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Fiscal terms for extractive industries: experiences from advising host governments

by

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Introduction

- The Commonwealth Secretariat's role
- Some basic challenges in advising on fiscal terms
- How petroleum and mining differ
- How this affects advice given on fiscal terms

The Commonwealth Secretariat's role

- We are a small group of economists and lawyers that offers advice to Commonwealth developing country governments on investment policy, legislation and negotiations in oil, gas and mining – this forms part of a wider organisational mandate to support private-sector led pro-poor investment
- We provide confidential client specific advice – our hallmark is rapid deployment and focussed contributions interventions
- The desired outcomes of our advice are investment flows founded on deals that can be implemented, are stable and are capable of generating a clear development dividend – however, we have limited influence over many of the factors that support or hinder such outcomes
- We have been active since the early 1970s and made advisory interventions in over 30 countries since 1990
- The typical recipient of our advice presents high risk exploration opportunities – few are big players in the industry at the point at which we advise – some, especially in mining, are contending with their first ever large scale mining investment

Some basic challenges in advising on fiscal terms

- There is huge uncertainty, especially at the start of an exploration programme – everyone is guessing about the economics
- Many positions are taken on likely economics, though production may be 10 years away and project life a further 10 or more years
- Companies (particularly their financiers) seek protection on the downside and believe they are entitled to capture any bonanza
- Governments believe they have an entitlement to some minimum return on exploitation of non-renewable resources and cannot be seen to miss out on any upside – there is ample evidence of this presently
- In these respects there is little difference whether one is advising on mining or petroleum fiscal terms

Are mining and petroleum the same?

- No… on average there has been more resource rent to share out in the case of petroleum
- That is partly a function of market structure in which a cartel operates – OPEC's supply response to high oil prices has been weak even though it has the lowest costs for bringing on new capacity – new capacity attracted by high prices has been largely non-OPEC and has often been in the upper cost quartiles – consider the supply response of Canadian tar sands
- Contrast this with mining, in which fierce competition has for a long period driven capacity costs (and eventually mineral prices) down
- With mineral prices, in the main, driven by fundamentals, price cycles are inevitable
- Oil bonanzas are both more likely (because of market structure) and larger – some oil (and gas) deposits are on a staggering scale

How has this affected petroleum fiscal terms?

- Established oil producing countries can take 70-90% of net project profits and still attract investors
- Competition for exploration opportunities can drive state take up – through competitive bidding of items such as signature bonuses and production shares
- Many governments seek to emulate this, even if the economics do not support this
- The problem is mitigated by retaining leeway to negotiate terms down or offer special incentives – where for example under-explored petroleum basins are being opened up
- The result is a proliferation of different "fiscal packages" both between and within countries reflecting a wide range of economic circumstances (e.g Indonesian frontier terms; various deep water incentives)
- Globally, we find levels of petroleum fiscal take that vary between as low as 30% and as high as 90% - in today's climate of clawing back by governments, the average is probably creeping up (e.g. Venezuela, Algeria, Chad)

How do mining fiscal terms differ?

- It is difficult to imagine mining taking place in country where 90% of net project profits might go to the country
- Levels of take vary within a smaller range – say 25% to 60%
- There has been a determined drive to fix fiscal terms on the basis of an "ideal" level of take, with less room for negotiation up or down
- Until recently, with exploration drying up globally and much of the developing world off the radar screens of miners, the "ideal" level was becoming a low level of take – the so-called "race to the bottom"
- Many mining regimes are also regressive – that means that at the high point in the minerals price cycle the fiscal regimes come under strain as governments seek to claw back what are seen as unnecessary fiscal concessions
- Some mining fiscal regimes are also weakened (from a government perspective) by the scope for investors to obtain pioneer industry status, EPZ status or other types of incentive under general investment legislation

How do mining fiscal terms differ?

- In some respects mining has some advantages from the point of view of somebody providing fiscal advice:
  - there is little variation in the structure of fiscal regimes – royalty and tax are the core elements in nearly every regime (but see below)
  - there is an absence of national companies as quasi-fiscal players (more on this later), thereby reducing fiscal complexity
  - there is more revenue transparency (this has emerged as one of the main points of difference from petroleum in the EITI debate)
- A problem we encounter, especially where there is no tradition of mining, is that there may be no clearly demarcated mining fiscal regime – other than royalty, applicable taxes may be a function of an array of generally applicable and mutually inconsistent tax legislation at national and sub-national level – it is rare to face these difficulties in the petroleum sector

How have we dealt with these features in mining?

- We do not generally favour tailoring of special packages for different levels of risk, since risk categorisation is less of a science in minerals exploration than it is in petroleum basin risk assessment
- We do not favour providing more leeway for negotiation, since:
  - this is a burden on weak mining administrations (more on this to follow); and
  - it is very rare that governments can generate competing proposals for exploration opportunities as a basis for negotiation in the way they can for petroleum blocks through licensing rounds
- We have found a suitable approach is to have a largely fixed regime to secure a minimum acceptable level of take for the country and offer incentives for risk taking by miners, so long as this is balanced by a progressive fiscal arrangement to capture part of any upside arising when mineral prices are high or a particularly rich deposit is exploited

More on mining administrations

- At the risk of over-generalising, we more often find national companies in the petroleum sector which are conversant with economics and engineering – these often do the negotiating on behalf of governments
- This is not the case in mining, in which even if there is a national company, it is unlikely to have a role in deciding fiscal terms
- Mining administrations (and indeed tax units in the Ministry of Finance) are often poorly placed to engage in complex negotiations over fiscal terms

A note on production sharing

- More than half of ventures in the petroleum sector take place under production sharing contracts (PSCs)
- PSCs operate on the basis of the company being contracted to work for a national oil company (NOC) and obtaining compensation in the form of a share of production – “tax” is the value of production retained by the NOC
- PSCs have never taken off in the mining sector ... why?
  - Limited role of national mining companies as instruments of national economic policy
  - Limited role of governments in marketing of minerals / taking price risk

Some other observations on fiscal terms

- The close attention paid to cost recovery under PSCs has led to the development of common petroleum accounting principles covering classes of costs, treatment of overheads and other matters relevant to managing transfer pricing risk – this is often absent in the legislation under which mining operations are taxed
- Fiscal arrangements to deal with field decommissioning have been worked out for petroleum operations around the principle of building up a financial reserve for use at closure – though this can be usefully applied to mining, arrangements are more likely to have to be adapted to the much wider variety of restoration and rehabilitation scenarios in mining projects, as well as fundamental issues of mineral price volatility

Concluding observations

- It is important to be aware of how differences between petroleum and mining affect the types of fiscal arrangements that have developed in each sector
- It is not obvious that there is that much that mining can or should borrow directly from petroleum fiscal policy experience (or vice versa)
- The discussion of differences should not obscure the fact that on most substantive points of fiscal policy, there is much in common between mining and petroleum
- One should also not lose sight of the fact that mining is altogether more diverse than the petroleum sector and that many of the challenges in advising on mining fiscal issues arise from this diversity. Examples of such issues include:
  - valuing minerals (for royalty and tax purposes) when certain minerals markets are illiquid
  - addressing the fiscal implications of a great variety of mineral beneficiation scenarios
  - tailoring specific terms for small scale mining