Analysis of Additional Royalty Payments with Reduced Sponsor State CIT

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Agenda

- Review of Sponsor State CIT concerns
- African Group Proposal for Additional Royalty Payment
- Challenges with Choosing a Single Rate
- Approaches for Choosing a Rate
- Sensitivity Analysis to Additional Rate
- Alternative Approaches to Additional Payment Mechanism

Concern that Not All Collectors Will Pay Sponsor State CIT

- Without consideration of an additional royalty, the Option #4 suggestion was a 3→7.5/12.5%
  - This led to a 45.4% ETR (25% CIT to Sponsor State)
- If zero CIT is paid in this same system, the ETR is 29.0%

- Concerns that some contractors **may not** pay any or all of this tax.
  - Effective Tax Rate would be much lower than industry standards (40%-50%)
    - Is this system still **FAIR**?
  - Contractors have more net revenue that could be shared with ISA
    - Are we **Maximizing ISA Revenue** while allowing contractors to be economically viable?

	25% SS Tax	0% SS Tax
ETR	45.4%	29.0%
Lifetime royalty revenue	$5.215B	$5.215B
Lifetime SS CIT tax	$3.988B	$0
TOTAL	$9.203B	$5.215B
Collector IRR	17.65%	19.39%

In general, there are two approaches to address this concern

- **Additional royalty rate from which you can deduct your SS tax payment**

- Calculate how short (if at all) you are of the ETR and you have to make up the difference through a payment to the ISA

African Group Proposal for Additional Royalty Payment

- **Goals of this proposal:**
  - Those contractors paying less (or no) Sponsor State CIT, will be liable for this additional payment and keep them at threshold Effective Tax Rate
  - Those contractors paying full 25% Sponsor State CIT, will not have any additional liability

- Have an additional royalty liability separate from the baseline royalty payments
  - $Payment = Gross\ Additional\ Royalty\ Liability - SS\ CIT\ Actually\ Paid\ and\ Verified$
  - $Gross\ Additional\ Royalty\ Liability = 6\% * Aggregate\ Relevant\ Metal\ Value$

- In the notes, they estimated a 7.2% additional royalty would result in:
  - Zero additional payment for those paying 25% CIT after the deduction
  - Additional $4.125B over the lifetime of the project for those that don't pay the CIT

Choosing a rate that requires no additional payment from contractor already paying 25% CIT

- Rate must result in a liability that can be completely offset by the CIT deduction
  - Additional Payment = $0

$$Additional\ Payment = Addt'l\ Rate\ *\ Metal\ Value\ -\ Deduction = \$0$$

$$Addt'l\ Rate = \frac{Deduction}{Metal\ Value}$$

  - Deduction varies by year, use value from the year with the smallest deduction (this is also the least profitable year)

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Implementing Additional Royalty Rate that is Fully Offset by Sponsor State CIT into the Financial Model

- Should be straightforward
  - Determine amount to be paid in CIT if contractor is paying 25% of profits
  - Choose rate which when applied to metal value, gives equal amount

- EXCEPT, contractor profit varies with time (even if metals prices and cost are assumed to be constant) → 25% tax on profits also varies with time
  - Accounting rules allow for different depreciation over time
  - Maintenance CAPEX and other occasional costs don't occur every year

The rate that would fully be offset by the Sponsor State CIT is different in different years

Challenges with Choosing a Single Rate

- CIT payment (deduction) is dependent on profit, which is dependent on the baseline royalty rates (among other things)
  → **Cannot set rate independently of setting the baseline rates**

- System that uses the "least profitable" year as the basis for calculation, is losing out on some revenue

- Any system that does not use "least profitable" year as the basis, will require additional payment from contractors that are already meeting their tax obligations

Years 1-4	Year 5	Years 6-11	Years 12-25
No Additional Royalty	High Profits due to: Low Base Royalty in Peirod 1 Profits High → High CIT Payment High CIT Payment → Large Deduction from Additional Royalty	Profits Lower due to: Higher Base Royalty in Period 2 Capital Depreciation Still Occurring Low Profits → Low CIT Payment Low CIT Payment → Limited Deduction from Additional Royalty	Profits Rise due to: Fully Depreciated Capital High Profits → High CIT High CIT Payment → Large Deduction from Additional Royalty

Should we choose a rate that offsets during years 6 to 11 or the latter years?

Approach #1: Maximum rate that requires no additional payment if CIT = 25%

	CIT = 25%	CIT = 0%
Year with Lowest Deduction	Year 11 (last year still depreciating)	
CIT Payment in that year	$107.4 million	
Maximum Add'l Rate that can be fully offset	4.5%	
Effective Tax Rate (no add'l royalty)	45.4%	29.0%

Effective Tax Rate (with add'l royalty)	45.4% (unchanged)	37.2%
Base Royalty Payment (lifetime)	$5,215 million	$5,215 million
Additional Royalty Payment (lifetime)	$0 million	$2,227 million
Sponsor State CIT Payment (lifetime)	$3,988 million	$0
Total Royalty + CIT Payments (lifetime)	$9,203 million	$7,452 million

Shortfall in Payment for those paying no CIT = $1,751 million

* Based on Option 4: 3% → 7.5%/12.5%, with Threshold ETR = 45%

Approach #2: Additional royalty rate that results in threshold ETR for contractors paying 0% CIT

- Additional royalty rate = 7.3% would result in ETR = 45% for contractors paying 0% CIT to sponsor state

|	CIT = 25%	CIT = 0%
Additional Royalty Rate	7.3%	7.3%
Base Royalty (lifetime)	$5,215 million	$5,215 million
Additional Royalty before Deduction (lifetime)	$3,629 million	$3,629 million
Additional Royalty (lifetime)	$412 million	$3,629 million
CIT Payment (lifetime)	$3,924 million	0
TOTAL Royalty + CIT (lifetime)	$9,551 million	$8,844 million
Effective Tax Rate	46.7%	45.0%

Contractors paying no CIT, will still pay **$707 million less** over project lifetime
Contractors paying 25% CIT, will see payments increase by **$348 million** over project lifetime

Approach #3: Compromise Rate Would Reduce Penalty on those Paying 25% CIT, but others will fall slightly short of threshold ETR

	CIT = 25%	CIT = 0%
Additional Royalty Rate	6.0%	6.0%
Base Royalty	$5,215 million	$5,215 million
Additional Royalty before Deduction	$2,983 million	$2,983 million
Additional Royalty	$139 million	$2,983 million
CIT Payment	$3,966 million	0
TOTAL Royalty + CIT	$9,320 million	$8,198 million
Effective Tax Rate	45.8%	42.3%

Contractors paying no CIT, will still pay **$1,122 million less** over project lifetime
Contractors paying 25% CIT, will see payments increase by **$139 million** over project lifetime

Sensitivity to Additional Rate

As the additional rate rises, the ETR gap shrinks. Yet, the additional payment also increases for those paying the 25% CIT

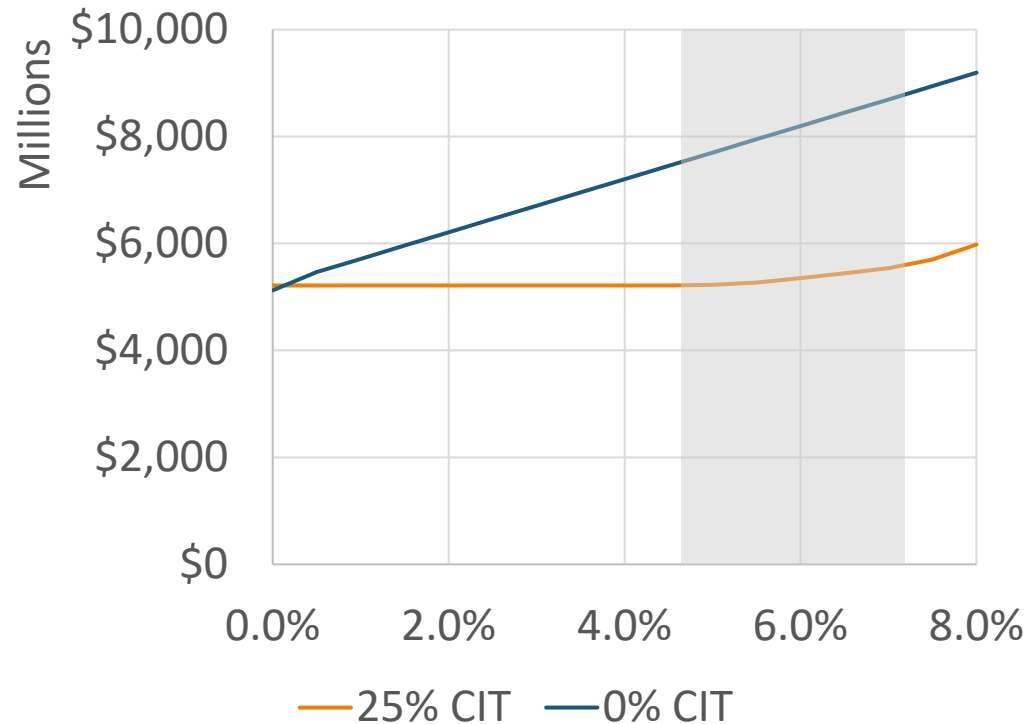**Effective Tax Rate vs Additional Royalty Rate**

Legend: 25% CIT, 0% CIT, Threshold
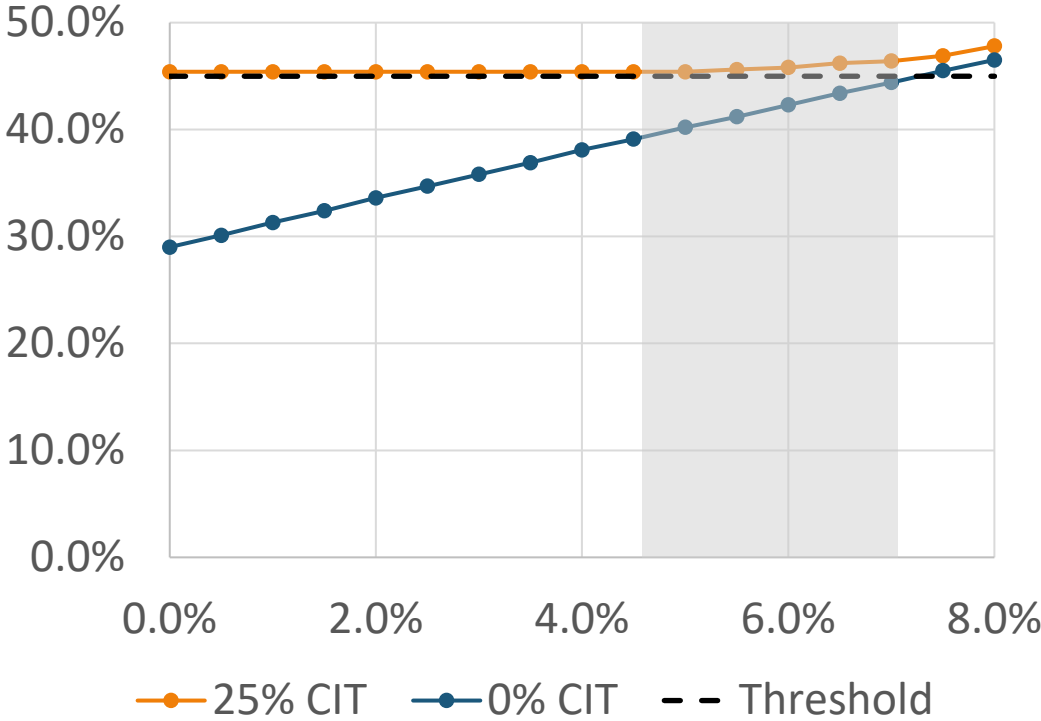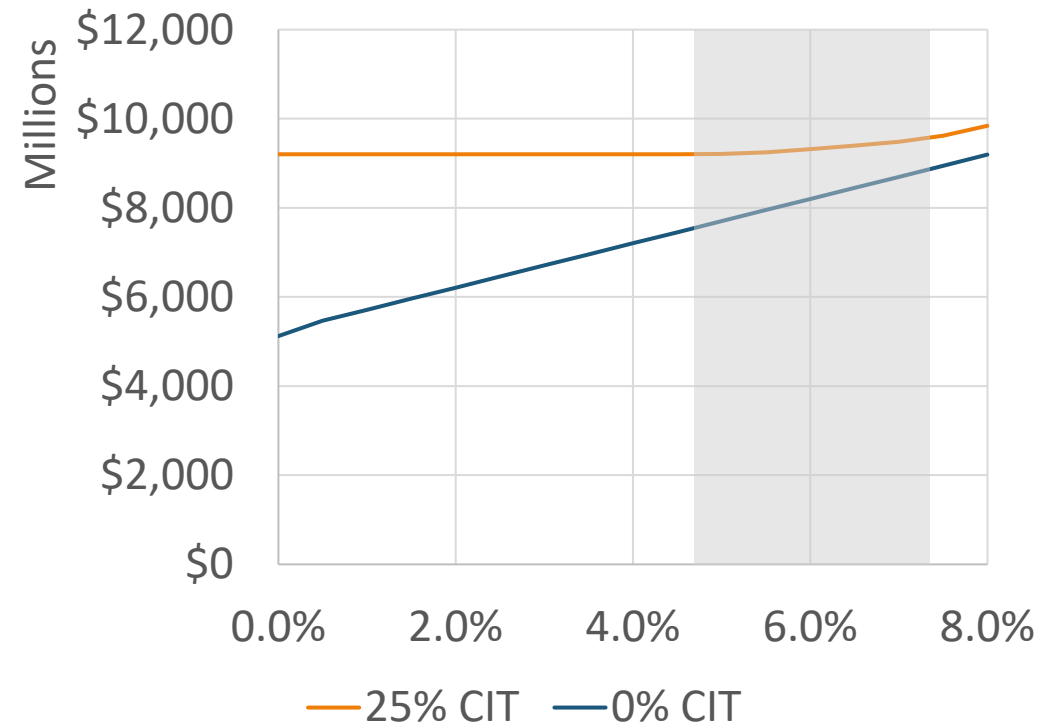
Additional Payment vs Additional Royalty Rate

Legend: 25% CIT, 0% CIT
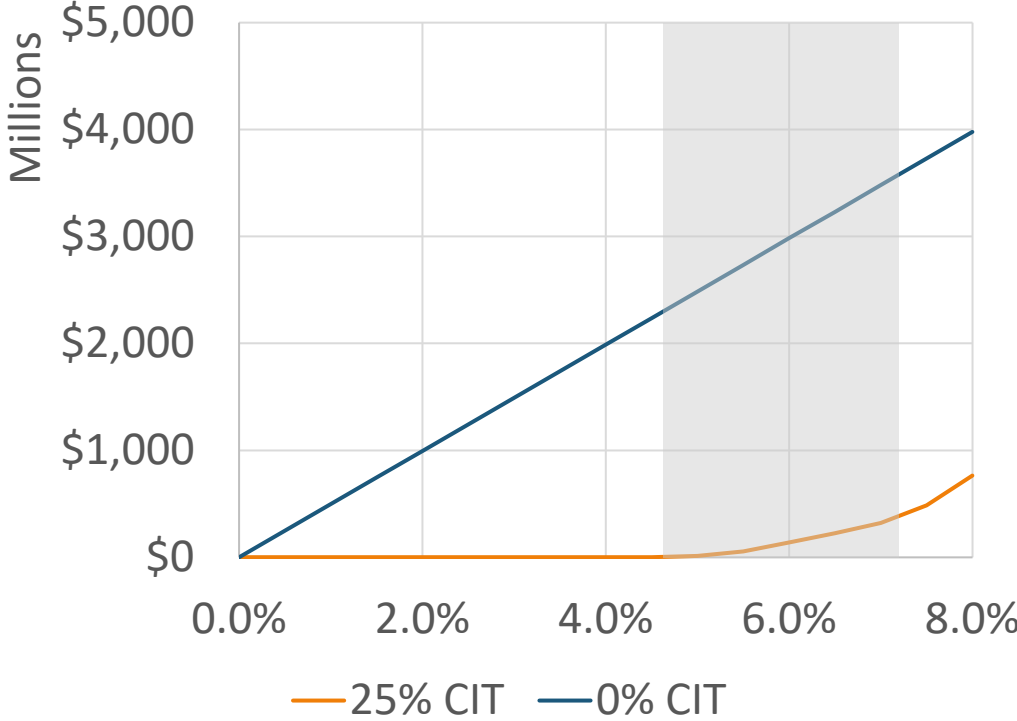
As the additional royalty rate rises, there is less incentive to pay 0% CIT

Payment to ISA vs Additional Royalty Rate

— 25% CIT — 0% CIT

Total Tax vs Additional Royalty Rate

— 25% CIT — 0% CIT

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Summary of the Challenges of an Additional Royalty with the CIT Deduction Mechanism

- Impossible to simultaneously fully meet both goals
  - ETR thresholds for contractors paying 0% CIT
  - No additional payment for those paying full 25% CIT
    - Therefore their ETR remains at threshold value

- Dependence on prior knowledge of contractors costs
  - Highly uncertain at this point
  - More will be known as we approach beginning of production

Could the Other Approach to the Additional Payment Mechanism Solve Challenges?

- Other approach: Calculate how short (if at all) you are of the ETR and you have to make up the difference through a payment to the ISA

- Potentially, but system would be complex:
  - Calculate ETR
    - If ETR is the total payments divided by before tax profit, calculating the total payments is straightforward. Calculating profit means I need an accounting system
      - Cost, revenues, and tax deductions

Contractor Submission Offers Another Mechanism

Approach:

- The contractors propose a different mechanism:

$$Payment\ due\ to\ the\ ISA = ETR\ Range\ - CIT\ and\ other\ payments\ to\ the\ Sponsor\ State$$

- If the contractor's ETR falls below the ETR range, the ISA will be entitled to an additional payment from the ISA Contractor: **"ETR normalization levy"**

- The contractor's approach is conceptually our second approach

Mechanism:

- If the Contractor ETR for the preceding 5-year ETR normalization period falls within the ETR range, the ISA ETR normalization levy is set to zero.

- If the ISA contractor ETR falls below the ETR range, the ISA may impose an additional ETR normalization levy to bring the contractor within the ETR range for land-based miners

- If in any given 5-year ETR normalization period the Contractor makes a loss, no additional levy will be due to the ISA.

How will ISA verify calculation of ETR?
5-year Normalization Period eliminates some of the issues surrounding year-on-year variability

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Additional Issue: Switching to Nodule Transfer Price as Royalty Basis

- Challenge: No arms length price currently exists, but one will likely develop when industry is mature

- Royalty rate on Nodule Transfer Price:
  - more in line with current land based mining practice
  - Simple to administer (if there is a global benchmark price)
  - Would automatically address concerns about other value metals extraction from nodule
    - The market price for nodules would reflect this value