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Business
Sport
Commentary
Letters
Entertainment
Arts &Leisure
Outlook
In Focus
Auto

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Shopping
Weather

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Fiscal budgets (Part I) - Prepayment of bauxite and alumina earnings

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As the two major long-term alumina contracts Jamaica has entered into over the last 23 years have been tied in one way or the other to prepayment arrangements it would be useful to provide some information on (a) the *raison d'etre* for having prepayment arrangements; (b) the factors which influenced the terms of these contracts when they were drawn up; (c) the nexus between these contracts and the prepayment arrangements; and (d) subsequent developments which rendered the pricing terms inadequate to meet costs of production at particular periods during the lives of these contracts.

These issues will be considered in the presentation below.

The raison d'etre for Prepayment Arrangements

The Jamaican economy has faced either fiscal or foreign-exchange challenges over many years; and the bauxite and alumina sector, particularly the Government's entities involved in it, has been called upon from time to assist in dealing with these challenges.

While it is not the purpose of this article to get into too much detail in respect of the reasons why the country has faced these challenges, it is necessary to say a few words about them.

In regard to the fiscal challenges, my own conclusions are that they arise from one or more of the following factors: (a) poor compliance as a 'cultural' practice; (b) high proportion of low-wage earners in the workforce; (c) less-than-efficient government in a number of areas not least of all in some where the 'spend' is large relative to the budget; (d) a public aversion to a meaningful tax on gasolene, a measure adopted by many countries in order to achieve the twin objectives of revenue and conservation in its use; and (e) it is more politically popular and 'agreeable' to announce a budget with 'no new taxes'.

In respect of the foreign-exchange earnings, it will be recalled that for many years our Net International Reserves (NIR) stood at high negative (at one year in the 1980s as high as minus US$800 million). The situation has turned around since the mid-1990s as a result of, *inter alia*, (a) the liberalisation of the foreign exchange market in September 1991; (b) growth of two traditional foreign exchange earning sectors, tourism and bauxite; (c) significant growth of remittances: (d) improved foreign-direct

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and salaries and a miscellany of other expenditures), it was required from time to time, over many years to 'forward' or prepay these earnings before they were due to meet some critical need by the state.

Early beginnings

The practice started benignly enough in the mid-1970s after the country had entered into a borrowing relationship with the International Monetary Fund (IMF).

In those days, the levy (which was a significant US$40 million- US$50 million per quarter) was paid quarterly on the 15th day of January, April, July and October of each year. But in order to meet IMF tests, particularly those at the end of the fiscal year, the companies were requested to make their payments on a negotiated discount basis 15 days early so that the payments could be brought into account at the appropriate times.

Escalation of prepayment system

The system of prepayment was escalated, in the 1980s, from the benign beginnings described above as a result of the severe economic challenges the country faced because of the deep recession in the bauxite and alumina industry. The industry, at that time, was the single largest source of foreign exchange for the country and a significant contributor to Government budgets (15.2 per cent, 12 per cent, 9.6 per cent and 13 per cent compared to tax revenues of 41.9 per cent, 43 per cent, 36.8 per cent and 50.2 per cent, respectively, for the fiscal years 1978/79, 1979/80, 1980/81 and 1981/82).

Given the stark circumstance 'novel means' had to be found to secure the financial resources needed to keep the economy going; and to this end various bauxite and alumina transactions were used as the basis for doing so.

Data on a number of these transactions for the years 1982 to 1987 were released to the public just before the 1989 general election. The data indicated that some US$313 million of prepayments was secured from various transactions, such as (a) bauxite sold to the United States (US) Government stockpile; (b) alumina sold (by time-swap) to the Venezuelan company, Venalum; and (c) alumina and aluminium secured from Kaiser Aluminum.

The prepayment arrangements entered another phase, consequent on the creation of Clarendon Alumina Production Ltd (CAP). The company was created, as I have described elsewhere, as a strategic riposte to the unilateral decision by Alcoa to close the Jamalco refinery in February 1985.

A prime objective of creating CAP was to keep operations at Jamalco going but another objective, almost, if not equal in 'importance,' was to secure prepayments against the company's production to support the country's foreign exchange budget. The Government knew it was a risky undertaking in creating CAP, for the following reasons.

First, it was seeking to enter a market with which much bigger players like Alcoa, Kaiser and Reynolds were having difficulty in coping. For example, when Alpart closed its alumina plant in the summer of 1985 the spot market price for alumina was US$85 per tonne, the equivalent of the cost of one commodity, oil, used in producing a tonne of alumina.

Vertical integration

These features provide such companies with the possibility of cross-subsidisation if, for example, a particular plant may experience adverse impacts from natural disasters or significant increases in the costs of input materials, or the price of its product may not be enough to cover cost

Third, given its financial situation the Government was in no position to put any equity into the company. (It was able to secure for the company a loan of US$20 million from the World Bank administered through our local EXIM Bank, to fund working capital).

Fourth, unlike the major companies, the regular capital financing had to be done from ongoing cash flows.

Despite these problems, the imperatives demanded that 'the deed be done'. In the event, the operations were started on the basis of a short-term alumina contract in a Buyer's market with the Austrian Trading Company ATC Handelsgesselschaft with the objective of converting into a longer-term contract.

Things did not work out with ATC Handelsgesselschaft but during its brief existence the contract served as a basis for prepayment arrangements.

ATC Handelgesellschaft was replaced by Marc Rich International AG with whom the Government entered into a 10-year (1986-1995) contract with the provision that if Alcoa resumed production in Jamalco the contract would have to be modified in proportion to CAP's stake in it. By virtue of government's determination to ensure full production at the plant and its need for a continuation of the prepayment arrangements, a bigger participation by government was a foregone conclusion and it was only a question of how much this would be.

Poor market conditions

The contract which was entered into with Marc Rich International AG had to take account of the poor market conditions which existed at the time and was expected to continue for quite some time. But it must be repeated that the larger objectives of keeping the plant operating at or near capacity, and using Government's share of the production as a means of securing prepayments, were driving forces for a contract to be made, notwithstanding market conditions.

The pricing arrangement was a mix of fixed prices, London Metal Exchange (LME)-linked prices and, later, some barter of oil for alumina.

The company was able to hold its own for a while, thanks to a combination of: (a) the decline of oil prices to less than US$10 per barrel and of caustic soda prices from some US$300 per tonne to US$50 per tonne early in 1986; and (b) outstanding performance by the workforce led by Gerry Dudley, managing director, and Fitz Carty, production manager.

Had the prices of oil and caustic soda gone the other way, it would have been a different story and the sequel by the CAP/Alcoa relationship might well have been different. One could take the view that fortune favoured the brave.

However, the collapse of the Soviet Union in the early 1990s was to have an adverse impact on the price of aluminium (and, as a consequence, alumina) as nearly all of that country's production (which was used mainly by its military/industrial complex) was sold into the so-called 'Western' markets.

Renegotiation declined

While the magnitude of the difficulties faced then were much less than those being faced now there were two similar features.

1. Contractual terms negotiated in a particular context proved inadequate at particular periods.

2. The purchaser declined to renegotiate the contracts but in the 1986-1995 one offered loans to make up the deficit.

3. The production of the company was needed as a means of securing prepayments for the Government's economic programme.

By and large the two major objectives were achieved:

1. The plant operated at or near capacity throughout but for *force majeure* events.

2. The Government of Jamaica (including the administration which took office in 1989) received some US$365 million worth of pre-financing through CAP up to 1999. This is separate from the US$313 million to which reference was made earlier).

In Part II, I will deal with the 2000 prepayment arrangement and the issues surrounding it at the time of concluding the contracts and subsequently.

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