



LIBERTAD Y DESARROLLO

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CODELCO: WHOM DOES THE NEED TO CAPITALIZE FAVOR?

- The “copper party” is over. The company requires high investment amounts to sustain current production levels.
- The first thing is to demonstrate that the projects are really beneficial for the country and not only for the stakeholders involved.
- Attractive projects in terms of their rate of return should not have financing problems; ideally, they should be a public-private mix.

There are few doubts that since 2004 our country started living a sort of “dutch disease”ⁱ as a result of the spectacular increase of the copper price. The fiscal improvement was highly significant, not only because of greater transfers from the National Copper Corporation (CODELCO, in Spanish) to the Public Treasury, but also due to a relevant increase of the private mining taxation. As a consequence of this boom, public revenues grew from US\$21 billion in 2004 to US\$61 billion in 2012.

FURTHER INFORMATION

http://www.lyd.com/wp-content/files_mf/tp1.149pol%C3%8Dtica%20fiscal%2013%20lml.pdf

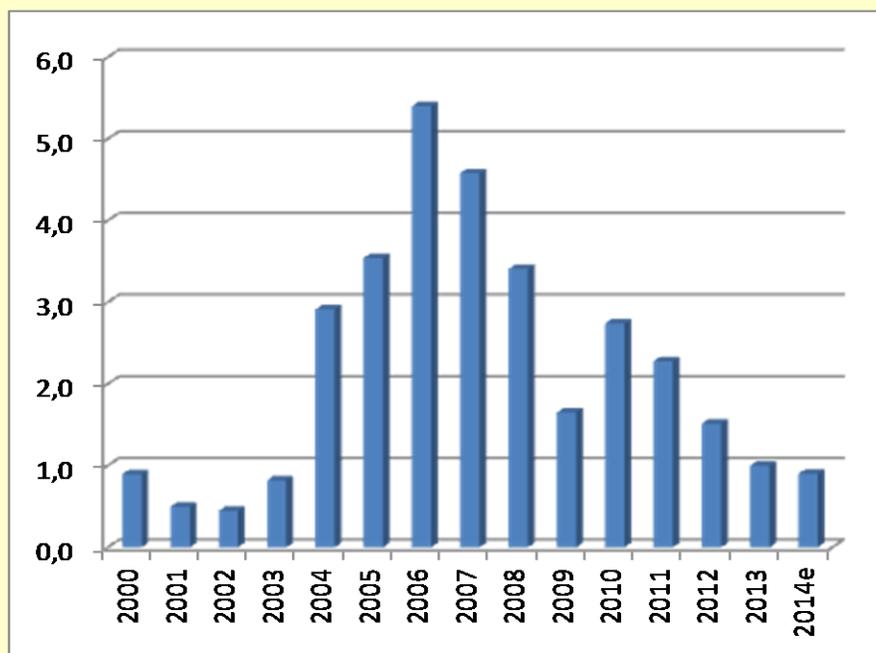
http://www.lyd.com/wp-content/files_mf/tp1.112lagallinadeloshuevosdecobre.pdf

In turn, public expenditure rose from US\$19 billion to US\$59 billion between 2004 and 2012. In addition, the rise allowed to improve the net creditor position of the Public Treasury by 14 points of the GDP between 2004 and 2008. In 2009 it dropped strongly, remaining relatively stable from then on.

However, it is evident that the mining boom came to an end, as we had already indicated in previous reports. The trouble is that the revenue increase of this period took on a structural characterⁱⁱ and, therefore, the mining contribution is part of the spending commitments of the Public Treasury, even though they have returned to normal levels, as shown in the following chart.

IN 2014, CODELCO'S CONTRIBUTION (GDP %) WILL RETURN TO THE LEVEL PRIOR TO THE BOOM

Chart 1: Contributions from CODELCO to the Public Treasury (GDP %)

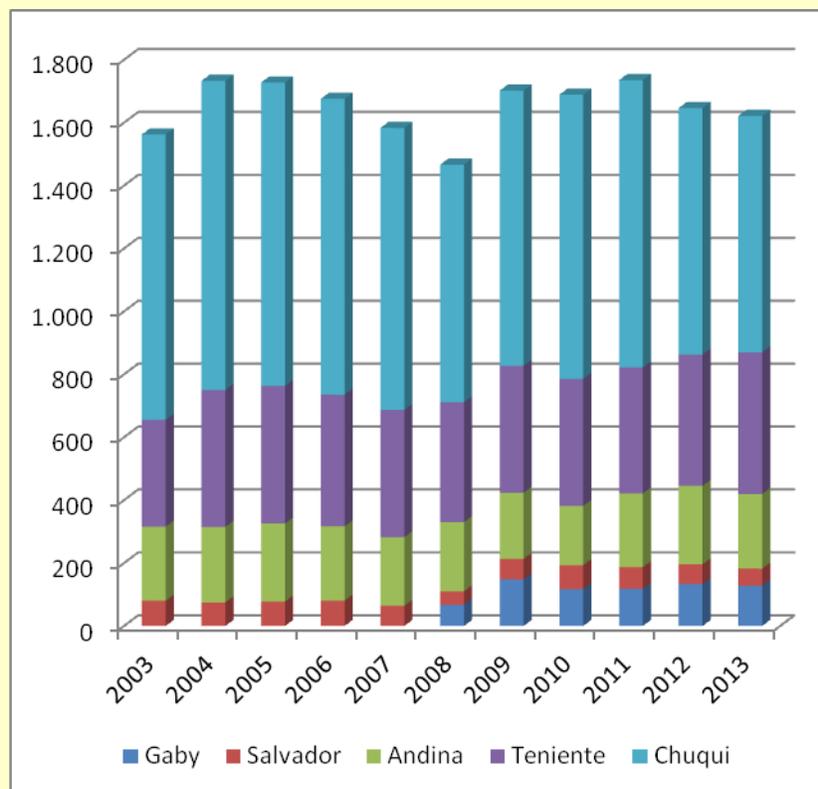


Source: Budget Office (Dirección de Presupuestos - DIPRES), LyD estimate for 2014.

Meanwhile, CODELCO's production has remained relatively stable, with a downward trend since 2011, as shown in the following chart.

**PRICES WERE RESPONSIBLE FOR THE MINING BOOM,
WITH RELATIVELY STABLE PRODUCTION LEVELS**

Chart 1: Copper Production in Thousand Tons



Source: Chilean Copper Commission (Comisión Chilena del Cobre - COCHILCO).

CAPITALIZATION OF CODELCO

The problem does not end there; from now on, CODELCO's contribution will return to the historical average in terms of the GDP, but also, in order to maintain this contribution level, large investments are required during the period 2014-2017, which in rough terms add up to US\$25 billion. According to information from CODELCO's 2013 Annual Report, if these projects are materialized, in an optimistic scenario the production would increase by 10% from now to 2020. In practical terms, the investment projects in the pipeline allow maintaining the current production levels.



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Structural projects in the pipeline and their state of development are the following:

- Underground Chuquicamata Mine: the feasibility engineering study was concluded and early underground and surface works are being executed.
- Sulphide Exploitation Radomiro Tomic: the feasibility study and the environmental assessment process are being performed.
- Ministro Hales: at commissioning stage.
- Andina Expansion: environmental assessment process is being performed, with important objections in this point.
- New Level El Teniente Mine: the mine's development works and the infrastructure are being executed.

The key questions behind the tensions that have arisen lately inside the company, and between the company and the government are, first, where these huge financial resources are going to come from and, second, what would be the rate of return of these investments.

One alternative is indebtedness, but considering that CODELCO's long-term liabilities amount to US\$17,169 million, with a current long-term liability/assets ratio of 1.69 times. It seems therefore reasonable to evaluate a mix between debt and capital.

For this capitalization, the government has mentioned more than once the possibility of handing over part of the funds accumulated in the Economic and Social Stabilization Fund (FEESⁱⁱⁱ, in Spanish) to CODELCO. Oddly enough, the use of financial resources in an objective different from a cyclic deficit financing would not be opposed to the language of the Fiscal Responsibility Law. However, it would be clearly against the spirit that inspired it, in the sense that this Fund should be available for responsible financing of spending at times when the GDP growth is below the trend GDP, as in fact will be the case this year. The adverse position of Arturo Cifuentes, president of the Financial Committee advising on the Sovereign Wealth Fund, regarding the possibility of investing the portfolio of financial assets on CODELCO, led the Minister of Finance to request his resignation. In addition to this concerning fact, the new president of CODELCO, Oscar Landerretche, spoke with the press about the future of the company, and he strongly highlighted the need for the State to take charge of the company's capitalization:

"If we don't take things seriously, our mining production will drop drastically. If this happens, CODELCO's contribution to the financing of public, social, education and economic policies will also decrease. The combined effect of this fall, together with the sharp increase of the social demands from Chilean citizens, and the imperatives of public policies and fiscal spending imposed by our



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transition towards a superior development state, will turn the Chilean fiscal problem into a bottleneck”.

Anyway, this urgency has sidelined common sense, inasmuch as the option to finance these projects through the FEES is equal to a decision on investment portfolio, and thus, it is necessary to technically evaluate the best portfolio for the Public Treasury, given the associated risks; this is the key aspect of decision making. If the projects in question have a return for the country that is lower than in alternative uses, then the financial resources of all Chileans should finance the best project. Landerretche mentions that if these funds are not handed over, CODELCO would stop financing social spending in the future. But, if the project’s rate of return is insufficient, the same social spending could be financed with the return of the best alternative project.

The decision of the Public Treasury about capitalizing the company should definitely consider the rate of return of the projects, and not only their being a means to maintain jobs that are politically sensitive. This return also depends on the management and cost control capacity of the corporate government. The recent removal of the chief executive by the Board can be read as a pressure from the workers, especially in Chuquicamata, and if this is the case, it is a bad signal for the future of the company, which should be rectified and considered when evaluating this project portfolio.

The recent episode evidences again that it is important that the capitalizing investor exercises an effective control and minimizes the company’s capture risks, a task for which a minority private investor can be of great support, since it mitigates the suspicions concerning the bad use of the resources. The last events dealing with the subject, more than attenuating these suspicions have increased them.

ⁱ Dutch disease refers to a situation of abundance of resources as a result of a positive shock in the tradable sector of the economy.

ⁱⁱ The current price of copper is very similar to its trend price.

ⁱⁱⁱ Today, this Fund accumulates slightly less than US\$16 billion.