Getting a Good Deal from Oil and Minerals

By Matthew Genasci

Summary
Parliament has an important role to play in the design and oversight of oil and mineral fiscal regimes—the set of taxes and other charges that determine how revenues are shared between the state and investors. Well-designed fiscal regimes should capture a fair share of revenues for the state while preserving adequate incentives for investment. Legislators can help shape the returns their country will receive from oil and mineral extraction by approving laws that: provide a minimum return to compensate for the loss of finite resources; capture an adequate share of windfalls generated when prices are high; are transparent and consistently applied; and reduce opportunities to exploit loopholes.

A fiscal system must be analyzed as a whole, not in pieces. Parliaments should ask government officials to submit revenue projections that show how much money oil and mineral companies will produce and clarify some of the assumptions that underpin those projections. Also, a perfect set of policies will yield nothing if there is no ability to enforce them. Parliaments can push for the sanctioning of oversight mechanisms, including audits, to verify that the country receives its dues from companies. Establishing a transparent fiscal system will enable better oversight by government agencies and parliament.

Fiscal regimes for oil and minerals
A fiscal regime is the set of instruments (royalties, taxes, production shares, etc.) that determine how the vast sums of money oil and mining projects generate are shared between the state and investors. Fiscal instruments are generally set by legislation or specific contracts.

A well-designed regime gives investors the incentives to explore for and develop resources while ensuring that the state—the owner of those resources—becomes richer than it was before the extraction. This is the essence of a good deal in the oil and mining sector.

Fiscal regimes must strike a balance. Excessively high taxation can stifle investment, while overly generous incentives can result in a permanent loss of national wealth. Regimes should be predictable, though a regime that does not allow for adjustments to changing oil and mineral prices and production levels will not render a fair sharing of revenues between companies and government if economic conditions change. This is likely to generate calls for renegotiating the fiscal regime, thus undermining the interest government and companies have in a predictable, stable investment climate.
Parliaments should ensure that fiscal terms are structured with six important characteristics of the oil and mineral sector in mind:

1) **Resources are finite.** The state must generate sufficient returns to compensate the country for the value of the asset being depleted. Royalties ensure the state is at least compensated for the loss of resources, without regard to the profitability of a given operation.

2) **Extractive projects have large upfront costs and long production timelines.** Fiscal regimes need to create incentives for companies to invest in exploration and development.

3) **Extractive projects can generate substantial windfalls.** Windfalls (or rents”) are the financial returns above those a company requires to invest. Establishing mechanisms to measure and tax a share of windfalls can give the state a greater share of returns and result in a more robust, stable fiscal regime.

4) **Uncertainty is inherent in the extractive sector.** Oil and mineral projects may meet technical challenges or be affected by unexpected price increases or contractions. Fiscal regimes should divide risk appropriately between the investor and the state so the state does not end up bearing a share of risk disproportionate to its expected return. They should ensure a minimum return under all circumstances (e.g., through a baseline royalty) as well as progressive elements to capture a share of windfalls.

5) **Large resource revenues may lead to negotiated rather than standardized fiscal regimes.** To the extent possible, a country should set its fiscal instruments through laws or generally applicable model contracts. Setting fiscal instruments through laws rather than individual contracts can reduce transparency and accountability since contracts are usually kept secret. Also, if the applicable fiscal regime varies from contract to contract, it can make monitoring compliance onerous for the government.

6) **The extractive industries are characterized by significant asymmetries between states and private actors.** States own the resources and thus have real bargaining power. Companies, however, often have more information about the specific parameters of oil and mining projects, which can give them the upper hand in negotiations. They are also often more sophisticated in their tax planning than states are in their tax administration. Transparency and consistency can help strengthen the state’s hand.

**Principal fiscal tools**

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

1) **Royalties.** A payment made to the owner of reserves, usually the government on behalf of the people, for the right to extract those reserves on a per unit basis. Royalties are usually charged as a percentage of the value of oil or mineral extracted, without accounting for development or production costs.

2) **Income taxes.** Assessed as a percentage of the net profits of a project after deducting costs.

3) **Bonuses.** An upfront payment for the right to extract. Bonuses may also be paid upon reaching certain milestones (e.g., completion of a feasibility study, etc.)

4) **Withholding taxes.** Income earned by subcontractors, lenders and shareholders should be taxable in the country where oil or minerals are extracted, but administratively this can be difficult. Companies therefore withhold a share of the income earned by these third parties and transfer it to the government as a withholding tax.

5) **Production sharing.** These arrangements, which are most common for oil projects, 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).

6) **State equity participation.** A state may purchase or negotiate shares in an oil or mineral project on preferential terms. Equity gives the state a share in the distributed profits of a company after the company’s cash needs are met. It may also entail additional obligations by the state.
7) **Resource rent taxes.** A special tax designed to capture part of the extra profits that can arise when international prices of resources soar.

Fiscal regimes generally use a combination of these and other tools to create the overarching system. Understanding the way these different tools interact is important for policymakers because what ultimately matters is the government’s “take” from the application of the fiscal regime as a whole.

**Loopholes and pitfalls**
Often, the royalty or tax rate or state equity share gets the most attention in public debate on fiscal regimes, but the rules used to calculate the base of those fiscal tools is equally important. If the royalty is simply based on the sales price the investor receives, what guarantee does the state have that the price reflects the minerals’ true value? What guarantee does the government have that reported costs have not been inflated to reduce taxes? Without proper enforcement, companies may use abusive transfer pricing (purchasing from or selling to related parties at artificial 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.

Other loopholes include thin capitalization, which entails financing a project with an excess amount of debt. Companies may inflate their interest deductions and reduce their taxable income or overprice services received from their home offices. States can adopt rules to limit these deductions to prevent the loss of tax revenues.

Tax holidays can have a corrosive effect on revenues. Once they’re introduced, they can create overwhelming pressure on the government to offer similar incentives to other companies, magnifying the revenue loss.

**Robustness and flexibility**
A key criterion for evaluating a fiscal regime is its robustness. A regime that gives the state a fair share when prices are, for example, $700 per ounce may not look as good when prices rise to $1,500 per ounce. During the commodities boom from 2005 to 2008, contracts signed in times of low prices suddenly became inadequate, resulting in several costly renegotiation processes. The use of resource rent taxes or windfall profits taxes can ensure the state receives an acceptable share of revenues under changing circumstances and thus make a fiscal regime more stable and predictable.

Too many countries have taken the opposite approach, making fiscal regimes unresponsive to change by utilizing stabilization agreements. These guarantee that no change in fiscal legislation applies to a pre-existing contract. When used, these agreements should be limited to a short period of time and a limited number of taxes.

**Parliamentary strategies for effective policy and oversight**
Parliaments can shape fiscal regimes through their role in reviewing, debating, amending and enacting the following instruments:

- **Upstream oil or mining laws** generally establish parameters for royalty payments and sometimes for resource rent taxes. These laws may also set parameters 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 and minerals, such as rules for home-office expenses, the carry-forward of tax losses and the separate taxation of individual projects, known as ring-fencing.
Investment promotion laws establish the parameters for any investment incentives, like tax holidays, that may be offered to oil 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.

Through their oversight role, parliaments should:

- Ask the government to provide revenue projections over the life of any major project—particularly when special fiscal exemptions or incentives are granted—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 the disclosure of all exemptions and incentives granted to specific companies and question the government on the rationale for granting them.
- Ask government officials to explain the actions they are taking 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 ones aren’t? For the negotiable items, what controls 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 has been done? If prices increase by 100 percent, how will the return to the state and the company change? What if prices fall by 50 percent?
- What steps has the government taken to reduce the risk of transfer-pricing abuse? Are there internationally available price indices that could be utilized for a given project? If so, what is the rationale for not using them?
- How does the fiscal regime compare with those of neighboring states?
- When individual companies have received different fiscal terms than those in the general law, what is the estimated revenue effect to the government? 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)?

Further learning

- Ask civic groups or parliamentary staff to prepare an overview of the national fiscal regime, including its strengths and weaknesses in relation to other countries.
- Contact peers from other countries to learn from their experiences.
- Read publications and data on fiscal regimes at www.revenuewatch.org.

Addressing Tanzania’s low mineral revenues

Tanzanian legislators’ calls for an overhaul of the mining legal framework led to the establishment of a presidential committee to identify the causes of the country’s meager gains from the mineral industry. This committee, known as the Bomani Commission, included prominent legislators. It reviewed all mineral contracts, traveled to study other countries’ fiscal regimes, and produced a set of recommendations that were later partly incorporated into new mining and tax laws passed in 2010. They included an increase in royalty rates, the abolition of fuel levy and excise duty exemptions, and the introduction of ring-fencing. If adequately implemented, these measures will increase Tanzania’s gains from its minerals.