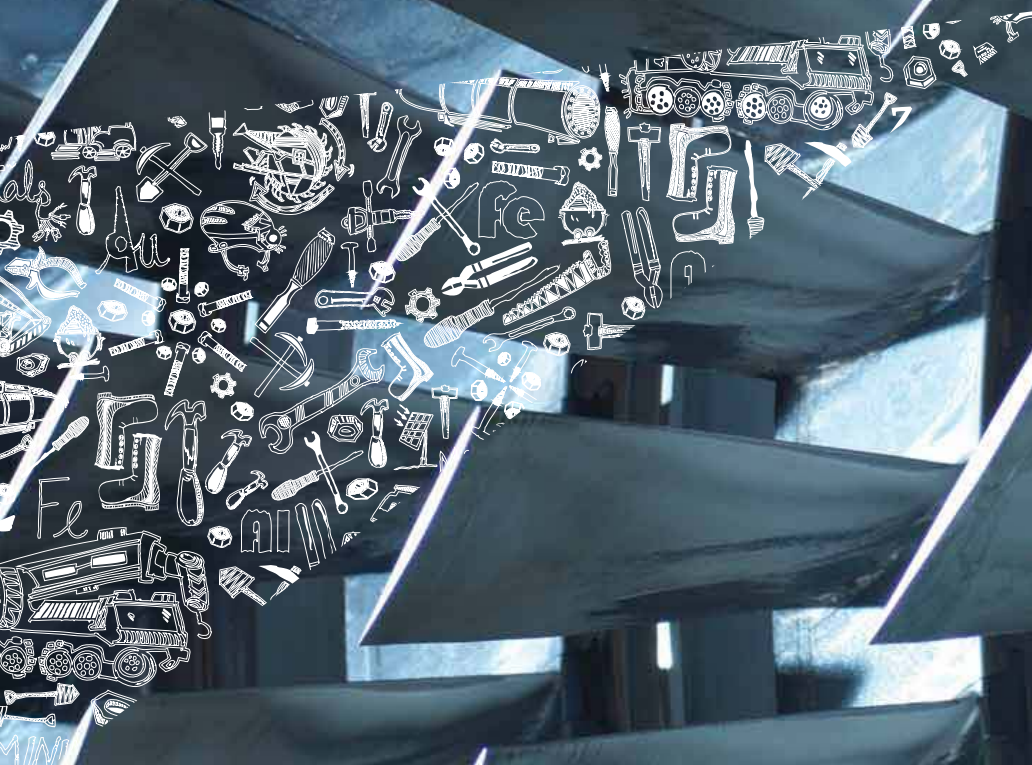


# Business risks facing mining and metals 2011-2012

Executive summary



### The trends of 2010 and implications for 2011 and beyond

In our 2010 report we revealed that **Capital allocation** was the number one business risk facing mining and metals companies. The more uncertain economic environment at the time, combined with a number of other factors, like volatility of prices, limited cash flow and availability of debt capital, all made the decisions on how to allocate capital in 2010 more complex than ever.

One year on and our analysis shows that while Capital allocation still remains a significant business risk, it is more for the reason of returns matching risk appetites. As a result, its position as number one in our top business risks list has been overtaken by the increasing threat posed by Resource nationalism. In 2011 **Resource nationalism** has become the number one risk for mining and metals companies as governments globally continue to make demands in order to increase their slice of the profit pie.

Interestingly, **Climate change**, which was deemed number 10 on the list last year, is now no longer on the radar possibly due to increased confidence that any action that will impose real costs on mining and metals is still a long way off. By contrast, **Maintaining a Social licence to operate** does not appear to have been impacted much by change in either economic terms or priorities from clients. In our 2010 report it was ranked number five, and in 2011 and beyond it remains a significant risk, sitting at number four on the radar.

**Fraud and corruption**, which was just 'off the radar' last year (ranked number 14), has now moved up to number 10 on our list given recent regulatory developments, while **Interruptions to supply** is new to the top 10 this year.

### Identifying the top 10 business risks of 2011-2012

#### 01 Resource nationalism

Resource nationalism is the biggest risk in 2011 and 2012. Because the mining and metals sector rebounded quickly from the global financial crisis, it became an early target to help restore treasury conditions. In a number of producer nations, concerns over 'Dutch disease' or two speed economies have led to plans to tax mining more heavily, and provide tax relief to other sectors.

From the outset of 2011 we have seen numerous countries changing their fiscal environment (taxes, royalties), and some have invoked 'use it or lose it' clauses. Governments worldwide have also been looking to increase local participation in projects and we think that this trend will only increase. South Africa's new royalty regime came into effect on 1 March 2011, Ghana plans to double royalties on mining to increase government revenues, and the Australian Government's proposed Minerals Resource Rent Tax is still on track with its draft legislation.

#### 02 Skills shortage

Skills shortage, which was number two in our list for 2010, remains the second biggest business risk for mining and metals this year and next. Indeed, we believe it may become a bigger risk in both developed and developing countries as we move into 2012.

At the moment the mining and metals sector is utilizing staff from other sectors where upturn is yet to happen, but this is a short-term approach only. There's the demographic challenge to consider as large numbers of near-retirement age workers in developed countries have left the sector while others have been made redundant due to the global financial crisis.

According to the report 'Skills Australia', the Australian minerals industry alone will need an additional 86,000 workers over the next 10 years just to maintain its current international market share<sup>1</sup>. This phenomenon is not limited to Australia, with skills shortages apparent in South Africa, Canada and South America. Projects are being cancelled or deferred due to the inability to staff up construction and operations. The tight labor markets also provide an environment for greater industrial disputes as organized labor seek to increase wages.

<sup>1</sup>Mining to need 86,000 extra workers', *Business Day*, 27 July 2008

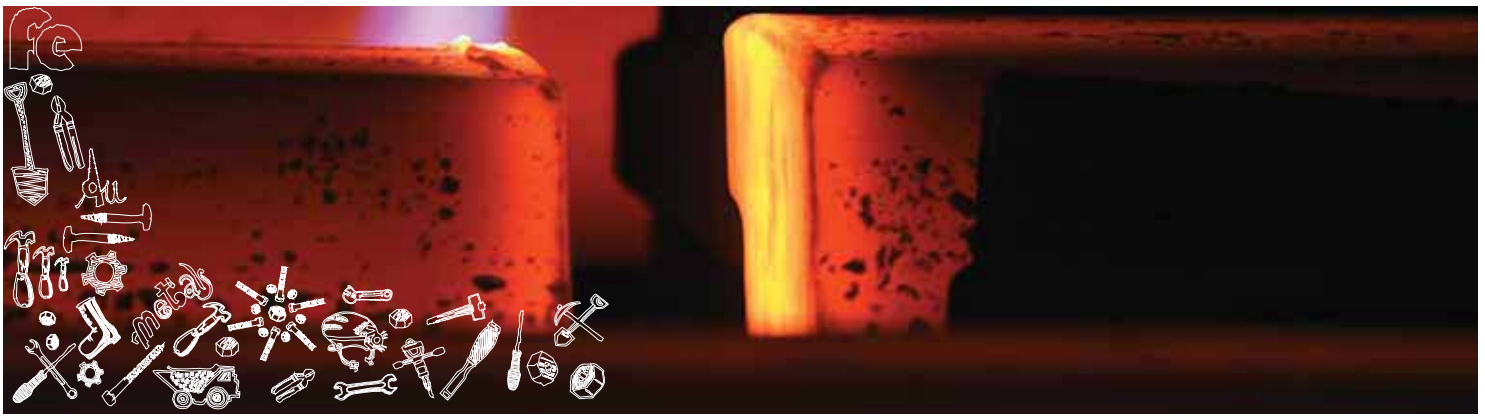
#### 03 Infrastructure access

Infrastructure access has become more of an issue of risk in the last year, mainly because the lack of available infrastructure means that production cannot get to the markets where the demand is. In fact Sinosteel has terminated its West Australian iron ore project due to delays in infrastructure. A lack of sufficient rail networks appears to be the largest global bottleneck. Some current and well-known rail bottlenecks include Australia's Queensland coal rail development, China's third coal rail development and Russia's aging rail network. Recent innovation in financing infrastructure, such as greater use of take-or-pay contracts, has enabled additional investment in critical infrastructure by current infrastructure owners. However, if the sector is to meet the expected supply challenges for the expected growth in demand from the rapidly developing economies, greater innovation is required to bring together producers, customers, infrastructure, operators, financiers and governments.

#### 04 Maintaining a social licence to operate

In our 2010 report, the issue of maintaining a social licence to operate rated number 5 and it has become a more significant risk in the 2011-2012 top 10 list. There are a number of issues that can affect a company's social licence to operate and here are just a few examples:

- ▶ **Environmental performance** – Difficulties can arise in relation to the environmental impacts of new and existing mining and metals operations. Issues such as the impact on bio-diversity, water extraction, water pollution, air emissions, soil contamination and waste management are often a point of concern for local communities and regulators.
- ▶ **Risk to reputation caused by safety incidents** – Failure to ensure that safety incidents do not occur can have a negative impact on company reputation. For instance, Massey Energy is currently facing accusations by mine worker unions that it traded safety for profit. This was in light of the accident at its coal mine in April 2010 which resulted in the death of 29 workers.
- ▶ **Land disputes** – Obtaining a social licence to operate can sometimes be difficult when land disputes arise between mining and metals companies and local communities. Such disputes can delay or even prevent projects from proceeding.



## 05 Capital project execution

Capital project execution, which was not deemed a major risk a year ago, now sits in the middle of our list of top ten risks in 2011 and beyond. As the global economy has continued to recover, a large number of new mining projects, expansions and restarts have been virtually simultaneously announced. The projects are often calling on the same resources to be developed. Upstream metals and mining projects comprise a significant percentage of company spend and require particular focus on budgets, schedules and execution. These issues alone, if managed poorly, can be the cause of dramatic losses in project value.

As a consequence, tight management and execution of major capital project plans in today's mining and metals landscape of a scarcity of inputs has become more imperative than ever. Addressing risks surrounding the construction of mining projects is also critical and many miners have seen cost escalations that have forced them to defer, cancel or suffer the costs of project delays &/or overruns. Some examples of this are the Ambatovy nickel project in Madagascar where costs were estimated to have risen from US\$3.3b to US\$4.5b, and the Karara iron ore project where costs increased by 20% due to cost escalations and scope.

## 06 Price and currency volatility

Price and currency volatility was rated number 9 in our top 10 in 2010, but in 2011 and beyond we see that this risk has grown in importance to many mining and metals companies. Companies' operating costs are often not in their functional currency, and therefore volatility in foreign exchange prices can put extreme pressure on them. Exchange-traded funds (ETFs) in the market add a new dimension to commodity price volatility beyond pure supply/demand factors as evidenced by disconnect of price to inventory. For example, in periods of risk aversion and dollar strength, gold prices can still rally in response to inflows into physically backed gold ETFs. When commodity prices fall, investors may offload ETFs which could then flood the market and cause prices to plummet even further. How companies conduct their business in such a volatile environment will be a great differentiator of success.

## 07 Capital allocation

Despite the industry being in a strengthened position in 2011, the capital allocation challenge remains a big issue for many companies. External risks need to replace depleting reserves, and narrowing growth opportunities make the decision of how and when to allocate capital extremely complex.

Indeed, our 2010 "Governing not grinding" report (audit committee survey) highlighted the importance of ongoing assessment of risks, accepted rates of return and impact on capital allocation decisions. It revealed that numerous major projects were delayed or divested where the level of risk and rate of return appeared misaligned, and that hedging strategies were being re-considered by many. It also confirmed that capital was being diverted into vertical integration to mitigate price risk; into value-add product ranges to minimize margin impact; and into geographical diversification to mitigate political risk. Some shareholders, who don't perceive there has been an adequate return on investment for the risks being undertaken, are demanding surplus cash be returned to them.

## 08 Cost management

Cost management is still a great area of concern. This is largely due to the fact that operating costs are on the rise partly due to a scarcity of key inputs, labor, capital equipment and energy. Mining consumables are tied to the price of oil and steel, both of which are expected to increase as world economy improves. Similarly, transportation costs are increasing while sector specific costs are increasing at a greater rate than normal inflation.

## 09 Interruptions to supply

The risk of interruptions to supply joins our top 10 this year, largely due to the spate of natural and environmental disasters that have taken place globally over the last 12 months. All of these disasters have highlighted the risk of a major catastrophe to global supply, as well as the potential knock-on effects. Understanding and preparing for the occurrence of catastrophic risk is both challenging and essential. The consequences extend beyond individual projects, right along the supply chain, with wider-reaching implications for prices, future supply and investment decisions. For instance, the 2011 floods in Queensland have resulted in US\$2.3b of lost sales and a 25-50% reduction in production. Key infrastructure was also seriously impacted, with ports not receiving coal supplies for shipment, which in turn led to critical depletion of stockpiles. Planning for the risk of interruptions to supply, and the ongoing evaluation of management's ability to respond to and recover from this risk, has never been more vital.

## 10 Fraud and corruption

Fraud and corruption is new to the radar in 2011 and beyond. It makes this list because of the increased political risk we've observed in a number of key mining and metals companies' investment destinations and a change in the regulatory environment. For those companies that have chosen to grow, we've seen there was a propensity for them to take on greater political risk. In 2010 and into 2011 we saw more companies venturing back into riskier regions, such as West Africa, South America, and Asia – specifically Papua New Guinea and Mongolia. This expansion into emerging and frontier markets also created a greater focus on sovereign risk, notably security of tenure and changes in mining, tax and royalty regimes. This, alongside new fraud and corruption regulations, heightens the need for increased focus in this space, particularly as the consequences can be severe.

## Ernst & Young's Global Mining & Metals Center

With a strong outlook in the sector, the global mining and metals industry is focused on future growth through expanded production, without losing sight of operational efficiency and cost optimization. The sector is also faced with the increased challenge of changing expectations in the maintenance of its social license to operate and meeting government revenue expectations.

Ernst & Young's Global Mining & Metals Center brings together a worldwide team of professionals to help you achieve your potential – a team with deep technical experience in providing assurance, tax, transactions and advisory services to the mining and metals sector.

The Center is where people and ideas come together to help mining and metals companies meet the issues of today and anticipate those of tomorrow. Ultimately it enables us to help you meet your goals and compete more effectively. It's how Ernst & Young makes a difference.

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