

**THE INVESTMENT CLIMATE
FOR EXPLORATION
IN CANADA**

**A Brief Submitted to the Energy & Mines Ministers= Conference
Toronto, Ontario
September 10-13, 2000**

**Prepared On Behalf of
The Canadian Mineral Industry Federation**

August 16, 2000

The Investment Climate For Exploration In Canada

Toronto, ON September 10-13, 2000

EXECUTIVE SUMMARY

Canada's investment climate for mineral exploration is severely depressed with an attendant erosion of the exploration support sector. The crisis is now primarily the result of a lack of Canadian investor interest.

Last fall and winter, the PDAC and Canadian Diamond Drilling Association (CDDA) conducted a national campaign with the objective of producing a better understanding of the nature of exploration with respect to mining, the investment challenge the exploration sector faces and to promote a better understanding of the jurisdictional costs of our recommended **Focussed Flow- Through Share** (FFTS) Program. As a result we have received strong support from provincial, territorial and federal politicians and officials from across the country. This support is very much appreciated. In spite of this support the program is still not a reality, and in the meantime the condition of the exploration sector has worsened.

The sustainability of the Canadian mining industry is at stake, as are the many rural and northern communities which rely on mining, and rail and port facilities throughout southern Canada, all are economically vulnerable without mining. Since the exploration sector is currently missing out on a significant portion of a metal price recovery cycle, which commenced in 1998, the following questions arise:

1. Is Canada going to be able to resuscitate its moribund exploration service sector?
2. Is Canada going to be able to re-establish its competitive lead in global mine exploration by jump starting its domestic exploration?
3. Is Canada prepared to sacrifice the sustainability of the Canadian mining industry?

It is long past the time to act. The PDAC exhorts the Hon. Ministers Goodale and Martin, whose personal interest in this matter is gratefully acknowledged, to initiate the process in time for the 2000 taxation year.

Recommendation 1: That the Federal Government work with the PDAC to develop the FFTS program and implement it by means of an Order-in-Council in time for the 2000 taxation year.

The PDAC is most encouraged by the response of Ministers to recommendations to spend \$363M over ten years to address infrastructure gaps in the national geoscience database. We are very appreciative of the Federal Government's recently announced program to spend \$15M over three years to produce new geological maps and data for under-explored areas with high mineral potential and make this information more accessible on the Internet.

Recommendation 2: That Ministers now approve the implementation of the proposed cooperative Ten-Year Geological Mapping Strategy as an effective measure for attracting exploration investment across Canada.

The Investment Climate For Exploration in Canada

Toronto, ON

September 10-13, 2000

INTRODUCTION

On behalf of our 4190 members we would like to thank the organizers and leaders of this conference for the opportunity to make this presentation. Toronto is a major financial center for the mine exploration industry and is home for the PDAC. Toronto is also home to a government that has been very supportive of us in our present crisis.

CURRENT TRENDS IN EXPLORATION

The mining industry is subject to change through both relatively short periodic commodity price driven cycles and longer term, secular trends. The cycles are characterized by a periodicity ranging between four and seven years duration on average and each one is somewhat unique in terms of what causes the initiation of an upward or downward direction. The secular trends usually occur over a period of decades and are characterized by more permanent, evolutionary changes in the industry. Any adjustments required to accommodate to these trends would normally be handled as a normal course of business; that is, the industry would 'right itself' without having to ask for government assistance.

The conjunction of a cyclical low with dramatic secular changes, as has occurred in the latter half of the 1990's, exceeds the exploration sector's collective memory for severity. The result has been the erosion, at an unprecedented scale, of the active ranks of Canadian explorationists and the industry's attendant service sector. Assistance is therefore requested from governments to arrest further collapse.

Cyclical Trends

The downturn commenced in late 1996 as a result of a financial crisis in southeast Asia, and became a worldwide phenomenon affecting a large spectrum of commodities and both the senior and junior sectors of the industry. A number of additional factors included the collapse of some emerging regional economies, production overcapacity of certain commodities and increased central bank selling of gold. Added to this were the effects of the Bre-X scandal which reached a climax in 1997. Investors alienated from the junior exploration sector were subsequently swept up in "dot.com" mania, a new competitive challenger for high risk capital.

Diamonds never lost their luster and price recoveries for many metals commenced in late 1998. Palladium and platinum prices have risen dramatically setting record and/or testing long term highs respectively. Gold prices remain weak, nickel prices have pleasantly surprised even producers over the last several years and copper has been fair in spite of major new low cost producers coming on stream. Zinc has been a steady performer.

In 1999 the “mining market”, which is comprised of shares of mine operating companies, rose in value by an average of over 60%. While mining stocks actually kept pace with the high tech market, as represented by the Dow Jones Internet stock index for most of 1999, shares in most junior mine exploration companies remain in a state of collapse for the third consecutive year¹. **A significant portion of a commodity price cycle high has therefore passed without junior exploration company participation, which puts grassroots exploration directly out of phase with prices.**

Recent analysis of global financing and exploration trends by the PDAC, combining its own survey data and that of several other organizations², may be summarized as follows:

- The decade of the 90's was characterized by a complete economic cycle in exploration spending with 1992 representing a 23 year low, followed by a recovery which peaked, in phase with commodity prices, in 1996, then plunged to the unprecedented low currently in progress, which is now out of phase with commodity prices;
- From 1997 to 1999, Canadian equity financings for exploration and development declined by 54%;
- From 1997 to 1999, exploration in Canada declined by 39%³;

¹ CANACCORD Capital's *The Mining Monitor* - July, 2000

² Gamah International: Natural Resources Canada; Metals Economics Group; Financial Post

³ NRCan expenditure statistics used for relative decline. The PDAC has concerns with the actual exploration values on the NRCan web site and other publications. For example NRCan's preliminary estimates for B.C. in 1999 is \$42.2M. The B.C. government estimates \$25.0M. The B.C. estimates include in-mine exploration expenditures at Sullivan and Myra Falls etc., and possibly rehabilitation costs at an advanced exploration project to be returned to the Crown by the developer, as well as severance costs related to exploration office closure. The PDAC feels strongly that actual grassroots or green field expenditures, which are the real measure of health of the mine exploration sector, are being masked by deposit appraisal and operating mine property exploration expenditures that are more properly described as brown field exploration.

Secular Trends

The primary forces behind secular changes that have been affecting the Canadian mining industry over the past two decades have included a globalization of the industry, driven in large part by the transition of developing countries into free-market economies, and an evolution in the policy and regulatory regimes governing exploration and mining. The resulting trends may be summarized as follows:

- Domestic reserves of traditional metal products mined in Canada, including nickel, copper, lead, zinc and molybdenum, have been in decline since the early to mid-1980's. The exceptions are diamonds, uranium, palladium and gold;
- There are now on the order of 100 countries competing for a finite pool of exploration capital, an increase of 50% since the end of the Cold War ten years ago;
- In response to globalization major mining companies have reduced shareholder risk by growing through acquisition. To a significant degree Canada's major mining companies no longer explore in Canada at a grassroots level. The exploration arms of the many senior Canadian companies which once nurtured future generations of explorationists are now limited to small due diligence teams pursuing the next global takeover target;
- Over the past ten years a significant percentage of exploration spending by Canada's top producing companies has shifted from Canada to offshore targets (Figure 1). Over 40% of expenditures in Canada by majors in 2000 will be attributable to just two companies, a precarious base;
- Consecutive record low dollar expenditures are evident for 1999 and 2000 from Figure 2 (adjusted for inflation the downward trend would be even steeper to the lower right). The Canadian junior sector followed suit;
- Average financing size has slumped to around \$500,000 gross which is inadequate to fund serious exploration programs. Year end flow-through share issues appear to have peaked strongly in 1995, 1997 and 1998 as a component of junior financings (Figure 3), while 1999 is a record low. This clearly reflects deepening investor indifference for junior mining shares;

- Most securities industry firms have terminated mining analysts, some firms their mining departments. This has sharply reduced capacity for the exploration juniors to finance, since brokerage house sponsorship is a requirement, and has also dramatically reduced broker coverage of the sector to potential investors;
- In order to maintain their duties to their shareholders to enhance value, officers and directors of some junior companies have decided with reluctance to metamorphose their companies into “dot . coms”, sometimes extinguishing their own positions;
- Large diamond drilling companies which were once capable of handling any job anywhere in the world have closed regional offices, retired senior executives and severed middle managers, with the subsequent loss of capacity and long-term expertise;
- Many geoscience professionals and technicians have been forced into early retirement or career changes. Even within the PDAC, both a past president and serving director have left the industry this year, a “brain drain” sustainable mining and northern communities can ill afford.

FACTORS AFFECTING THE INVESTMENT CLIMATE

Aside from the influences of global economic conditions and long-term trends in metal prices, there are many factors that can influence secular changes in the investment climate for exploration of any particular country, the most important of which fall under the major headings of a) geological potential and b) the policy and regulatory regime. Geological potential is a condition that cannot be changed; however, it is essential for a country to maximize this potential through the activity of its geological survey and the development of a comprehensive and current geoscience data base. The policy and regulatory regimes are expressions of the political sophistication, stability and public priorities of a country, and are the primary means through which a government can affect its investment climate, either positively or negatively.

In our brief last year, the PDAC outlined how various policy and regulatory developments in Canada over the past few decades have transformed what used to be one of the most sophisticated and competitive regimes in the world to one which is now lacking in timeliness, predictability and certainty. This detracts from our investment climate in an environment of increasing global competition.

We recognize, on the one hand that the investment climate for exploration is severely depressed. This situation is acute and requires immediate attention. On the other hand, making progress on the more chronic conditions affecting our investment climate will require long-term commitments. Nevertheless we need to begin addressing them now!

In recognition of these two realities our 1999 recommendations were presented as both short-term, immediate measures designed to stimulate investment and longer-term initiatives aimed at the more chronic investment impediments. The short term measures focused on the introduction of a premium on flow-through shares and revitalization of geological survey activities across Canada. The longer-term

measures drew attention to public land use, project review with a particular emphasis on the environmental assessment process, Aboriginal issues, abandoned mines and regulatory issues. We are encouraged by the fact that there has been progress with respect to funding geological survey organizations and there is some attention being placed on the issue of abandoned mines. As far as we are aware, there was no other response to the remainder of our 1999 recommendations.

Last fall and winter, the PDAC/CDDA conducted a national campaign with the objective of producing a better appreciation of the nature of the exploration and investment challenge and increased understanding of our recommended **Focused Flow-Through Share** (FFTS) Program. As a result of this we received strong support from provincial, territorial and federal politicians and officials from across the country. This is very much appreciated. In spite of this support the program is still not a reality, and in the meantime the condition of the exploration sector has worsened.

The following statistics confirm the decline over the past year:

- Preliminary data indicate that in spite of healthy prices for many commodities dramatic decline are continuing through 2000 for grassroots exploration. For instance, as of June 30, 2000, CDDA statistics indicate surface drilling is down 12% from 1999. The worst year in the CDDA record book is currently 1999.
- In spite of prices rises of 247% for palladium (\$847 vs \$343 US/oz) and 175% for platinum (\$611 vs \$350 US/oz) from August 2, 1999 to August 2, 2000, there is only modest exploration activity in progress in those Canadian jurisdictions which have the best geological potential and existing production. Juniors are even finding it hard to raise significant money to take advantage of “the coat tail effect” from Ekati, Diavik, and Snap Lake to fund diamond plays elsewhere in Canada.
- PDAC membership has dropped 27% from 1997 to August 15, 2000, the trend is to more international memberships than Canadian.

STIMULATING INVESTMENT

Focussed Flow-Through Shares

Junior companies are unable to borrow money from lending institutions (they have no income and no collateral), they are entirely dependent on stock markets for capital. Therefore the primary objective of any incentive program must be to rekindle investor interest in this sector. All those who have carefully analyzed the options available have concluded that the most direct and effective approach to accomplishing the objective to increase the attractiveness of flow-through shares to potential investors is

through the introduction of a redesigned Mineral Exploration Depletion Allowance (MEDA) which offers a premium to investors as an incentive. MEDA, which was operative between 1983 and 1987, has an impressive track record of stimulating investment and the discovery of new mines.

Since exploration funds raised on the basis of flow-through shares can only be spent in Canada, it would have the potential to kick-start grass roots exploration, primarily in rural northern ridings. We envisage that money raised by tax incentives could result in a major discovery, which in turn would remind investors that they have made money with junior mining stock issues before and can again. The PDAC further anticipates that reviving exploration domestically will establish a competitive edge for Canada early on in the process of a global exploration recovery.

Canadian juniors or juniors which finance on Canadian exchanges have accounted for up to two thirds of junior global exploration activity in the mid 1990's⁴. This means that when Canadian investors' loose interest or 'sneeze', global exploration catches a 'cold', and no one should attribute the global downturn in exploration as anything other than Canadian lead. The problem is not 'asian flu'.

MEDA was chosen as the starting point because it had been popular with investors and was far more successful at discovering mines than commonly credited, including laying the foundation for the Canadian diamond industry. Benefits are still flowing into the Canadian economy from mines such as Eskay Creek, Louvicourt and Lindsley, which were discovered directly by MEDA financed drilling programs.

In response to our strong recommendations at the previous Mines Ministers' Conference in Charlottetown, the Hon. Ralph Goodale challenged us on three points:

1. To build a business case
2. To achieve a national consensus of support
3. To harmonize with the investor incentive system already in Quebec

Firstly we successfully completed the business case by documenting the current crisis state of the exploration sector, evaluated alternative solutions and prepared a business plan or forecast based on the only clear solution. With considerable assistance from government officials and politicians across Canada, we arrived at a redesigned MEDA which we called the **Focussed Flow-Through Share (FFTS)** program. FFTS as proposed by the PDAC and Canadian Diamond Drilling Association of Canada (CDDA), is characterized by the following features:

HIGHLIGHTS: FOCUSED FLOW-THROUGH SHARE PROPOSAL

⁴ Gamah International

- Follows existing CEE qualification provisions and definitions (as maybe amended from time to time with industry input)
- Only surface work will be eligible for premium (no underground work)
- Three year maximum limit for premium (early termination possible)
- High premium in first year to attract investors, premiums decline in following years
- Estimated Federal tax foregone over three years is \$295M, which would attract \$1,100M in exploration expenditures

Secondly the national consensus required by Minister Goodale was achieved by representatives of the PDAC/CDDA and regional associations who met with officials and politicians in their home jurisdictions across Canada to present the business case. This case not only included estimates of the up-front tax costs each would have to forego, but involved up-dates on the deepening crisis which now includes collapse of capacity in the exploration service sector. Unfortunately what is transpiring in the field, rural communities and regional financial centers is not well understood by Federal officials in Ottawa.

The level of ongoing provincial and territorial written support, and in the case of Ontario action taken, has been impressive. We appreciate that Ontario liked the PDAC/CDDA proposal so much that they incorporated the name ‘focused flow-through share’ into a tax program they announced in May. However, if Ontario has to go it alone it will go hard on those jurisdictions which lack large population centers, because great drill targets outside Ontario may go untested. A national taxation incentive is essential, which will harmonize with Quebec and now Ontario.

As early as last November concerned Quebec politicians and government officials clearly saw the potential of tapping into the larger pool of national investors, which in turn allowed the PDAC to successfully surmount Minister Goodale’s third challenge. In this regard we are very appreciative of support from the Quebec Government and help from the Quebec Prospectors Association.

The initial federal FFTS business proposal was formally presented to the Finance Minister on December 7th, 1999 followed by a more extensive plan presented to Finance officials on December 21st, 1999 (Appendix ‘B’). The PDAC appeared before several House of Commons Standing Committees, Liberal rural and national caucuses and met with ministers and senior government officials in all federal departments with an interest in the sustainability of mining in Canada. The PDAC/CDDA also undertook to keep provincial and territorial politicians and officials updated on a regular basis.

On April 11, 2000 the House Standing Committee on Industry issued its Report on Productivity and Innovation. Recommendation #26, which is the sole recommendation directed to the mining industry, states: *“That the Government of Canada consult with the Mining Association of Canada, the Prospectors and Developers Association of Canada and the Canadian mining industry to clarify the definition of the Canadian Exploration Expenses and **make flow-through share investments***

*more attractive for potential investors”*⁵. The Government of Canada is required to respond to this recommendation no later than September 11, 2000.

On June 30, 2000 we had an encouraging meeting with the Honourable Paul Martin. Minister Martin quickly grasped the difference between mining (i.e. operating companies with cash flow) and junior mine exploration companies (with no mine income) that finance by equity. We addressed the issue of fraud in the Quebec provincial program which, while regrettable, has been greatly exaggerated by those who would prefer to see flow-through shares and presumably labour-sponsored venture capital pools done away with. We also discussed the third and last of Minister Goodale’s requirements from Charlottetown, namely his insistence on harmonization with the Quebec flow-through system to ensure that investors will still assume appropriate levels of investment risk and no jurisdictions will get a “free ride” on the Federal Treasury.

The Federal Government had an opportunity to act in the last Federal Budget, or subsequently through an Order-in-Council. However in spite of meeting Mr. Goodale’s three challenges by January and successfully raising additional political support in Ottawa and nationally, the position of the Federal Government continues to be one of hesitation, “consultation” and indecision. It is long past the time to act.

Recommendation 1: That the Federal Government work with the PDAC to develop the FFTS program and implement it by means of an Order-in-Council in time for the 2000 taxation year.

Revitalizing Geoscience Activity

Traditionally, Canada has had a competitive edge for exploration investment due to the quality of the geoscience information available from Federal and Provincial Survey organizations.

Three factors now place this competitive edge at risk:

1. The constant advance of science and technology gradually decreases the utility of existing data, which eventually become obsolete;
2. Major gaps in coverage still exist;

⁵ Bolding by PDAC for emphasis

3. The erosion of Canada's geoscience knowledge base as a result of decreased geological survey funding over the past 12 years.

In its 1999 report to Mines Ministers, the IGWG/Industry Task Force on Alternative Funding Arrangements for Government Geological Surveys (the "Task Force") presented a plan to address some of the gaps in the geoscience knowledge base and put Canada's competitive advantage in geoscience back on track over a ten year period. An estimate of the additional costs to achieve this target was \$363M over ten years. The Task Force also recommended that the National Geological Surveys Committee develop a national geological mapping strategy to achieve this objective.

We are most encouraged by the response of Ministers to these recommendations. As part of the *Action Agenda for Mining in Canada*. The National Geological Surveys Committee is actively working on Cooperative Ten Year Geological Mapping Strategies for Canada and we have participated in some of the discussions. We strongly support this initiative and we understand that the concept has broad support from industry groups across the country.

The PDAC also supports the \$15M, three-year Targeted Geoscience Initiative (TGI) introduced recently by the Federal Government to produce new geological maps and data about under- explored areas with a high potential of mineral deposits and to make this information more accessible through the internet. We understand that this \$15M is being used to fund projects across the country that have a total value of almost \$40M over the next three years.

At the provincial level Ontario's *Operation Treasure Hunt*, recently expanded the time for a year and \$10M to three years and a total of \$29M, is a terrific example of short to medium term product development to enhance investment opportunities. However, to produce the kind of geoscience that will stimulate ongoing investment, stable funding over longer terms is required.

GEOSCIENCE MULTIPLIER EFFECT⁶

- For mineral exploration, every \$1M of government investment to enhance the geoscience knowledge base will likely generate \$5M of private exploration expenditures, which in turn, will result in the discovery of new resources with an in situ \$125M (within a certain probability).
- Anywhere from 20 to 66 person years of exploration employment in short term work is projected for every \$1M of government geoscience investment. There is significant potential for long term employment resulting from discoveries. The development of new resources with an in situ value of \$125M would provide continuing employment to about 80 persons.

⁶ Action Agenda for Mining in Canada Committee

- Every \$1M of government investment will create projects that provide an opportunity to train five students on-the-job. The capacity building opportunity for Aboriginal communities is significant.

The PDAC sees these as first steps in a process that will require a concerted effort by all levels of government, supported by industry, to allow Canada to regain some ‘market share’ in the global mineral exploration sector over the next ten years.

Recommendation 2: That Ministers now approve the implementation of the proposed cooperative Ten - Year Geological Mapping Strategy as an effective measure for attracting exploration investment across Canada

CONCLUSIONS

New geology maps and geotechnical surveys at appropriate scales get the creative ‘juices’ flowing in the exploration community and claims are staked. Entrepreneurs agree to promote exploration proposals based on new interpretations and measurements which were made possible by the new maps, technological advances and continually improved understandings of how ore deposits form in various geological environments.

Promotion leads to **investors funding work** to test the proposals. The work performed is filed for assessment to keep mineral claims in good standing, which in turn enhances provincial and territorial databases. When discoveries are made they either pass into the national inventory for future re-evaluation or progress through positive feasibility and permitting processes to become mines.

Depending on the commodity, the Canadian problem of declining reserves in many metals could be reversed, the sustainability of the mining industry prolonged. **What is currently missing from the aforementioned exploration cycle is the investor**, the ‘economic driver’ You can help change this.

APPENDIX A

IF APPROVED, WILL FOCUSSED FLOW-THROUGH WORK OR WORK TOO WELL?

The PDAC has been cautioned by investment dealers, at those few brokerage firms which still handle mine exploration stock issues, that investors are unlikely to stampede through their doors for a 30% premium. There are new additional impediments to junior companies hoping to raise funds quickly. Over-reaction to the Bre-X scandal by security and exchange regulators is affecting timing, listings, reducing stock liquidities (always a problem for junior issuers) and driving up overheads to a point where increasingly less of the investors= money remains to be spent exploring.

Most investors hold their equities in RRSPs and don’t need the premium writeoffs one might otherwise assume given years of rising market indexes. A minimum alternative taxation measure is now in place which did not exist in the

1980's. There is also truly awesome competition for high risk dollars from high tech, bio tech, internet stocks and labour-sponsored venture capital funds.

Senior accountants at the “big five” have confirmed the above-mentioned claims of stock brokers. Tables for residents of Ontario prepared by Ernst & Young indicate that if the Federal Government does not match the 30% bonus depletion announced by Ontario the at-risk capital to an investor only drops by 8%, vs 27% with a federal ‘match’. Accordingly a federal ‘match’ is essential. A 40% premium for the 2000 taxation year is now necessary given how late it is in the taxation year and the state of the collapsing mine exploration service sector.

If FFTS does not work there will be no foregone taxes, but there will be increased burdens from the unemployed and distressed families and communities. If FFTS is well subscribed estimated foregone federal tax revenues of \$295M over three years would generate \$1.1B in exploration expenditures.

APPENDIX B

This appendix, which contains a formal proposal to the federal finance minister for the implementation of a focussed flowthrough share program and data on the anticipated impact on Canadian jurisdictions of the program, is available in hard copy format only. To obtain a copy, please contact Mari Ann Semkiw at the PDAC office, email msemkiw@pdac.ca; tel: 416 362 1969, ext. 227.