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where there is no longer an acceptable chance of making an economic return, especially if there is the risk of further adverse fiscal change. Often fiscal regimes are stabilized in the contract to ensure predictability.

The ideal is to anticipate as many scenarios as possible (e.g., high and low prices, drilling and development cost changes, recoverable reserve levels, etc.) and develop flexible fiscal terms to deal with such possibilities from the start. These can ideally deal with a variety of technical risks and different types of opportunities as well (e.g., onshore, deep water and unconventional oil and gas developments). To illustrate, Russia has a tax system that proposes different terms depending on the type of opportunity. This deals with uncertainty by providing flexibility in a predictable manner.

If this flexibility cannot be addressed in the terms from the beginning, investors will value (and see less risk in) changes introduced by modifying the terms of the successive licensing rounds if available or via a mutual renegotiation process rather than through unilateral modification of the fiscal terms. Whilst there may be merit in competitively tendering exploration acreage, there may be other situations where it is not in the best interest of the government to follow this approach e.g. where licenses are due to expire and it is mutually advantageous to enter into negotiations to extend the license. [See also the Guidance Note on Negotiation and Renegotiation of Contracts]

Predictability is also enhanced through simplicity of terms, which is an important driver and may need to be balanced with the other considerations. Especially when considering administrative implementation, the terms should be clear and simple enough to be administered with the human and financial resources and capacity at hand.

Long term perspective

Many oil and gas fields have a life cycle from exploration to abandonment of 30 to 40 years or longer. The life cycle of mining activities can be even longer. Fiscal certainty over a long time span is therefore critical in investment decision making but will be challenging in view of what

Stakeholders

The overall framework determining government take will do more than allocate El revenues between the resource holder and the investor. The choice of specific El related instruments or combinations thereof is likely to have an impact on the business a country seeks to tax (and attract to make investments) rather than just have a revenue raising capability. This is more so the case for extractive industry taxation as for general profit taxation as general profit taxation is primarily set up to raise government revenue where an El fiscal regime allocates risks and returns of a venture.

There are El specific drivers that need to be considered in order to fully understand a government take regime and its potential consequences on government and investor behaviour.

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Competitiveness: Many types of fiscal regime can work if they are competitive and predictable for investors. However, it is important to understand the allocation of risks and returns under the fiscal regime ultimately adopted by the country. While any fiscal system can be designed to give a level of economic return at a specific commodity price, how the underlying risk and return profile changes under different cost / revenue scenarios will determine the interest levels from investing companies. Often progressive systems are considered more competitive by investors as they move the timing of government share closer to the economical break-even point. As previously noted, more frontloaded systems (such as systems including signing bonuses, or introducing ring-fencing per well) are generally considered less competitive by investors.

Predictability

There are a number of excellent sources available to describe in detail fiscal instruments that have typically formed a part of fiscal regimes for the extractives sector⁵.

Contractual arrangements

The resource holder sets the legal framework within which to work or agree with the investor. Sometimes the details of the legal arrangements are set by law or even by the constitution, sometimes only the framework is set. In certain countries the terms are negotiated and set contractually.

Regardless of the legal instrument involved, , there are largely three different types of natural resource arrangements:

Concessionary systems

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remuneration for the work that exceeds the recovery of its costs, which are shared as such between the agreed partners.

In the oil and gas industry, PSAs are used in case the parties agree to share the production and related costs of the oil and gas produced. Unlike concession agreem

Special features on profit based taxation:

- Depreciation rates considering appropriate rates for capital expenditure deduction that provide an optimal level for both tax revenue and investment. For instance assets that require high capital expenditure may have a high depreciation rate to encourage investment. In both Mining and Oil and Gas taxation, accelerated depreciation is often available, sometimes limited or focused on the early years of production. Increase depreciation rates support asset investment.
- Uplift Unlike accelerated depreciation where depreciation rates are increased but the amount of depreciation in total is limited to the investment costs (i.e. the depreciation base), the uplift actually increases the depreciation base. For example, both Denmark and Norway apply an uplift in their hydrocarbon taxation. For every 100EUR spend, an uplift of 25% is permitted such that depreciation on 125EUR is allowed. Uplifts have been used effectively by both countries to keep the asset investment pipeline filled.
- Ring-fencing ring-fencing occurs when certain costs or revenues are considered separate from other costs and revenues, creating separate bases for taxation within a single taxable entity. The ring-fence can occur per type of activity. For example, in the United Kingdom the upstream taxable base is ring-fenced and subject to a higher rate compared to other business activities. The ring-fence can go further into detail, e.g. requiring a taxable base be determined per mine or per field. Ring-fencing will bring forward the timing of realization of government take for the government. It may give rise to tax payments before an overall

publicly owned to begin with (for example, in most Commonwealth and European Union countries), a resource royalty is paid instead of a tax.

Specific arrangements

rs with additional revenues

or other economic value:

- State participation (mainly for Oil and Gas);
- Bonus payments often related to the signature of the contract or the transfer of the lease;
- Carry (mainly for Oil and Gas and generally involving PSAs);
- Land rentals (mainly for Mining); and
- Other non-revenue/cash based systems like:
 - Infrastructure requirements building roads, hospitals, schools, water projects, housing communities. E.g. in Ghana, one investor has committed to building a 15km road, taking over this responsibility from Government;
 - Infrastructure transfer/Intellectual Property transfers;
 - Training levy/support for study costs; and
 - o Sponsorship of specialist courses at universities.

State participation can be another effective route to ensuring Governments secure an appropriate share of the upside in times of high prices or lower costs, whilst maintaining progressivity. Government equity ownership essentially places the government, or a government owned entity, in the position of a partner in the joint venture, along with the operator and any other investor partners involved. This participation can align investor and government interests, providing project advantages such as risk sharing, development ownership, and ensured support for development. Participating partners are however expected to equally share in the costs of the venture—thus government will have to consider how to fund this.

Bonus payments provide early, upfront revenues to countries, and thus have a timing appeal to governments, but are least favoured by investors as they are upfront payments, unrelated to actual production and thus are most regressive. Where bonus payments are involved, it will be important to consider which part of government receives the payment, how transparent the payment is and whether it goes to the national budget or to the budget of the administrative entity where actual exploration and extraction will take place.

From an investor point of view, frontloading negatively affects the risk/return balance

evaluate and compare projects on a discounted cash flow basis, thus the timing of investments or

project. From an investor point of view, terms that defer cash payouts or accelerate the value return of costs will be favoured.

Signature bonuses generate revenue early in the venture. They provide government take before any revenue or production is generated from the venture. If equity elements, i.e., state participation rights, are reserved, depending on their size and funding, they also can impact the risk/return balance significantly. Equity rights generally do not require cash payments from investors, (unlike especially the signature bonus), except in the case that the equity rights of the government include a carry arrangement.

Royalty systems come into play once production starts but do not require the venture to be profitable. As they are production related, their make-up may have an impact on the production profile. They are less regressive than bonus payments, since they at least require production and thus some revenue generation, but they are less progressive than income or profit related payments.

Profit related fiscal instruments give rise to government share around the time the venture becomes profitable However there are aspects of profit related instruments that may frontload though ring-fencing or other types of limitations of cost recovery tend to accelerate the moment of taxation and impose taxes before the investor, on an overall basis, is profitable.

Uplifts and increased depreciation on the other hand push the moment government share is achieved from profit related fiscal instruments further into the future. Depending on how the depreciation regime is set up, these instruments generally have a positive poaymenhe be faachieve

important in the later stages of the basin life where the size of discoveries statistically becomes smaller and smaller. It helps to manage the risk that discovered resources are left in the ground. Progressive systems can also be designed to cater for differing conditions, such as water depths, remoteness of locations, production levels and discovery size.

[examples to be included in editing]

Progressive fiscal attributes often make it easier to ensure that the interests of all parties remain aligned over the life of the venture, and under a wide range of macro-economic conditions. R-Factors¹¹ or Internal Rate of Return (IRR) creaming mechanisms¹² are examples of fiscal attributes that are progressive in nature. Value based creaming mechanisms, for example, can be tuned to ensure that the government keeps an appropriate share of the economic rent from the natural resource development interests regardless of the commodity prices. This avoids the need for arbitrary / unilateral increases in levels of taxation (which may

automatically to changes in both cost and revenues.

 $Windfall\ profit\ taxes\ are\ not\ always\ progressive\qquad \hbox{due t a172 Tm-}20(rc)3(lic)3(a)-4(l\)-11(n)4(a)-4(t)-2(u)4(re16MC\ a172\ Tm-20(r)5.74\ Tm[(\)]\ TJETB219.$

- By making small discoveries uneconomic to develop i.e. they result in Governments taking a proportionally larger share of small discoveries and a smaller share of large discoveries¹³.

For example, over the life of oil and gas basins, many royalty systems have had to be changed frequently by Governments wishing to remain competitive. Effectively, the changes have been made to give a royalty system features of a profit-based system, thereby making it more progressive.

Whilst some governments have chosen to abolish royalties, e.g. UK and Norway, for the reasons outlined above, they remain a popular choice for governments that seek to guaranteTBT7Shii6.11 T 11 3507a-11(4 58

regressive instruments such as a signing bonus or a ring fenced system, a tax system can become so frontloaded it becomes uncompetitive. This may delay exploration or production, leading to reduced or no revenue.

Delineation issues

In case various types of taxation or rates are combined, the delineation of costs and revenue will require special attention in the legislative process.

The rules need to be clear and precise as to which costs and which revenue belong in which instrument. If not, the overall fiscal and tax regime becomes unclear in its results. For example, in case activities are ring-fenced, the legislator should determine against which revenues the costs are to be deducted. It is not always clear which activities are covered within each ring-fenced instrument and a specific separation

taxation. It is important to understand how production sharing is done, how and where the volume of the production and the sharing is determined. Timing, responsibility of measurement, reporting and verification are important as is the allocation of risks. It is important to understand who will bear the commodity price risk in case production is shared in kind and who bears the exchange rate risk and for how long in case of sharing in cash. If the PSA and the corporate income tax are mute on these points, or if the arrangements under the PSA are not in line with the corporate income tax, it will be unclear as to how these issues will be dealt with under the general taxation regime.

When sharing production, the composition of the group of investors and their legal arrangements should also be considered from a tax point of view. Apart from the potential direct tax consequences, the indirect tax consequences should be considered. For example, under PSAs the production tends to be transferred from the government to the operator and from the operator to the Joint Venture (JV) or the JV partners. Especially in case of transfers in kind, each of these transfers could be subject to indirect tax at federal or subnational level. It may not be economically intended to levy tax at each of these transfers but arrangements need to be made to ensure the applicable laws are complied with and expectations are managed. Again, resolution and clarity of these types

International tax aspects

It is important to define whether and which part of the fiscal take is considered for foreign tax credit purposes⁹. This is influenced by the provisions of the relevant double tax treaty as well as by the characterization of the tax or levy in the relevant law or contract and by the taxation rules of the home country of a particular investor. Even if the tax or levy is clearly profit related, attention needs to be given to the description and features, especially if agreed in a PSA.[example to be included under editing]

The existence as well as the wording of a double tax treaty and of national taxation in the home country of the investor is relevant for the eventual tax burden on a project. The interaction between the tax system of the home country of the investor and that of the host country of the investment influences the eventual economics of a project. In other words, clarity in these rules, and oftentimes the existence of a negotiated tax treaty, can allow an investor to enter a higher bid.

Relevance of sub-national taxation and allocation of revenues

It is important to consider how the revenue from El is to be allocated amongst the subnational levels of government of the host country. The imposition of taxes and their allocation depend on

In certain countries, subnational levels of government have a mandate to introduce their own fiscal instruments. In other countries, only the federal government imposes taxes and subsequently appropriates the revenue.

Without clarity on allocation, the fiscal terms may not be stable as local entities may become dissatisfied with the revenues they are receiving. [reference to recent studies to include as editing]

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