

Getting a Good Deal from Oil, Gas and Mining

FISCAL REGIMES FOR OIL, GAS AND MINERALS

A fiscal regime is the set of instruments (taxes, royalties, dividends, etc.) that determines how the often-vast sums of funds generated by oil, gas and mining projects are shared between the state and investors. Fiscal instruments are generally set by legislation or specific contracts.

When designing or assessing fiscal regimes, members of parliament (MPs) should take into account the following goals related to oil, gas and mining sector management:

- **Fiscal regimes need to create sufficient incentives for private companies to invest.** Extractive projects have large upfront exploration and development costs and long production timelines. The fiscal regime must assure companies that the rules will not be unduly changed once investments are made. Stable fiscal regimes that provide a fair return to both investors and the state under a variety of circumstances will be less likely to attract pressure for renegotiation.
- **Fiscal regimes should divide risk appropriately between the investor and the state.** Uncertainty is inherent in the extractive sector. The fiscal regime should ensure that the state does not end up bearing a share of risk disproportionate to its expected return.
- **The state should be compensated for the loss of resources, regardless of the profitability of a given operation.** This is because oil, gas and mineral resources are finite. Fiscal instruments such as baseline royalties provide a guaranteed return for the state even if a project runs losses.
- **Fiscal regimes should be progressive.** Extractive projects can generate substantial rents. Rents (sometimes called “windfalls”) are the financial returns above those a company requires to make the investment profitable. Mechanisms to measure and tax a share of windfalls can enhance state returns in times of high profits and adjust to allow for adequate company returns during times of low profits.
- **Countries should set fiscal instruments through laws rather than individual contracts.** Negotiated rather than standardized fiscal regimes are prevalent in the extractive sector. Setting fiscal regimes through laws increases transparency and accountability, because contracts are more likely to be kept secret. Also, negotiations bring additional opportunities for corruption or manipulation. Additionally, if the applicable fiscal regime varies from contract to contract, it can make monitoring onerous and frustrate the efforts of policymakers to carry out policy reforms.
- **Transparency and consistency can help strengthen the state’s position.** The extractive industries are characterized by significant asymmetries between states and private actors. Companies often have more information about the specific parameters of extractive projects and are more sophisticated in tax planning, which can give them the upper hand in negotiations.

Key messages

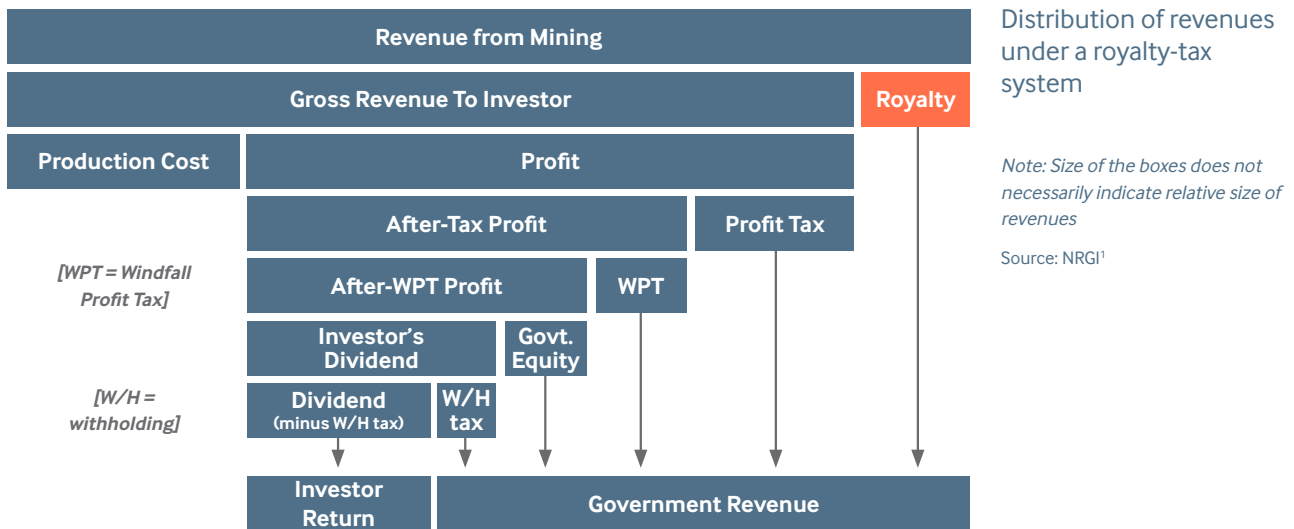
- Members of parliament (MPs) have a key role in ensuring that oil, gas and mining activities bring benefits to their constituents.
- Design of effective fiscal regimes is an essential part of this role. Effective fiscal regimes ensure that the government maximizes revenues from oil, gas and mining. These revenues can in turn be used to alleviate poverty and bring socio-economic improvements.
- MPs should be aware of the principal fiscal tools at their disposal as well as the strategies they can employ to oversee the extractive sector.
- Parliamentarians should play a key role in the design of fiscal regimes that avoid common loopholes and pitfalls, such as thin capitalization or abusive transfer pricing.
- MPs’ main role, once a fiscal regime has been established, is ensuring implementation, continued oversight and transparency of the regime.

PRINCIPAL FISCAL TOOLS

The basic building blocks of most fiscal regimes are the following:

- **Royalties:** Payments made to the owner of reserves, usually the government on behalf of citizens (current and future), for the right to extract those reserves on a per unit basis.
- **Income taxes:** Taxes assessed as a percentage of the net profits of a project after deducting allowable expenses.
- **Bonuses:** Up-front payments by the extractive company to the government for the right to extract. Bonuses may also be paid upon reaching certain milestones (e.g., attainment of a particular level of production etc.).
- **Withholding taxes:** Income earned by subcontractors, lenders and shareholders in relation to oil, gas and mining activities, which should arguably be taxable in the host-country, but administratively this can be difficult. A common practice is therefore for companies to be required to withhold a share of payments to these third parties and transfer it to the government.
- **Production sharing:** Arrangements most commonly used for oil or gas projects, which establish formulas for the sharing of physical production of oil and gas between the private investor and the state (often through a state-owned enterprise).
- **State/government equity participation:** Share of the state in the distributed profits of a company. A state may purchase or negotiate shares in an oil, gas or mining project.
- **Resource rent taxes (also called windfall profit taxes):** Special taxes designed to capture part of the extra profits created when international prices of commodities soar.

The revenues the government receives will depend on the application of the various fiscal tools as a whole, rather than any individual tool on its own.



A "FAIR" SHARE FOR THE STATE

Fiscal regimes in the extractive industry vary significantly from one project to another. According to a cross-country study by the International Monetary Fund, fiscal regimes that raise less than one third of the revenue for mining operations, and 65-85% for

petroleum may be a cause of concern. Yet these ranges are mainly indicative, as a fair share for an extractive project at one point in time in a specific region may be different to the fair share for another project elsewhere, as it will depend on a number of factors.

Furthermore, Precept 4 of the Natural Resource Charter suggests that revenues must be shared between the project sponsor and the state in a manner that allows the government to realize the full value of its non-renewable resources, while encouraging private investment and allowing the private company to recover its operational costs.

LOOPHOLES AND PITFALLS

Often the royalty rate, tax rate or state equity share get the most attention in public debate on fiscal regimes. However, these fiscal tools are only the rates applied to certain revenues – and thus *the way in which rates are applied* is of equal importance to the rates themselves in determining tax liability.

For instance even if the royalty rate is high, companies' liabilities will be low if the sale price used in computing the royalty is low. If the royalty is simply based on the rate applied to the sales price the investor receives, what guarantee does the state have that the price reflects the minerals' true value? Similarly, what guarantee does the government have that reported production costs have not been inflated to reduce taxes? Without proper controls, companies may use abusive *transfer pricing* (purchasing from or selling to related parties at artificially high or low prices) to shift taxable income out of the country of production. Parliament can help mitigate these problems by pushing for the use of transparent price indices for royalty and tax purposes.

Another common loophole is **thin capitalization**, which means financing a project with an excess amount of debt. This excessive debt then allows the company to inflate its interest deductions and reduce taxable income. States can adopt rules to limit interest deductions to a reasonable level to prevent the loss of tax revenues, or can utilize tools like resource rent taxes which do not allow the deduction of any interest expense in their calculation.

PARLIAMENTARY STRATEGIES FOR ESTABLISHING EFFECTIVE POLICY AND CONDUCTING OVERSIGHT

MPs can shape fiscal regimes through their role in reviewing, debating, amending and enacting the following legal instruments:

- **Upstream oil, gas or mining laws** generally establish parameters for royalty payments and sometimes for resource rent taxes. These laws may also set conditions for state equity participation, production-sharing arrangements and bonuses.
- **Tax laws** govern the basic income tax calculation and withholding tax rates, including provisions addressing possible loopholes. Tax laws may also provide provisions specific to oil, gas and minerals, such as rules for home-office expenses, special depreciation rules, the carry-forward of tax losses, and the separate taxation of individual projects, known as ring fencing.
- **Investment promotion laws** may establish the parameters for any investment incentives, like tax holidays, that may be offered to oil, gas and mineral companies.
- **Contracts**, in countries where parliamentary approval is required, may include special rules for the fiscal tools (though this is a practice that should be avoided when possible) and establish terms for the stabilization of the fiscal regime applicable to the project.

Tax regimes and contractual terms should enable the government to realize the full value of its resources consistent with attracting necessary investment, and should be robust to changing circumstances.

Precept 4,
Natural Resource Charter

Through their oversight role, parliamentarians should:

- Ensure that all legislation affecting the fiscal elements of oil, gas and mining projects are coherent. Some countries have wrestled with inconsistencies between pieces of legislation.
- Ask the government to provide revenue projections over the life of any major project and request a detailed listing of all assumptions (prices, costs, etc.) upon which these projections are based. Over time, legislators should request regular reporting of revenues the state receives and compare them against these projections.
- Request disclosure of all contracts with companies so that parliamentarians can access information about deals, including all the exemptions and incentives offered to companies that may deviate from those contained in generally applicable law. Contract disclosure is essential for effective parliamentary oversight.
- Ask government officials to explain the actions they take to ensure compliance with the fiscal regime, including conducting independent tax audits.

QUESTIONS PARLIAMENTARIANS CAN ASK

- How much discretion do the relevant ministries have in determining the overall fiscal regime for a project? Which items are negotiable, and which are not? For the negotiable items, what controls or parameters have been established to rein in complete discretion?
- What assumptions have been used in projecting revenues to the state for any fiscal regime (whether included in the generally applicable law or a negotiated package)? Are these based on company assertions or independent analyses and verification?
- What kind of risk analysis have the government and the relevant authorities done? If prices increase by 50, 100, or 200 percent, how will the return to the state and the company change? What if prices fall by 25, 50 percent, or more?
- What steps has the government taken to reduce the risk of transfer-pricing abuse? Are there internationally available price indices that could be utilized to calculate royalties and taxes for a given project? If so, what is the rationale for not using them?
- How does the fiscal regime compare with that of states with comparable extractive sectors?
- What is the estimated revenue effect to the government, when individual companies have received different fiscal terms than those in the general law? How do these terms differ from those applying to other companies? What is the justification for the difference? Where stabilization clauses have been offered, has the government considered a more limited stabilization (e.g., a shorter time period or a limited number of stabilized taxes)?
- Are extractive companies willing to disclose contracts? If not, why? Is the government implementing the right policies to incentivize contract disclosure?

Further reading and engagement

- Read the Natural Resource Charter, a set of economic principles for governments and societies on how to best manage natural resources at www.naturalresourcecharter.org.
- Link to Precept 4 on taxation: <http://naturalresourcecharter.org/content/precept-4>
- Browse through a database of petroleum, mineral and land contracts at <http://www.resourcecontracts.org>