

Attachment to Coordinator Paper: (1) Overview Note on Extractive Industries Taxation Issues¹

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Executive Summary/Purpose

The purpose of this note is to give an overview of some of the taxation issues for extractive industries in developing countries and the interactions between them, options available, and the likely effect of taking such options in particular circumstances. This is intended to help policy makers and administrators in developing countries as well as to provide information to other stakeholders. Background contained in this note will provide a broader context for viewing the overall issue of natural resource development and the more specific issues addressed in additional guidance notes, some of which accompany this note, with others to follow. These notes will deal in more detail with significant issues identified in this overview note.

The work covered by this and each of the additional more specific guidance notes stems from a mandate given by the UN Tax Committee to the Subcommittee on Extractives Industries Taxation Issues for Developing Countries to consider, report on and propose guidance on extractive industries taxation issues for developing countries, focusing on the most pressing issues where guidance from the Committee may most usefully assist developing countries. The work will seek to provide policy and

Persons obtaining the license to explore and extract the natural resource from its owner, usually the country.

Those engaged in finding, developing, producing, and selling non-renewable resources such as crude oil, natural gas, and hard minerals and their products.

The general framework governing natural resource activities, generally falling into two broader categories: concession regimes or contract regimes.

Specific economic elements relating to extractive industry activities within a particular country including taxation, other payments such as bonuses and royalties, legal framework, and state participation.

The entity in charge of performing the actual extractive industry activities with respect to a particular project. It can be the license holder or one of the license holders, if the license was granted to a consortium or joint venture.

In the extractive industries, the term 'royalty' refers to the obligatory payment made by the operator of the extraction project to the state as a compensation for the extraction rights. Royalties are generally calculated with reference to the type, quantity, quality and/or value of the extracted mineral resource as a percentage of the gross volume or value of the production (i.e., costs generally do not reduce the base), and are due once production commences. The term 'royalties' as defined under article 12 UN Model Convention has a different meaning and refers to the payment for the right to use property (in case of the UN Model both tangible and intangible).

A company or individual providing various types of services and other supplies in the framework of the extractive industries.

Direct government ownership of a portion of a project (beyond its ownership of the underlying resource reserves); also known as "Equity Participation".

Background

Extractive industries are engaged in finding, developing, producing and selling non-renewable natural resources such as crude oil, natural gas and mining products.² The extractive industries are an important sector and thus a potentially important revenue base in many developing countries and emerging economies. Given projections that by 2040 world population will grow by 2 billion persons and per capita GDP will double, the International Energy Agency (IEA) forecasts that the world's energy requirements will increase by over 35 percent by 2040. While the growth rate of renewables will far exceed that of conventional fuels, and energy efficiency improvements will be substantial, the IEA projects that oil and

² Crude oil and natural gas are key energy resources, as well as inputs to other worldwide products, such as chemicals, plastics, and fertilizers. Hard minerals comprise a wide variety of products, such as copper, iron, gold, bauxite and numerous rare earth minerals, which are also used as inputs for many essential products, such as steel, aluminium, electronics, and medical devices. Hard minerals also include coal, which is predominantly used in electricity generation and steelmaking.

natural gas demand will increase by over 15 percent and 50 percent, respectively. Coal demand is also expected to rise such that these three fuels, without other additional significant breakthroughs, will

Mining, Environment, Finance, Tax Policy and Administration, along with those entrusted to govern, manage, or reinvest revenues from natural resource development, is important in arriving at the correct balance at the outset and on an ongoing basis.

The extractives industries are unique in many ways: The sector is shaped by high sunk costs in the form of substantial investments that cannot be recouped if a project is unsuccessful; long lead times from initial investment to project start-up and very long production/project lives; fluctuating costs and commodity prices that in turn influence the profitability of exploration, development and extraction; volatile demand; and environmental impacts, including ultimately 'decommissioning' or reclamation responsibilities.⁶ The extractive industries are often located in remote areas, at great distance from their eventual markets. At the same time, companies active in the extractive industries have the potential of substantially increasing their contribution to the economy.

funding that often exists, access to specialists in tax design and administration is often asymmetrically held as between multinational companies and developing countries.

In designing an overall taxation regime and developing its administration, each country must carefully determine its priorities and consider a wide array of choices available to it. There are numerous issues it must deal with, and the approach on any particular issue may not be the same across countries. Ultimately, it is recommended that each country develops its own set of principles and goals, tailoring these to its specific priorities and to its unique circumstances (including location and quality of the natural resources to be developed, infrastructure, political and economic climate, development needs, and other resources available in country). Once those principles and goals are determined, the choices a country makes in its taxation system design, including the structure and administration of taxation, other fiscal terms, and legal/regulatory requirements, should be tested to determine whether they advance and are consistent with those objectives.

Some reoccurring issues that countries face are summarized below. They underscore the interests that a country will need to balance, such as:

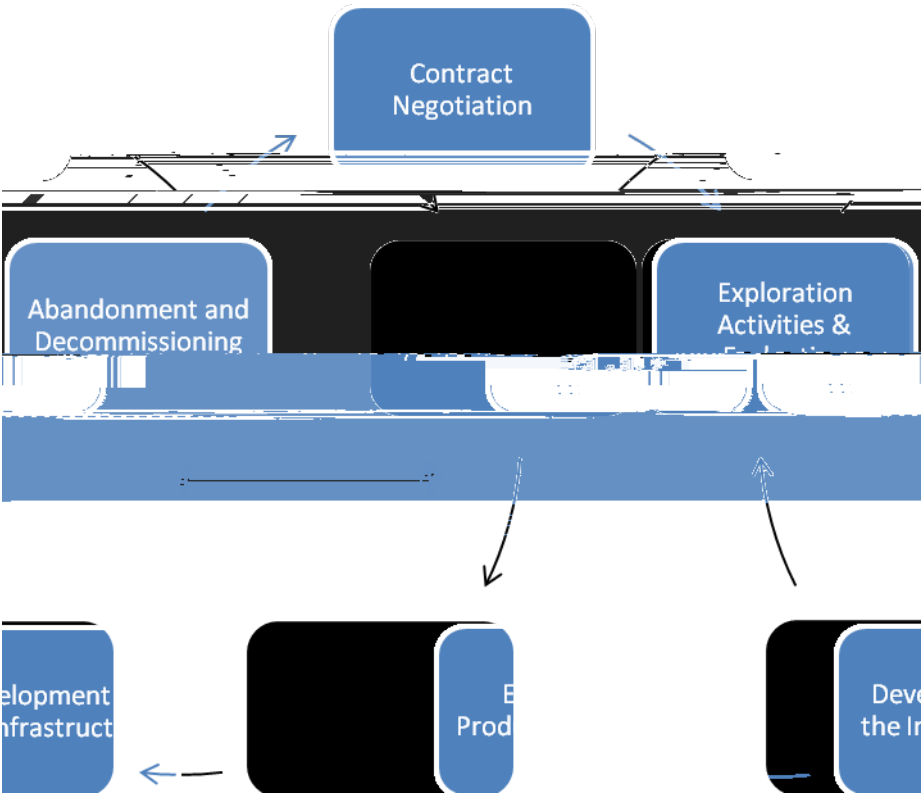
- Attracting foreign or domestic direct investment in the extractive industries
- Ensuring the government receives an adequate share of revenues
- Weighing timing issues in relation to receipt of revenue
- Ensuring sound environmental policies and protections exist
- Fostering the development of local capacity in providing goods and services to the extractive industries
- Reconciling transparency, and confidentiality, and
- Designing appropriate governance rules for the extractive industries, including capacities to deal with potential corruption.

Additionally, as revenues are generated under the fiscal plans, management of such funds over the short and long term requires planning, diligence, and governance structures.

Industry Overview

As noted, there are similarities but also many differences between the extractive industries and other industries which should be taken into account when designing and administering a tax regime. In order to better understand the specific problems that may arise in the extractive industries, a diagram of the

Extractive Industry Structures: Life Cycle



Extractive Industry Structures: Oil and Natural Gas

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generating long-term revenue to pay for government programs, and supplying inexpensive domestic energy. In contrast, NOCs with strategic and operational autonomy¹¹ balance profit-oriented concerns with the well-being of the country as a whole.¹²

IOCs are investor-owned, market-oriented, and mainly aim to increase shareholder value. Various degrees of size, specialization, and integration exist in IOCs. Often companies specialize in one or more individual industry segments, such as the exploration and production, refining, transportation/distribution or marketing segments.¹³ Many of the largest multinational oil and gas companies integrate all businesses, and are referred to as 'vertically integrated' oil companies.

The O&G industry is often considered to have two major parts, the Upstream activities i.e., those related to the exploration and production of crude oil and natural gas, and the Downstream activities, i.e., those related to the transportation, refining and marketing of oil and natural gas and their products.

Upstream

The exploration and production activities are the beginning stages of the life cycle and involve large upfront capital investment with significant risks that commercially successful results will be achieved. Lead times from exploration through development to first production are long, often ten years or more, further increasing project risks.

Investors often seek to reduce risks via project diversification, often in cooperation with other partners. The oil and gas industry is characterized by joint ventures (JVs) involving an operator along with several other investing partners that own undivided interests in the project and participate in decisions pursuant to an operating agreement. This approach is (and has traditionally been) the most common way of sharing economic risks. JV partners can also include government bodies or NOCs.

The first phase of Upstream activities, i.e. the acquisition of exploration rights, can occur via several methods, including participation in companies, entering into a joint venture with other investors to find or to develop resources, international bids (unilaterally or with partners), direct negotiations with governments and/or nationally owned oil companies, and outright purchases of assets or companies.

An exploration contract or license can last for several years, divided into sub-periods during which the company commits to a series of investments in geological, geophysical, and seismic work and to drill a certain number of exploratory wells.

The operation, management, and policy-making procedures of a JV are regulated in a 'joint venture' or partnership agreement called a 'Joint Operating Agreement' (JOA). In the JOA, one of the participating companies is designated as the 'operator'; responsible for the day to day management of the activities to

¹¹ NOCs with strategic and operational autonomy

be performed, and the implementation of the decisions taken by the partners, including representation vis-a-

An integrated company's S&T function is important since companies often lack sufficient production of their own, in total or in the right locations or specifications, to meet their refining or marketing needs. These constraints are addressed by businesses actively involved in purchasing, exchanging, and/or selling of crude oil, intermediate or end products. Additionally, the fact that many producing and refining countries export their production to other markets requires a robust supply and transportation industry.

Liquefied Natural Gas—An Expanding Business¹⁴

The Liquefied Natural Gas (LNG) business involves upstream, midstream, and downstream elements in the commercialisation of natural gas resources through extracting and processing, liquefying, transporting such liquefied gas in special ships, re-gasifying it in processing facilities, and delivering it to customers. LNG projects involve very large upfront capital investments, with a development phase typically between five to six years. Given the significant upfront capital investment, LNG suppliers typically require revenue certainty by having offtake contracts for a significant portion of the expected LNG production to be in place prior to a final investment decision. Once LNG projects are in the production phase, they can continue producing for 30-50 years (or longer) depending on the size of the gas resource and the investment of additional capital expenditure during the project life.

Extractive Industry Structures: Mining

The mining industry worldwide is often described as having a formal and an informal sector. The formal sector has been estimated to include approximately 6,000 public and state-owned companies. Within this group, the 20 largest companies accounted for some 30 per cent of global output in 2010, and the largest 150, sometimes referred to as the 'majors', accounted for approximately 85 per cent of global output.¹⁵

The 'majors' are often broken into two categories, global (the largest 50 companies, with asset bases in excess of \$10 billion) and senior companies

standards in some parts of the informal sector of the industry can be challenging.¹⁶

In addition to the above and in recognition of the socio-economic and environmental implications of mining, regular studies should be undertaken to determine the impact of mining on the environment as well as surrounding communities and to properly plan for mitigation efforts.

Production

Physical production of the ore, which can be called the 'mine/mill' phase of mineral development, makes up the bulk of the mining life cycle. At this stage, due to the detailed development work that has been done, the overall life of the mine, based on current economic and market fundamentals can be determined. The ore that is mined is generally physically prepared (via crushing, grading, and grinding) and concentrated for further processing so as to extract the raw mineral.

Waste and tailings resulting from the processing activities need to be carefully managed at this stage so as to prevent adverse environmental effects.

The ore or unrefined mineral product may then be further processed near the mine/mill facility, but is more often transported to an offsite processing facility. Processing can take the form of smelting,

Fiscal systems governing natural resources generally fit into two broad categories, concession or contract regimes.¹⁷ Though not without exceptions, concession regimes are more commonly found in Europe, Australia and North and South America and contract systems in Africa, the Middle East and Asia.

Concession regimes

Concession regimes are often also described as 'tax and royalty' regimes. These are common both to the mining and petroleum industries and are usually prescribed by law.¹⁸ Minerals or oil and gas extracted pursuant to

for which guidance notes might be issued beyond 2016 based upon recommendations of the Subcommittee.

Tax treaty issues

Bilateral tax treaties play an important role in coordinating rules for cross-border tax treatment and eliminating obstacles to cross-border trade and investment. Extractive activities usually include numerous cross-border elements. They are undertaken by investors, license holders, service providers and suppliers who are often not resident in the source country. Natural resources produced are typically exported. These elements raise several tax treaty issues for the extractive industry which

negotiation of such contracts, and the options regarding their renegotiation as circumstances or parties involved change.

Additional issues

Consideration of additional issues, not otherwise covered in these guidance notes, will be undertaken.

Possible areas for additional guidance are:

IMF, Guide on Resource Revenue Transparency (2007), available at <http://www.imf.org/external/np/pp/2007/eng/051507g.pdf>.

C. Nakhle, 'Petroleum fiscal regimes', in P. Daniel, M. Keen and C. McPherson (eds.), The Taxation of Petroleum and Minerals: Principles, Problems and Practice, (Routledge, New York 2010) p. 89.