

Yukon Mineral Royalties

Perspective developed by the Yukon Conservation Society

What is a royalty?

A royalty is a fiscal instrument designed to pay the owner of a non-renewable resource, such as minerals, gems, oil and gas when that owner allows an individual or company to remove that resource from the land and sell it for profit. Royalties are often described as “resource rent”. They may be payable to government or to a private lease-holder. In this paper, we will only discuss royalties for minerals and diamonds payable to government.

The minerals industry is opposed to mining royalties, and says that they are “regressive tax instruments, which can contribute to inefficient resource exploitation and premature mine closures”¹. A World Bank Study, paid for by BHP Billiton presents the industry point of view most succinctly.

However, mining is a non-sustainable activity which depletes the mineral wealth of a jurisdiction and therefore depletes the wealth available to future generations. Experience in Yukon suggests that it very often leaves behind a legacy of contamination that must be managed forever. A royalty is a payment to the landowner, most often government as trustee for the people, for the privilege of extracting resources from public lands.—It does not replace the need for reclamation security to clean up or remediate damage done by mining.

How do royalties work?

There are three generic ways in which the amount of the royalty is determined: the “net smelter return”, the “net profits interest”, or a “gross over-riding royalty” or GORR. These are described below.²

The GORR started in the oil and gas industry, is occasionally used for diamonds, gravel and quarrying, but almost never for minerals. This is also referred to as a “Unit-Based Royalty”. In the Over Riding Royalty, the owner of the resource is entitled to a share of the substance produced, less the costs of getting the substance to the point of sale. It does not work very well if the product produced has to be substantially changed before it is saleable. For example, it might work for oil or quarried rock or for Placer gold (see note following) which is sold as is, but not for a hard rock mineral that must be milled, processed and smelted.

¹ Otta, James, Craig Andrews, et al. Mining Royalties: A Global Study of their Impacts on Investors, Governments and Civil Society, World Bank Publications, Washington DC, 2008

² Baldwin, Christopher G. Understanding royalty structures, Lawson Lundell, Vancouver , 2003

The Net Smelter Return Royalty is calculated “on the amount received by the mine or mill owner from the sale of the mineral product to the treatment plant that converts the output of the mill to marketable metal. From the gross proceeds received there may be deductions for costs incurred by the owner after the product leaves the mine property and before sale, such as the costs of transportation, insurance or security, penalties, sampling and assaying, refining and smelting and marketing. *No deductions are made for the operating costs of the mine-mill complex*”.³ (Italics ours)

The Net Smelter Return Royalty is most often seen in private agreements between mining companies, and agreements with some First Nations. In the case of a public (Government) royalty, the calculation would not depend on the mine owner making a profit but instead would acknowledge that part of the value of the product of the mine should go to the owner (the public) for allowing the mining company to exploit it whether or not a profit is made.

Royalties on Net Profits are described by Barton as follows: “a net profits interest ... is ... calculated as a percentage of gross cash income from a mine-mill complex less all expenses incurred to produce the income” (at page 462). “Typically, the NPI does not become payable until the operator has recouped, from net profits, its capital investment and all pre-production costs.”⁴

The NPI is the most common form of royalty collected by governments in Canada, and is, essentially, based on the company’s ability to pay.

Current Royalty Regime in the Yukon⁵

The Yukon is the only territory with devolution and resource sharing agreements with Canada. The agreements were completed during 2001, with the CYFN representing 11 of the 14 Yukon First Nations, and representatives of the three non-CYFN nations, at the table.

The Agreement provided that the Yukon Government would collect all royalties, rents and fees for resources on public lands. Responsibility for contaminated mine sites falls to either the federal or Yukon government, depending on when they were licensed and created, etc.

Royalties in the Yukon are set out in the Quartz Mining Act (QMA), enacted in 2003. Section 102 of the QMA specifies an annual royalty payable to the Yukon Commissioner on mining profits. There is also a royalty regime under the Yukon Placer Mining Act. (See note below)

³ Barton, Canadian law of Mining (Calgary: Insitute of Resrouces Lw, 1993 at 461, quoted in Baldwin.

⁴ Baldwin

⁵ Royalties- Energy, Mines and Resources- Government of the Yukon, at http://www.emr.gov.yk.ca/mining/royalty_narrative.html

The Quartz Mining Act

The Yukon considers the royalty to be “a share of the profits from a mine in the Yukon ...reserved for the Yukon government as owner of the mineral rights, for permitting extraction of mineral resources. It is paid by a mine owner or operator to the Yukon government. It is not a tax.”

An individual or corporation with mining production in the Yukon files a “consolidated” royalty return for all its mining activity in the Yukon. That is, net profits from multiple mining operations can be combined in a single royalty return. If a mine is combined with an exploration venture or a mine in development, then there would usually be a loss, not a profit. The regime could penalize a company with more than one profitable operating mine in the Yukon, as the profits (if any) would be combined which could lead to a higher rate of royalty (see table below).

The royalty is payable annually on an escalating rate basis for any profits from mining that exceed \$10,000. For a company with \$8 million in profit, the calculation would be:

	Net profits	Rate	Royalty
On the first	\$10,000	0%	\$0
On the next	\$990,000	3%	\$29,750
On the next	\$4million	5%	\$200,000
On the next	\$3 million	6%	\$180,000
Total	\$8million		\$409,700

The Act provides for a “on the excess above \$10 million, a proportional increase of 1% for each additional \$5 million.”⁶ This open-ended provision could lead to a ridiculously high rate for a large and extremely profitable company – a profit of \$480 million would lead to a charge of 100% royalty.

However, for the purposes of the royalty, profit is the amount by which the revenues exceed eligible deductions. In practice, allowable deductions are such that companies rarely show any profit at all. Even if one mine is profitable, the company can deduct its losses from exploration and development at any other operations it has in the Yukon.⁷

It is important to note that the definition of “profit” for the Quartz Mining Act royalty is not the same as the definition of “profit” for corporate income tax purposes.

Currently, allowable deductions under the QMA are:

- Transportation of product to the point of sale
- Actual and proper working expenses of the mine
- Cost of supplying light, power and transportation used in the mining operation
- Cost of food and provisions for employees

⁶ Quartz Mining Act, Section 102, Paragraph 1.

⁷ http://www.emr.gov.yk.ca/mining/determination_of_deduction.html

- Cost of supplies consumed in the mining operations
- Cost of securing the mine and mineral plant
- Cost of insurance of the product, mining plant and equipment
- Depreciation allowance for plant, machinery, equipment and buildings
- Cost of development works in the year, at the minesite and elsewhere in the Yukon
- Exploration and development expenses for mines in the Yukon, in the year in which they are incurred;
- Corporate income taxes payable on the profit of the mine in the Yukon

Costs not directly related to the mine operation are excluded, such as general corporate costs, promotion and payments to a community not related to carrying out of operations. Also costs are to be net of any subsidies, tax credits and cost recoveries. Neither can the operator deduct capital costs.

The inability to deduct capital costs pooled over time is a major concern of the new royalty proposal from the Yukon Government and will be addressed below.

How the revenues are currently calculated for royalty purposes.⁸

The Yukon regime focuses on the market value of the output from the mine. The earliest point at which mine output is sold is typically after processing into mineral concentrate. The company is required to report the quantity, weight and other particulars of material removed from the mine. Generally gross receipts from sales of concentrates are used as a base to work out the revenues. A “pit mouth” evaluation of the ore is obtained by allowing the mine operator to deduct operating costs of the processing and *amortized capital costs for any processing assets (e.g., the mill), the “treatment charge”*. The mine output is considered revenue for the royalty, even if it is stockpiled. Hedging gains and losses are excluded from revenues, but advance sales are not. The process by which the “treatment charge” is calculated in the Yukon is not transparent or easily understood.

Yukon First Nations and Royalties

In areas of the Yukon where a Yukon First Nation has settled a land claim, there may also be lands with mineral title held by the First Nation, and some of these are subject to mineral claims held by third parties (mining companies). Chapter 23 of the Umbrella Final Agreement (UFA) deals with the sharing of resource royalties.

As part of the negotiated final agreements, the Yukon government continues to administer mineral claims on settlement land through the encumbering rights provisions. In this case, permitting, licensing and the collection of royalties continue with the Yukon government. Royalties paid on Category A settlement lands flow to the respective First Nation.

⁸ http://www.emr.gov.yk.ca/mining/determination_of_revenue.html

Chapter 23 provides that Yukon First Nations receive 50% of the first two million dollars of any amount by which Yukon government royalties exceed Yukon First Nations royalties, after which the First Nation share is 10%. These amounts are prorated among Yukon First Nations on the same basis as financial compensation paid pursuant to Chapter 19.

The only First Nation in the Yukon with an operating hard rock mine on their traditional territory currently is Selkirk First Nation, with the Minto Mine. The Minto Mine shipped its first concentrates on October 25, 2007, and has been stockpiling concentrates at Skagway for shipping and at the mine site during freeze up.

Selkirk First Nation has a 0.5% net smelter return (NSR) royalty agreement with the mine.⁹ The SFN agreement is not based on profit but on the amount received by the company when the concentrates are sold, net of costs to get the product to the market.

If, and when, Sherwood Copper has to start paying royalties under the QMA, the Yukon Government will collect those royalties and remit them to Selkirk First Nation. Those amounts will be considered First Nation Royalties for the purpose of Chapter 23 royalty sharing; i.e., for determining to what extent, if any, Yukon government royalties exceed Yukon First Nation royalties. Under the current regime, the mine will not pay YTG royalties for some time, as they still have substantial exploration and development expenses every year.

Current Debates about Royalties

What emerges as indisputable is the principle that it is just and necessary for the State, as owner of the minerals, to impose a charge or compensatory fee for these non-renewable and scarce resources”.¹⁰

Mining royalties are a politically hot issue in many parts of the world these days, and they have recently ignited huge debates in the United States, Alberta, Peru, Tanzania, Ghana, Colombia, South Africa and Chile, among other places.

Although the demand for change in the Yukon is coming from the mining industry, in other parts of the world the demands are coming from communities, indigenous organizations, and development and environmental NGOs. Industry demands can be summed up as “pay as little royalty as possible with greater access to mineral resources”. Challenges to the royalty system from other sectors are more complex.

In essence, the challenges from these other perspectives are:

⁹ Sherwood Copper Company, Management Discussion and analysis, September 2007, page 4.

¹⁰ Mining Policy Research Initiative. Mining Royalties, International Development Research Centre, 2004

- Can a royalty system be used to compensate future generations for the depletion of mineral resources?
- Can a royalty system be used to fairly distribute the benefits of mineral production?
- Which royalty structure makes the best contribution to sustainable economic development?
- How do royalties fit within the broader system of tax and financial incentives to the mining industry?
- How can affected publics maximize their financial return from mining?

Can a royalty system be used to compensate future generations for the depletion of their mineral resources?

“Non-renewable resources cannot be replaced. Once extracted, they are gone forever. The principle of intergenerational equity adheres to the notion that future generations should share in the resource endowments benefiting current generations.”¹¹

The Northern Policy Forum sponsored by the Walter and Duncan Gordon Foundation in 2007 was entitled: “Power, Revenue and Benefits - Ensuring Fairness Now and Across Generations”.¹² The Forum brought together a number of leaders from across the territories to look at issues like royalties. It also published a number of important background papers and case studies addressing the issues.

In this context it is important to recognize that mineral depletion is a serious and on-going concern. At the Mines Ministers meeting in Whitehorse in 2006, the Mining Association of Canada stated:

”Canadian mineral reserve levels are declining, and have been declining for over two decades. Copper reserves have declined from 17 million tonnes in 1980 to less than 6 million tonnes at present. Zinc reserves have fallen from 28 million tonnes to 5 million tonnes, while silver and lead reserves have shown similar 80% declines during this quarter-century period. Gold reserves increased in the 1980s, reaching a new peak in 1996, but have since dropped by 40 percent and have now returned to the lower levels experienced in the early 1980s. At current rates of production, Canada has 5.5 years of lead reserves remaining, seven years of zinc, 10.5 years of copper, and 15 years of gold and 21 years of nickel reserves.”¹³

In a study published on January 17, 2006 in the *Proceedings of the National Academy of Sciences*, Yale University researchers said that their findings had determined that supplies of copper, zinc and other metals cannot meet the needs

¹¹ Irlbacher-Fox, page 14

¹² <http://www.gordonfn.org/northernpolicyforum.cfm>

¹³ Mining Association of Canada presentation to Mines Ministers Conference, Whitehorse, August 2006.

of the global population forever, even with the full extraction of metals from the Earth's crust and extensive recycling programs, and that depletion will be an immediate problem for some precious metals like platinum.¹⁴

The Canadian mining industry approaches this problem by asking for more support to the exploration industry, so that more reserves will be discovered and, in turn, depleted. Without policies and incentives to protect any remaining reserves from immediate and total pillage, future generations are likely to find themselves with no metals left to mine at all. Even the Yukon Government recognizes this problem:

”In modern mining, the easily accessible mineral deposits have for the most part, been found and worked out. Currently, exploration for mineral deposits is a time-consuming and expensive process, requiring specialized equipment. Once an ore body is located, an operator will typically have to remove lots of non-ore (i.e., waste rock and other material) to expose the valuable minerals, either open pit or underground.”¹⁵

If a royalty scheme is to protect future generations, for whom there will be no valuable mineral deposits, or very limited deposits, then the scheme has to provide incentives to conserve, reuse and recycle minerals, as opposed to mining them in the short-term. And where minerals are to be mined, it has to ensure that the royalties charged provide revenues for future generations. This is true whether the royalty is collected by federal, provincial or Aboriginal governments.

Intergenerational equity: How the funds are managed.

How the money from revenue sharing is managed by the recipient is just as, or even more important to issues of fairness and intergenerational equity, than the source of the money. Ciaran O’Faircheallaigh¹⁶, an Australian academic, has undertaken an exhaustive study of the management of these funds by indigenous peoples.

The Inuvialuit Government has enshrined the concept of intergenerational equity in the Inuvialuit Final Agreement, section 6.4

“Restrictions shall be placed on the Inuvialuit Regional Corporation from time to time on any financial distribution from the Inuvialuit corporations to encourage the preservation of the financial compensation for the future generations of Inuvialuit”.¹⁷

¹⁴ National Science Foundation <http://www.physorg.com/printnews.php?newsid=9971>

¹⁵ Quartz Mining Act Review: Mine Royalty Provisions, page 13

¹⁶ http://www.griffith.edu.au/school/gbs/ppp/staff/ciaran_ofaircheallaigh.html

¹⁷ Irlbacher-Fox, page 15

The Vuntut Gwichin First Nation of Old Crow, Yukon, has established an investment trust for most of its land claim capital that has protected the funds from short-sighted expenditures.

“This arrangement has allowed for substantial capital growth and yet provides funding to support language, culture, education of youth and elders initiatives.”¹⁸

Another model is to be found in Norway. When oil and gas development took off in Norway in 1969, the government was very concerned with protecting the country’s economy from boom and bust cycles in the industry, with protecting themselves from the inflationary pressures of the oil boom, and with ensuring that the revenues would be available for future generations. A study undertaken for the Northern Policy Forum by Ole Gunnar Austvik, found the following:

In Norway, private companies are taxed at a marginal rate of 78% of profit (economic rent), taking the position that from a state point of view, companies should be given only the profit they need to do the job...the government also looked at the 22% left and questioned whether this should be ‘given away’ ... This the government itself made huge investments in production...and became an active participant through the state oil company, Statoil...¹⁹

Royalties as such are being phased out. Proceeds from the tax are placed in a Permanent Pension Fund, established in 1990. The fund now stands at \$400 billion and is growing at \$50 billion a year. 60% of the shares of the Fund are placed in ethically screened investments, some in environmentally –friendly businesses, and some in real estate. 4% is used to balance the federal budget, and the national debt has been completely eliminated.²⁰

Can a royalty system be used to fairly distribute the benefits of mineral production?

Many First Nations in the North as well as in the provinces have been asking for “revenue sharing” based on a percentage of the royalty collected by government.

“In the NWT, Comprehensive Land Claim Settlements with the Gwich'in, the Sahtu Dene and Metis and the Inuit of the Nunavut Settlement Area provide for these Aboriginal groups to receive a share of the resource royalties, including those from mining, from Crown Land in the N.W.T. The Gwich'in and the Sahtu Dene and Metis each receive 7.5% of the first \$2 million and 1.5% of any additional amounts of resource royalties from the Mackenzie Valley Claim Area. The Inuit of the Nunavut Settlement Area receive 50% of the first \$2 million and 5% of any additional amounts of resource royalties from the Nunavut Settlement Area. Where DIAND collects royalty on a mineral right under the Canada Mining Regulations which is located on Aboriginal owned subsurface, the Crown

¹⁸ Irlbacher-Fox, page 15

¹⁹ Austvik, Ole Gunnar. Reflections on Permanent Funds: the Norwegian Pension Fund Experience, Northern Policy Forum, Walter and Duncan Gordon Foundation, 2007.

²⁰ Austvik, Ole Gunnar.

remits 100% of the royalty to the Aboriginal group owning the subsurface of the land”.²¹

Many more First Nations, like Selkirk First Nation, have negotiated their own royalty arrangements with the mining company. These vary considerably in their ability to provide a steady income, and – like the government royalty- are limited by the life of the mine on their territory.

A World Bank Study²² published in 2006 spends considerable copy on the issues of “fiscal decentralization”. “The sharing of revenues...may be dependent on the relative power of respective levels of governments. Although individual communities have relatively little power compared with the central government, they can exert a large effect on a mine, perhaps to the extent of preventing or closing it. Thus, local activism can lead, in some instances, to redistributing a unique tax such as royalty.”²³

Royalty is well-suited for distribution, as it is usually collected mine-by-mine. A number of countries distribute royalties.²⁴

- Mozambique distributes a percentage of taxes to local governments.
- Ghana and Namibia have Mineral Development Funds that distribute a percentage of mineral taxes for specific purposes. The Ghanaian MDF shares 20% of the revenues with local communities affected by mining, landowners and local governments. The Namibian MDF is more tied to promoting mining.
- In South Africa, the Mineral and Petroleum Resources Development Act gives local affected communities a “preferent right” to prospect, explore and develop a mine on their land.
- In Papua New Guinea, the Mining Act returns 20% (and in some cases up to 50%) of the royalty to landowners who have been affected.
- In Peru and Brazil, the royalty laws allow for distribution of the royalty to statutorily defined parties. Some of these are affected communities.
- In Argentina, the provinces own the mineral rights and levy the royalty. In some provinces like Catamarca, there are provisions to return a percentage of the royalty to affected communities.

The first problem with using a share of government royalties to distribute benefits is that most royalty regimes collect very little money from companies at all, as we discuss below.

Which royalty structure makes the best contribution to sustainable economic development?

²¹ http://www.ainc-inac.gc.ca/ps/nap/discpap/obj_e.html

²² Otto James, et al. Mining Royalties: A Global Study of Their Impacts on Investors, Government and Civil Society, The World Bank, 2006.

²³ Otto, page 200.

²⁴ Otto, pages 200-205

In most parts of the world, unlike Canada, royalties are not based on Net Profits but on the value of the minerals extracted, usually the Net Smelter Return, or “ad valorem” model.

A book written for the World Bank -“Mining Royalties” – in Table 3.4-3.8 ²⁵ compares the systems in place in many mineral-producing countries and states/provinces in Australia and North America. The systems vary widely. In Africa, Botswana, Mozambique, Ghana, Namibia, South Africa and Tanzania have royalty systems based on “sales revenues”. In Asia, countries that base their royalty on sales revenues include China, India, Indonesia, Mongolia and the Philippines. In Australia, the Northern Territory bases the royalty on profit, but other states do not. Most Latin America countries base their royalty on sales revenue, as do most US States.²⁶

The same book quotes the following from a study by Harries:

”The net profit royalty is complex and often difficult to understand or confirm, requiring a lot of information and the services of an accounting professional to calculate and confirm. It is open to abuse and often best avoided.”²⁷

The quote continues to say that the “recipient” must be willing to wait for return, because all the development and capital costs will be deducted before a profit is realized; that the risks of the venture will be shared equally by both royalty payor and recipient; and that there will be a risk that the project, even if it is brought into commercial production by a generous and equitable payor, may never see a ‘net profit’, in which event he will never see a royalty payment”.²⁸

The problems with the Net profit model can be seen in the NWT and Ontario.

The North West Territories

The Northwest Territories has the worst royalty regime in Canada from the public’s point of view (and probably the best from industry’s). The lack of return to the GNWT and to the local communities has been the subject of many discussions.

Since 1999, under the Canadian Mining Regulations, mineral royalties in the NWT have been assessed on a sliding scale varying from 5% of total production with output less than \$5 million to 14% of total production value of mines with outputs greater than that. Then, all costs are subtracted from the royalty payment including all operations and capital costs, all exploration expenses incurred anywhere in the NWT, and even the royalty payment itself. The effective royalty rate is, therefore, very low –less than 1% in

²⁵ Otto, pages 79-94

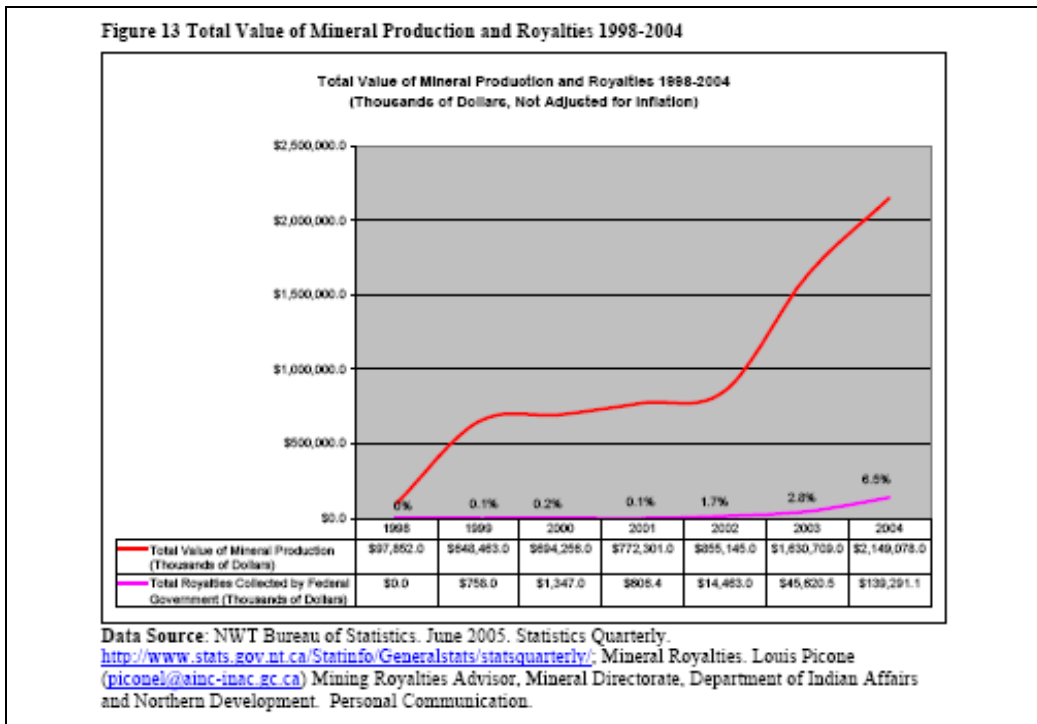
²⁶ Otto, pages 79-98

²⁷ Otto

²⁸ Otto James, et al. Mining Royalties: A Global Study of Their Impacts on Investors, Government and Civil Society, The World Bank, 2006.

2002 and only 6.5% in 2004, despite the burgeoning and wealthy diamond mines.²⁹ Total royalties collected by the federal government for resources in the NWT in 2006 were only \$270 million.

The NWT is negotiating with Canada to receive 50% of the royalties, with indigenous governments to receive up to 25% of the net benefit of the royalties.³⁰



A number of First Nations in the NWT have been able to negotiate their own IBAs for the Ekati, Diavik, Snap Lake and other mines. These Agreements have provided them with jobs and other economic benefits that exceed what they might have been able to earn from a percentage of the government royalty. However, these agreements are confidential, negotiated with great difficulty on a mine-by-mine basis, and are difficult to enforce once the mine is in operation.

Ontario

Although Ontario appears to have one of the highest royalty rates in the country, there are a number of factors that mitigate the rate. The rate is 10% of net profit in excess of \$500,000, with a deduction for processing in the province, of up to 65%. Allowable expenses in calculating “net profit” include: depreciation of mining assets of up to 30%;

²⁹ Cizek, Peter. Plundering the North for Hyper-Profits, Canadian Arctic Resources Committee, November 19, 2005

³⁰ Irlbacher-Fox, page 8

100% of income from the mine if this was earned before the mine was completed; 15% for processing and transportation assets; exploration and development costs are fully deductible and can be carried forward indefinitely. *All these factors combine to reduce the real royalty rate to about 4.9% or less.*³¹

There are also substantial tax holidays and benefits that further reduce the “Mining Tax” as it is called in Ontario, including a three year exemption for the first \$10 million of profits generated by a new mine or major expansion; a ten year tax holiday for new mines in “remote” areas.

Ontario has no revenue sharing arrangements with First Nations.

How do royalties fit within the broader system of tax and financial incentives to the mining industry?

Royalties are only one part of a broader system of taxation and public benefits that flow to and from mining projects and companies. Mining companies may be subject to corporate tax, capital tax, sales tax, import and export duties, withholding taxes, employment taxes and fees for various fees and licenses. Corporate income tax is based on profit, the ability to pay and allows deductions for capital costs, exploration and development expenses and operating costs.

In return, mining companies get access to land and minerals, water, energy and land for waste disposal, and the social systems that support their workers - for much less than their real value.

What public supports/subsidies exist for the mining industry in the Yukon?

In the Yukon, roads and power-lines are often paid for by the YTG. The cost of remediation of abandoned mines – estimated at \$265 million in 2002³² - is borne by federal and provincial taxpayers. There are also very specific programs from the YTG that subsidize mining and exploration: The Assay Coupon Program, the Fuel Tax Exemption, the Mining and Petroleum Research Group, The Yukon Mining Incentive Program (YMIP), and Yukon Mining Facilitators. Cost of the YMIP for 2007-8 was \$719, 850³³. Land, mineral, leases and royalties (for mining, agriculture and all other permits under the Ministry of Energy and Mines), only brought in \$178,000.

Programs that support infrastructure development for potential mines in the Yukon include the Yukon Industrial Support Policy³⁴, and the federal Resource Transportation

³¹ Fitzgerald, Liam. Provincial Mining Taxes and Other Developments, presentation at Fundamentals of Canadian Taxation, Insight Communications, Toronto, December 4, 2006.

³² DIAND Contaminated Sites program, April 2002, in Pembina Institute, Looking Beneath the Surface, page 84.

³³ YTG News Release #08-059, 31/03/2008

³⁴ <http://www.emr.gov.yk.ca/energy/coal.html>

Access Program, which provides assistance for the upgrading and development of new roads.

Under a deal signed in January 2007, Sherwood Copper's Minto Exploration will only have to pay \$7 million towards the construction of a \$31-million power line between Carmacks and Stewart Crossing, but no payments are due for four years after the mine starts production.³⁵ The Yukon Government also agreed to take back the diesel fuel tanks, once the mine is in operation. The mine is expected to employ 100 people for at least seven years. Although the power line will also supply electricity to Pelly Crossing, the subsidy represents a cost of \$240,000 per job at the mine.

Sherwood Copper's Financial Statements show an accumulated tax pool ("future income tax asset") of over \$6 million at September 30, 2007,³⁶ which can be used to write down any anticipated revenues now that the mine is in production. Since the company has made substantial use of flow through shares, they no longer can claim these exploration and development expenses.

The company also has a reclamation deposit of \$3,676, 530 with the YTG, which is expected to cover the costs of remediation when the mine site closes. It does not, of course, replace the mineral resource which has been taken away forever. Nor does it cover the costs of the socio-economic dislocation caused by the job loss. Although company agreement with the Selkirk First Nation provides for employment for Selkirk members, it is silent on what happens to them once the mine closes.

Response to specific proposals in the current Yukon Royalty Review.

The Quartz Mining Act Review: Mine Royalty Provisions, March 2008, has been undertaken to bring the Yukon hard-rock royalty regime in to line with other provinces and territories in Canada. The emphasis in the Review is clearly on competitiveness: that is, ensuring that the Yukon sets a low standard for royalties so that the royalty will not provide a disincentive for mining in the Yukon.

Although the current royalty regime is outdated and contains some ridiculous provisions as a result, it is stretching the matter considerably to argue that the royalty is the reason for the lack of mines in development. In the Fraser Institute Report on Mining for 2007-

³⁵ Sparks fly over proposed Yukon power deal, CBC, January 22, 2007

³⁶ Sherwood Copper Corporation, Interim Consolidated Financial Statements, September 30, 2007

2008³⁷, the Yukon scored fifth in the world for its composite policy and mineral potential, behind Quebec, Nevada, Chile and Manitoba. It was in fifth place in the world for its taxation regime. The only provinces ahead of it were Quebec and New Brunswick, making it third in Canada. According to the senior mining company executives interviewed for the study, Yukon is a very desirable place to do business.

It is hard to imagine how the regime could be made “more competitive”.

Of much greater concern to Yukoners, should be the legacy that mining has brought to the territory, and the urgent need to develop an “intergenerationally equitable” economic basis that is not dependent on the depletion of resources. Previous mining activity has not enriched the Yukon over the long-term, but has in fact, impoverished it.

The Review identifies four main concerns with the royalty regime:

- Competitiveness – the effective rate of royalty is too high
- Modernization – the act was written in 1922, the QMA allows for consolidated filing of royalty returns
- Allowed deductions do not reflect current industry standards and practices
- Responsiveness: the inclusion of royalty provisions in the QMA contributes to difficulty of review and revision.

The proposals put forward to solve these problems are:

- Cap the maximum incremental royalty rate
- Make the royalty the responsibility of each individual mine
- Eliminate the deductibility of income taxes from the royalty calculation
- Update the terms for deductibility of capital costs.
- Allow the deduction of pre-production exploration and mine development costs.
- Allow the deductibility of contributions that companies make to community infrastructure or economic development
- Shift amendments to royalty provisions from the Act to regulations

Addressing these proposals in order:

Competitiveness.

³⁷ Fraser Institute Annual Survey of Mining Companies 2007-8.
http://www.fraserinstitute.org/Commerce.Web/product_files/SurveyofMiningCompanies20072008.pdf

Since 1997, The Fraser Institute has conducted an annual survey of metal mining and exploration companies to assess how mineral endowments and public policy factors such as taxation and regulation affect exploration investment. Survey results represent the opinions of executives and exploration managers in mining and mining consulting companies operating around the world. The survey now includes data on 68 jurisdictions around the world, on every continent except Antarctica, including sub-national jurisdictions in Canada, Australia, and the United States. This year, Honduras, Namibia, and Panama were added to the survey.

1. *Cap the maximum incremental royalty rate.* There is no doubt that the uncapped escalating royalty rate leads to a ridiculous level of royalty For large mines (it can be up to 100% of profit). This change is long over due. However, it is also ridiculous to imply that this is the reason why there are no large scale mines operating or even near operation in the Yukon³⁸

It is proposed that the rate be capped at a level comparable to the “average effective royalty rate in the other mining regions of Canada”. This average is obtained by reference only to the statutory rates from these jurisdictions, and does not address how the rates work in practice. For example, the Ontario rate is shown as 10%, not 4.9% (see above).

The same problem exists with the tables that show a comparison of combined corporate income taxes and royalties, as effective tax rates vary greatly from statutory tax rates.

It does not make sense for the Yukon to lead a race to the bottom for the lowest effective royalty, when the territory should be concerned with protecting its already depleted mineral reserves for future generations. The only operating mine in the Yukon is Minto, which has already been subsidized so heavily that the Yukon will never recoup what it has invested, either in corporate taxes or royalties. The other mines on the horizon – Carmacks Copper and Wolverine - are so marginal that they will be unlikely to pay taxes for many years, if at all. Advanced exploration projects do not pay royalties or corporate income tax.

Recommendation: YCS supports this change with the following comment:

The existing provision of the QMA makes no sense. Capping the escalating rate is logical but doing so on a Net Profit Interest system changes very little as the chances of existing or proposed mines reaching profit levels that would generate royalties is very remote. Rather a Net Smelter Return system or a combination of Net Smelter and Net Profit could be developed including a reasonable cap that would generate royalties to acknowledge the public ownership of mineral resources at lower levels when profit is not generated and increases as profits become available.

Modernization.

2. *End consolidated reporting for mines in the Yukon.* Currently, the QMA requires a mining company to report on all its operations in the Yukon on one return, and the royalty is determined based on profit from all these operations. This allows a company to deduct its exploration expenses no matter where they are carried out in the Yukon in the current year from its production revenues from its mines. It is proposed to end this system and require reporting on an individual mine by mine basis. It is also proposed that:

³⁸ QMA Review, page 8.

- a. Where a mine has revenue from Category A and public lands, it categorize its production, revenues and costs with respect to each land category.

Recommendation: YCS supports these changes with the following comment:

These changes make sense as they will simplify reporting and not allow companies to deduct exploration from elsewhere against the revenues from the mine. It will also make clear which lands are generating royalties and who they belong to.

3. *Stop allowing the deduction of Income Tax in determining the profit for royalty purposes.* Currently there is a problem with a circular accounting practice, since royalties can be deducted from income tax calculations

Recommendation: YCS supports this change with the following comment:

This change makes sense but would be more effective if applied to a combination Net Smelter and Net Profit system as described above. It will mean more royalties early on in mine life, and it simplifies the calculation

4. *Include provisions for depreciation allowance based on amortizing the original capital costs of physical plant and equipment exceeding \$10,000, at a maximum annual rate of 15% to a total of 10-0% of the capital costs.* Some provinces and territories allow deductions of capital costs at an accelerated 100% rate, with full carry-forward. Other provinces use a depreciation rate of 15-30%. **This is a substantial change in the regime**, as the current royalty does not allow the deduction of capital costs. It will probably result in the profit being zero for most of the life of short-term mines. Capital costs for the Minto Mine are close to \$154 million by September 2007³⁹.

Recommendation: YCS can not support this change.

This change, when based on a Net Profit system, only goes further toward ensuring that no royalties will be forthcoming. The Yukon royalty regime should be based, not on the company's ability to pay, but on a Net Smelter Return or a combination Net Smelter supplemented by a royalty on profits when they occur. Such a system would be more effectively a rent for the resource being extracted. Depreciation is an allowable expense for both federal and Yukon corporate taxes, so it is already recognized within the overall tax regime.

Further, in the calculation of royalty currently, it appears that amortized capital costs for the mill can be deducted from revenues as part of the profit calculation. This again reduces the chances of any royalties being generated. **This should not be allowed.**

³⁹ Sherwood Copper, Interim Consolidated Financial Statements, September 2007 , note 6.

5. Allow the deduction of pre-production exploration and mine development costs. This change is recommended by the YTG on the basis that mining exploration has become more time-consuming and expensive. Similarly to the provision for capital costs, the carry forward of exploration and development expenses into the profit calculation will probably reduce the royalty amount payable to zero. **It is a substantial change in the regime.** Exploration and development expenses can be claimed in the calculation of federal and territorial corporate tax, and so are already recognized in the overall tax regime.

Recommendation: YCS does not support this change.

The Yukon royalty regime should be based, not on the company's ability to pay, but on a Net Smelter Return, or combination of Net Smelter supplemented by a further royalty on profits if and when they occur. This would be more effectively a rent for the resource being extracted. The company has already been able to use a portion of its exploration and pre-production expenses to raise capital from investors through the flow-through share program, and is able to deduct these expenses from corporate income tax.

6. Allow the deductibility of contributions or payments that companies make to community infrastructure or economic development that is negotiated or agreed to between the company and First nation governments or community organizations (whether municipal, hamlet or registered organization). An enormous investment is made by First Nations, civil society and the Yukon government in geological mapping, administration of mining, the subsidizing of mine infrastructure, environmental assessment processes and the healing of the social and economic dislocation causes by mining. Until this huge social, cultural and ecological cost is recouped, this proposal is insulting. It is also unlikely to do anything (considering how low the royalty rates are and will be) to stimulate more investment by mining companies in the community. Companies are currently allowed to deduct charitable donations from their corporate income tax. This proposal is NOT a proposal to institutionalize sharing royalties with First Nations; that is already in the UFA.

Recommendation: YCS cannot support this proposal.

Further, any subsidies and infrastructure contributions received by the mine from YTG should be deducted from the costs claimed by the mine in the calculation of royalties or in the alternative; any infrastructure assistance granted to the mine should be in the form of secured loans.

Responsiveness

7. *Establish royalty provisions as a regulation, not part of the QMA.* This would bring the regime inline with Alberta, Saskatchewan, Newfoundland and

federal regimes in the NWT and Nunavut. It will make it easier for the YTG to change the rates and policies in the regime.

Recommendation: YCS makes the following comment:

This proposal must be considered in light of the requirement for “certainty” both for the industry and for the public as owners of the resources. If a system based on Net Smelter Return or with Net Smelter Return royalties supplemented by royalties on net profit once they begin to be generated were included in the Act, then the details of application of the system could be captured in regulation as long as complete public consultation was required when regulations came up for development or change.

Conclusions.

Royalty is not a tax, but a payment to the Governments (First Nations and Yukon) for the extraction of a non-renewable and scarce resource, and should not be based on the company’s ability to pay, but on a real estimate of the social, ecological and economic value of the minerals extracted to both present and future generations. The Net Smelter Return formula comes closest to doing this in mainstream royalty agreements. It is the formula that mining companies rely on when they are negotiating with each other.

Should the public do business in a less business like manner?

History shows that there are few instances of mines declaring a “profit” in Yukon. This does not mean that mine owners and shareholders walk away without considerable benefits. The Yukon government does not have a responsibility to take care of company profits; its responsibility is to protect the lands and waters and the long-term interests of Yukoners and to make certain the ownership of resources by the public is substantively and substantially acknowledged.

It is important that a new royalty regime enshrine the right to an “interest in land”, however the royalty agreement has also to ensure that the royalty payer – the mining company – retains responsibility for proper closure and clean up in the event that the company walks and the royalty is not paid.⁴⁰


A Further Consideration

As pointed out above, the extraction and export of mineral resources removes them from our patrimony for succeeding generations. Many jurisdictions are now acknowledging this by setting up endowment type funds for the future, utilizing returns from royalty regimes or resource rent programmes. In the context of the present move to modernize the regime here in Yukon very serious consideration should be given to setting up an endowment like fund into which all the Yukon Government’s share of royalties are placed. This would ensure that the public would have a clear indication of what royalties are being generated, would know what they are to be used for, and would provide for future generations a means to transition when these resources are no longer available.

⁴⁰ Baldwin, Christopher G., Understanding Royalty Structures, Lawson Lundell, 2003.

A note on Placer Mining Royalties

The Yukon Placer Mining royalty regime is much more in need of reform than the Quartz Mining Act regime.

Under the [Placer Mining Act](#)  (Section 85), the Yukon levies a royalty on all gold shipped from the Yukon for export, whether in the form of raw gold as mined or bars. The royalty is computed at the rate of 2.5% of the value of the gold, or at such lesser rate as may be fixed by the Commissioner-in-Council. For this purpose, gold is currently valued at US\$15 per ounce.⁴¹ This royalty is a “Gross Over-Riding Royalty”, or “unit-based royalty”. (See above)

A report undertaken by Stephanie Irlbacher-Fox and Stephen J. Mills⁴² included a study of Yukon placer royalties. They found that:

“In 2005, 87% of the Yukon’s placer gold was produced in the Dawson Mining District with production totalling 70,322 crude ounces (\$29.9million). ..If royalties had been tied to gold’s market value, royalties of \$750, 000 would have been paid. The current regime values royalties at \$15.00 an ounce resulting in royalties of \$26,370. Under chapter 23 of the Umbrella Final Agreement, the Yukon must pay First Nations an amount equivalent to 50% of the first two million (that exceeds First Nation royalties) and 10% of any additional amount. The Tr’ondëk Hwëch’in portion of the First Nation share is approximately 9%. Therefore the First Nation received, at most \$1,186.As a self-governing First Nation, the Tr’ondëk Hwëch’in receives its funding from Canada through a Financial Transfer Agreement ... Certain revenues, including resource royalties are offset from the funding to be received from Canada...at the rate of 50% ..the net fiscal benefit is less than \$600.”⁴³

Currently, for an ounce of gold worth about \$900.00 US the Yukon Government receives a royalty of 37.5 cents Canadian. With the value of gold pegged at \$15.00 this royalty never changes with the market price of gold.

The undervaluing of the resource for royalty purposes is ludicrous. It not only results in ridiculously low royalties, it makes meaningless the provisions of UFA Chapter 23. The royalty sharing provisions were intended to generate substantial benefits for First Nations.

⁴¹ http://www.emr.gov.yk.ca/mining/placermining.html#Yukon_Gold_Royalty

⁴² Irlbacher-Fox, Stephanie and Stephen J. Mills, “Devolution and Resource Sharing in the Canadian North: Achieving Fairness Across Generations, Walter and Duncan Gordon Foundation, 2007.

⁴³ Irlbacher-Fox, page 13