Effective Extractive Industries Taxation Regimes



Workshop on Mining Taxation

African Union & European Commission in co-operation with UNECA

Anton Mélard de Feuardent

December 10, 2011

Fair Links

SUMMARY

- Specific Taxation Regimes for the Mining Sector
- Adjustment of taxation regimes to market price volatility: case study
- Diagnosis and Recommendations



SUMMARY

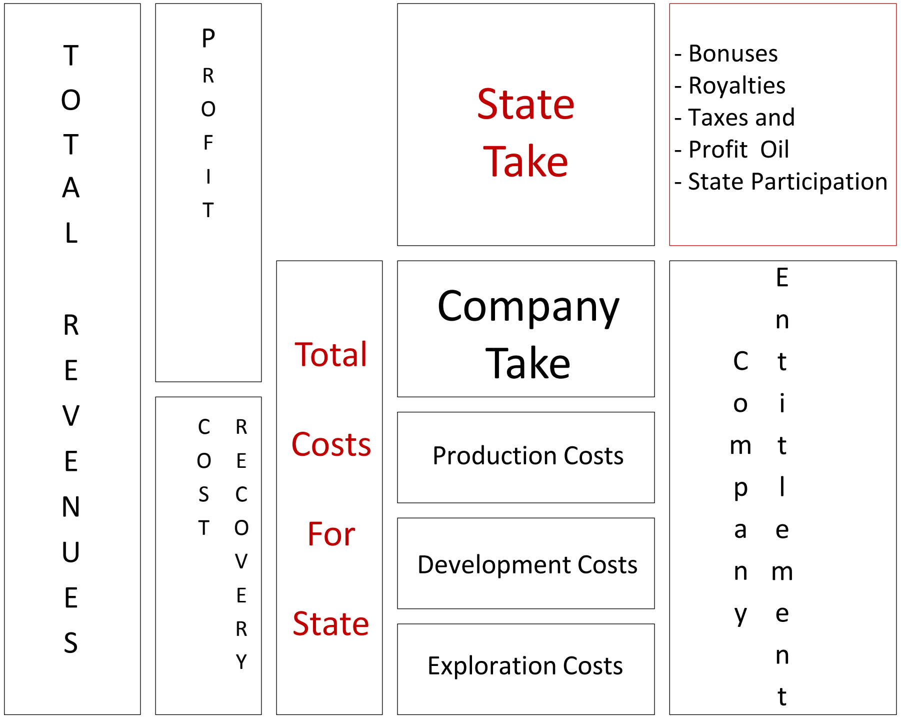
- **Taxation Regimes for the Mining Sector**
- Adjustment of taxation regimes to market price volatility: case study
- Diagnosis and Recommendations

▪ Taxation Regimes for the Mining Sector

- **Grounds of taxation regimes in the mining sector**
- Key features of taxation regimes in the mining sector
- Classification of taxation regimes in the mining sector

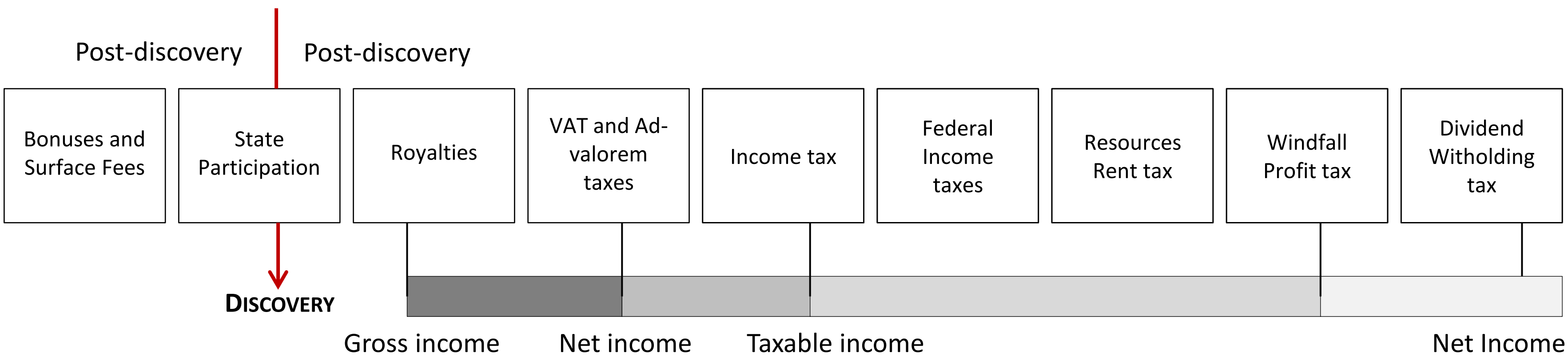
Grounds of taxation regimes in the mining sector

- The share of the extractive rent
  - The State is the owner the extractive non-renewable natural resources (US excepted)
  - The State's take of the extractive Rent is a compensation for the loss of the extractive non-renewable resources
  - The Company is the operator of the extraction: in charge of bearing the investment (exploration, development, production) and the risks (technological, geological, financial, geopolitical) of the project
  - The Company's take of the extractive Rent is a remuneration of its investment, risk and industrial performance



Grounds of taxation regimes in the mining sector

- Standard contracts do not exist in the Extractive Industries
  - A contract is necessarily based upon a specific economic model and specific economic expectations
  - Economic models are key to determine the share of the extractive rent
- Economic models use fiscal levies to determine the fair division of rent between the State and the Company



Grounds of taxation regimes in the mining sector

- Countries use a variety of taxation regimes to levy revenues and share the extractive rent
  - Concession contracts
    - Companies have full control over the production process
    - The owner of the extractive resources (e.g. the State) receives revenues or equivalent proceeds in return
  - Production sharing contracts
    - Production outcomes are negotiated between the State and the Company
    - The owner of the extractive resources (e.g. the State) receives a portion of the physical production as a payment for the ownership of the extractive resource



Grounds of taxation regimes in the mining sector

- Taxation regimes
  - Can be found in mining codes or in common-law tax codes
    - e.g. Mali (1991, revised in 1999), Ghana (1986, revised in 2001), Senegal (1989, revised in 2003)

  ⇒ **What about the economic underlying of mining projects?**

  - Can be set out in specific project agreements
    - Fixing a specific fiscal regime for each mining project

  ⇒ **What about transparency and economic justification?**

- Taxation Regimes for the Mining Sector
  - Grounds of taxation regimes in the mining sector
  - **Key features of fiscal policies in the mining sector**
  - Classification of taxation instruments in the mining sector

Key features of fiscal policies in the mining sector

- Mining projects extract non-renewable resources
  - The compensation for the loss of non-renewable resource is necessary
    - Tax policy response: Royalty tax + Specific income tax
- Mining projects are usually run by multinationals
  - Conducting risky operations
    - Tax policy response: Loss carry-forward
  - Exporting mining products on the international markets
    - Tax policy response: Exemption of export duties
- Mining projects are capital intensive
  - Imports of large quantities of equipment is needed
    - Tax policy response: Exemption of import duties, exemption or reduction of VAT



Key features of fiscal policies in the mining sector

- Mining projects can be developed on large or small scale
  - The extraction can either be industrial or artisanal
    - Tax policy response: variable royalty rate + variable income tax rate
- Mining projects are costly
  - Projects are developed in remote locations
    - Tax policy response: tax depreciation rates for infrastructure costs
  - Companies can operate on different licenses
    - Tax policy response: tax consolidation of exploration and production activities

Key features of fiscal policies in the mining sector

- Mining projects are finite
  - Site restoration and rehabilitation
    - Tax policy response: require a set-aside provision of funds
  - Guiding companies to environmental and social behaviors
    - Tax policy response: special incentives or penalties
- Mining products are distinctive
  - Mining products are rarely final goods
    - Tax policy response: variable royalty rate for different groups of minerals
  - Commodity prices are volatile
    - Tax policy response: loss carry-forward , windfall profit taxes
  - Long-term contracts, hedging contracts
    - Tax policy response: transparency on market price risk-sharing

- Taxation Regimes for the Mining Sector

  - Grounds of taxation regimes in the mining sector
  - Key features of the fiscal policies in the mining sector
  - **Classification of taxation instruments in the mining sector**

Classification of taxation instruments in the mining sector

- Taxation instruments are usually classified into two categories
  - Profits-based taxes
  - Production-based taxes

Classification of taxation instruments in the mining sector

- Profits-based taxes
  - Corporate income tax, determined by
    - The tax rate
    - The fiscal base
  - Net profit-based royalty
    - % of net profit
  - Withholding tax on remitted profits or dividends

Classification of taxation instruments in the mining sector

- Profits-based taxes are generally preferred by Companies
  - Can delay payments of taxes
  - Help Companies to optimize their tax-base
- Profit-based taxes may confuse the management of the extractive rent
  - Lead to irregular public revenues
  - Imply a strong level of State capacities to enable secure controls

Classification of taxation instruments in the mining sector

- Production-based taxes
  - Unit-based royalties
    - Based on volume or on weight
  - Value-based royalties
    - Based on the value of the product
  - Value Added Tax (VAT)
    - Consumption tax levied on value added
    - Most countries have chosen to negate its impac
  - Import/export tax
    - Can impact the country's competitiveness – not recommended
  - Withholding tax on imported services



Classification of taxation instruments in the mining sector

- Production-based taxes are preferred by States
  - Guarantee a regular level of public revenues
  - Are simple to administer and cost-efficient to collect
- Production-based taxes can raise Companies' financial risks
  - Constitute a yearly cost, even when the Company is facing losses
  - May discourage new investments or marginal explorations



SUMMARY

- Taxation Regimes for the Mining Sector
- **Adjustment of taxation regimes to market price volatility: case study**
- Diagnosis and Recommendations



Adjustment of taxation regimes to market price volatility: case study

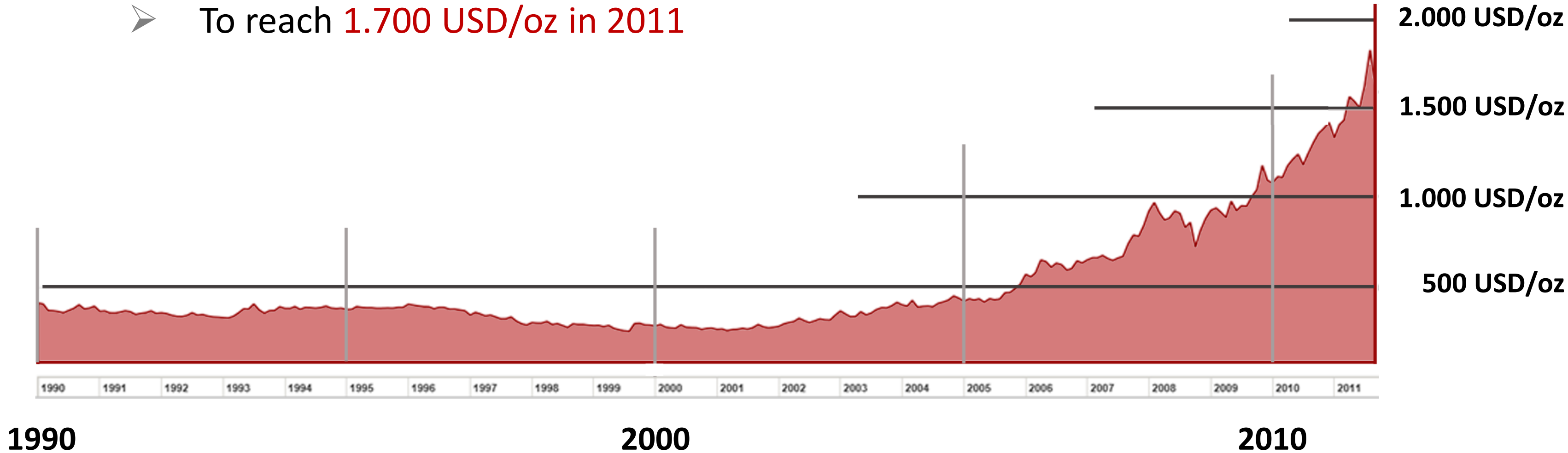
- Examples of taxation regimes for gold

	Country 1	Country 2	Country 3
Surface fees	N/S	N/S	N/S
Royalties	3-6% Tax holiday for the first 3 years	3+3%	5%
Income Tax	25%	45% Tax holiday for the first 5 years	25%
Dividends	10%	10%	10%
VAT and customs duties	Exemption	Exemption	Exemption



Adjustment of taxation regimes to market price volatility: case study

- Market price volatility analysis
  - Stable at 300-400 USD/oz for a couple of decades
  - Tripled during the last five years
  - To reach 1.700 USD/oz in 2011

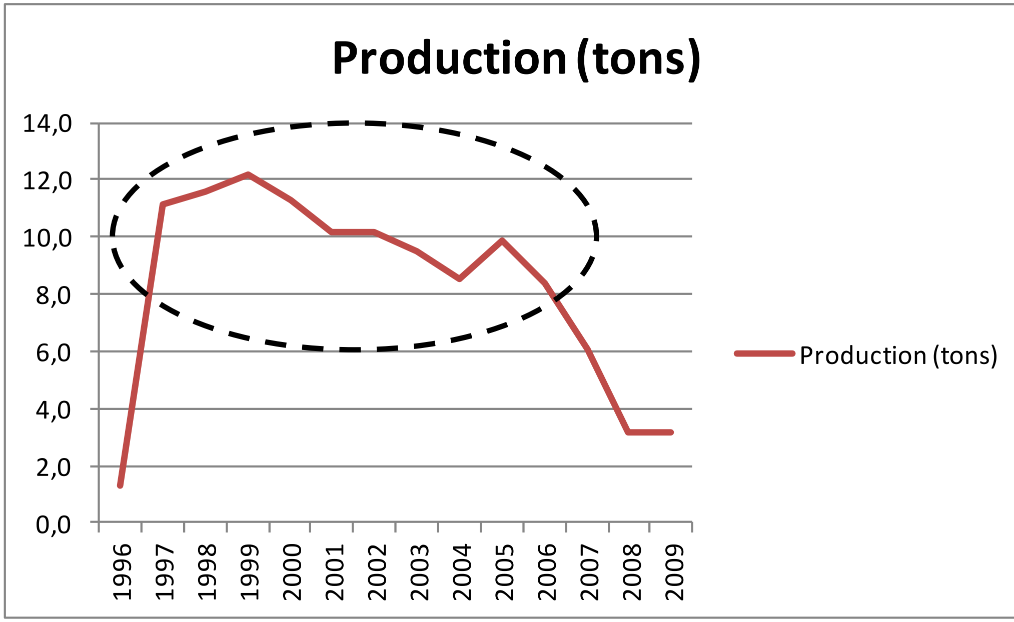


Adjustment of taxation regimes to market price volatility: case study

- Case study: a gold mine in Africa
  - Initial development plan (1990s)
  - Based on a gold market-price of 350 USD/oz
  - Investment of 200 MUSD
  - International Company : 90%
  - State : 10%

Adjustment of taxation regimes to market price volatility: case study

- Production profile
  - 120 tons of gold produced during 15 years
    - mid-1990→2010
  - High level production (“platform” type) for more then 10 years





Adjustment of taxation regimes to market price volatility: case study

- Division of the extractive rent
  - The State's take is composed of fiscal revenues…
    - Royalties + Ad-valorem taxes = 6%
    - Income taxes = 35-45%
  - … and of State participations
    - Dividends from the 10% capital owned in the production company
  - The company's take is composed of the shares owned in the production company
    - i.e. 90% in the present case study



Adjustment of taxation regimes to market price volatility: case study

- Case study: the project's IRR
  - The development plan has been designed with a market price of 350 USD/oz
  - Corresponds to an IRR beyond 20%
    - Exceeds the usual 15% usually used to compare mining projects' profitability

- A mining project's IRR must cover
  - The equity risk
  - The industrial risk
  - The geological risk
  - The geographical risk
  - The industrial performance

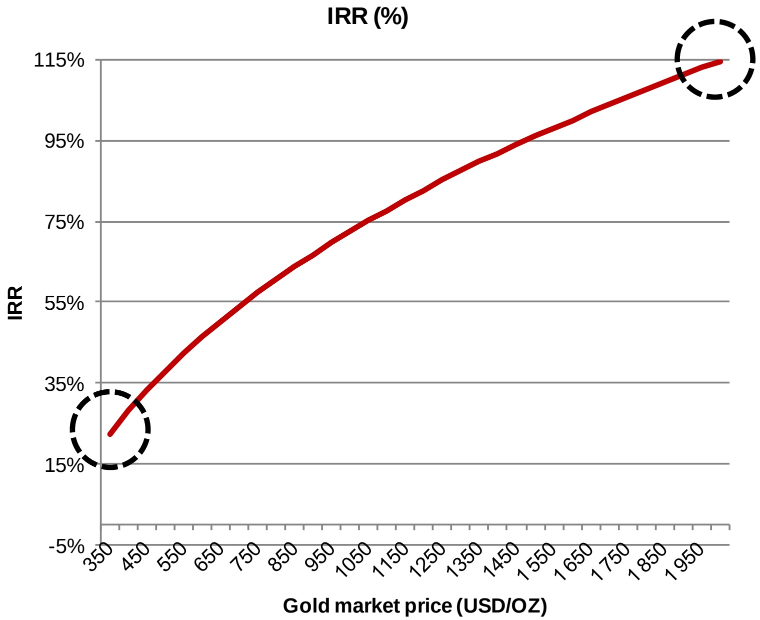
Adjustment of taxation regimes to market price volatility: case study

- Division of the Extractive rent

(kUS$)		1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Total	
Prix [1] **(kUS$/OZ)**		0,35	0,35	0,35	0,35	0,35	0,35	0,35	0,35	0,35	0,35	0,35	0,35	0,35	0,35			
Production [5] **(OZ)**		40 510	357 034	371 684	391 902	363 254	326 394	326 394	306 332	274278	316 395	268 555	194 480	101 275	101 275		3 739 762	
Production [5] **(tonnes)**		1,260	11,105	11,561	12,190	11,313	10,152	10,152	9,528	8,531	9,841	8,353	6,049	3,150	3,150		116,3	
OPEX par once produite [2] **(kUS$/OZ)**		0,1562	0,1169	0,1159	0,1106	0,1191	0,1227	0,1228	0,1306	0,1454	0,1276	0,1494	0,1752	0,2575	0,2575			
Revenus Bruts [c]		**14 179**	**124 962**	**130 089**	**137 166**	**127 139**	**114 238**	**114 238**	**107 216**	**95 997**	**110 738**	**93 994**	**68 068**	**35 446**	**35 446**		**1 308 917**	
Operating Costs		-6 328	-41 737	-43 078	-43 344	-43 264	-40 049	-40 081	-40 007	-39 880	-40 372	-40 122	-34 073	-26 078	-26 078		-504 491	
CPS	3%	-425	-3 749	-3 903	-4 115	-3 814	-3 427	-3 427	-3 216	-2 880	-3 322	-2 820	-2 042	-1 063	-1 063		-39 268	
Ad Valorem	3%	-425	-3 749	-3 903	-4 115	-3 814	-3 427	-3 427	-3 216	-2 880	-3 322	-2 820	-2 042	-1 063	-1 063		-39 268	
Total OPEX		7 178	49 235	50 884	51 574	50 892	46 903	46 935	46 440	45 640	47 016	45 762	38 157	28 205	28 205		583 026	
Amortissements [a]			-20 655	-20 684	-20 840	-18 979	-19 138	-17 568	-17 618	-17 632	-17647	-17 661	-5 917	-5 895	-5 873		-206 107	
Reversement de frais bancaires																	0	
Profit avant Impôt		7 000	55 072	58 522	64 751	57 268	48 197	49 734	43 158	32 725	46 075	30 571	23 994	1 346	1 368		519 783	
IBIC-IS	45%	Exonération		Exonération		Exonération	-5 422	-22 380	-19 421	-14 726	-20 734	-13 757	-10 797	-606	-616		-108 460	
Profit après Impôt		**7 000**	**55 072**	**58 522**	**64 751**	**57 268**	**42 775**	**27 354**	**23 737**	**17 999**	**25 341**	**16 814**	**13 197**	**740**	**752**		**411 323**	
Rente Etat		**1 551**	**13 005**	**13 658**	**14 705**	**13 355**	**16 554**	**31 970**	**28 228**	**22 286**	**29 912**	**21 078**	**16 201**	**2 807**	**2 818**	**0**	**228 127**	**38%**
CPS	3%	425	3 749	3 903	4 115	3 814	3 427	3 427	3 216	2 880	3 322	2 820	2 042	1 063	1 063	0	39 268	
Ad-Valorem	3%	425	3 749	3 903	4 115	3 814	3 427	3 427	3 216	2 880	3 322	2 820	2 042	1 063	1 063	0	39 268	
Impot sur les Societes	45%	0	0	0	0	0	5 422	22 380	19 421	14 726	20 734	13 757	10 797	606	616	0	108 460	
Dividends	10%	700	5 507	5 852	6 475	5 727	4 277	2 735	2 374	1 800	2 534	1 681	1 320	74	75	0	41 132	
Rente Partenaires	90%	**6 300**	**49 565**	**52 670**	**58 276**	**51 541**	**38 497**	**24 619**	**21 363**	**16 199**	**22 807**	**15 133**	**11 877**	**666**	**677**	**0**	**370 191**	**62%**
Total (Etat + Partenaires)		**7 851**	**62 570**	**66 327**	**72 981**	**64 896**	**55 051**	**56 589**	**49 591**	**38 485**	**52 719**	**36 211**	**28 078**	**3 473**	**3 495**	**0**	**598 318**	

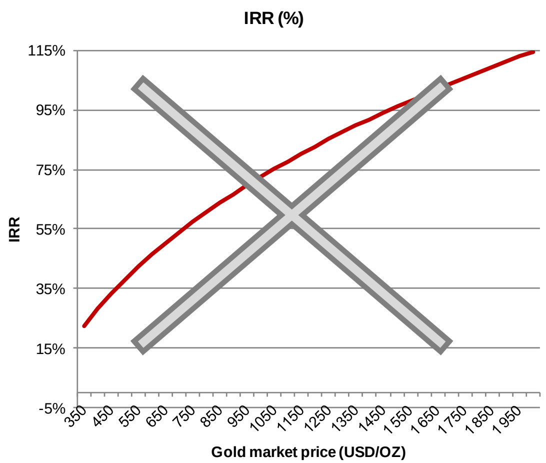
Adjustment of taxation regimes to market price volatility: case study

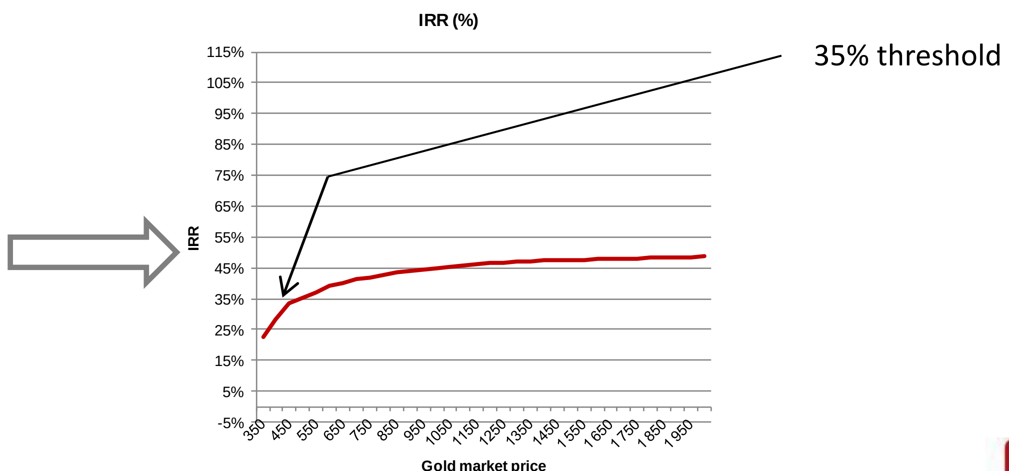
- The fundamental issue is rather to determine whether the Company is able to reach the internal rate of return it expected to reward its investment, risk and industrial performance
- Sensitivity analysis to gold market price volatility
  - IRR of 20% for a market price of 350 USD/oz
  - IRR of 111% for a market price of 2.000 USD/oz



Adjustment of taxation regimes to market price volatility: case study

- Analysis
  - Taxation regimes in most African countries do not allow to regulate the Companies’s levels of profits in high market price contexts
  - The IRR of the project should not exceed 35%



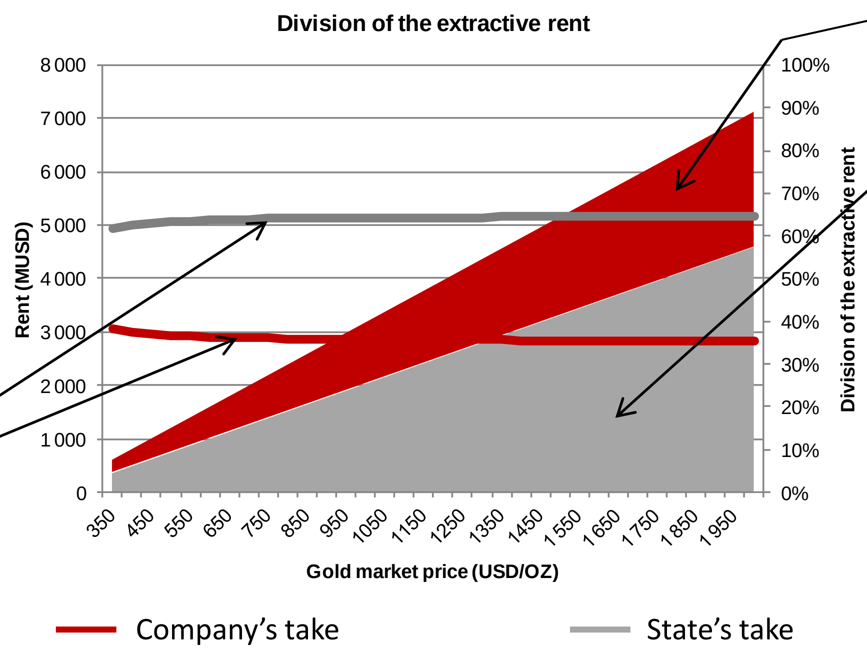


Effective Extractive Industries
Taxation Regimes

Adjustment of taxation regimes to market price volatility: case study

- Sensitivity analysis to gold market price volatility

The evolution of the State's take of the extractive rent remains relatively low compared to the Company's take

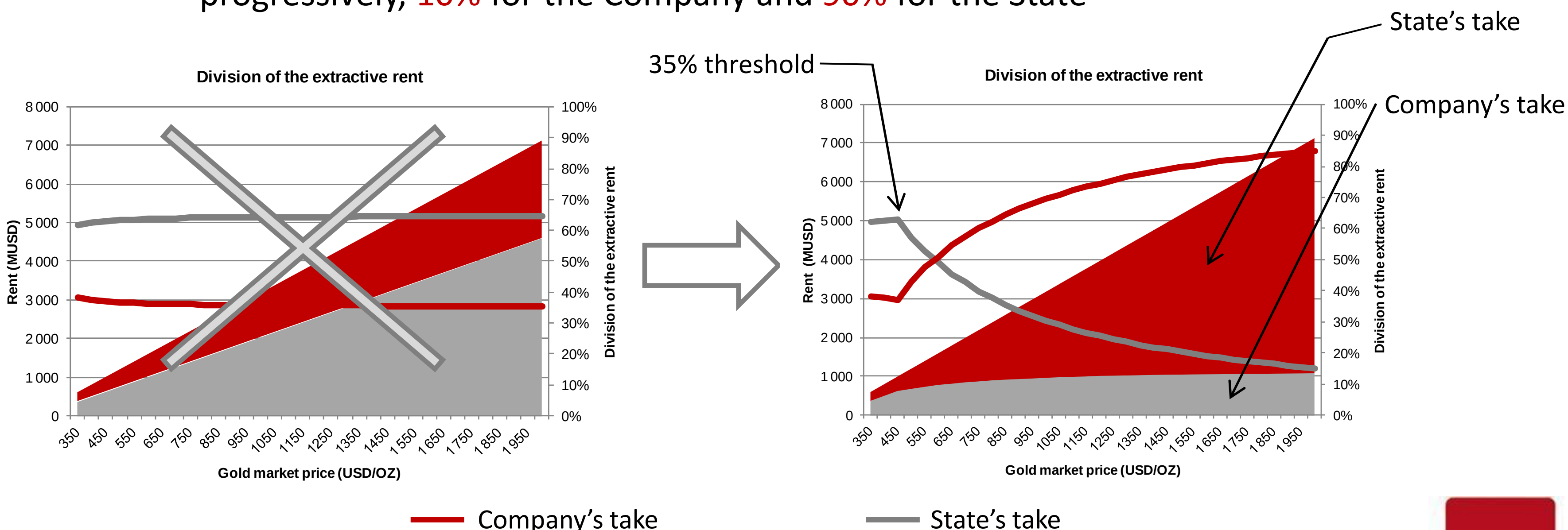


The evolution of the division of the extractive rent, however, remains stable :
- 62-64% for the Company
- 36-38% for the State

www.fair-links.com

Adjustment of taxation regimes to market price volatility: case study

- Analysis
  - Over 500 USD, the division of the extractive rent should reverse to reach, progressively, 10% for the Company and 90% for the State



Adjustment of taxation regimes to market price volatility: case study

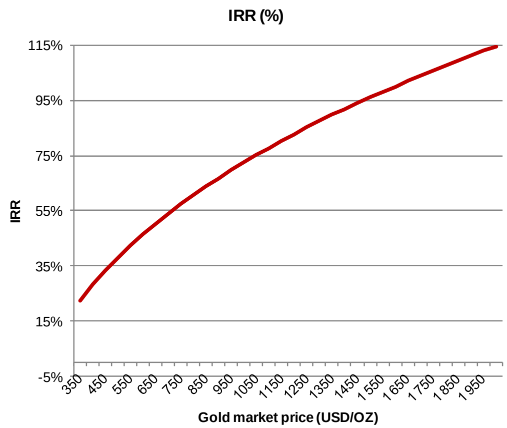
- Taxation regimes in country 1 and 3
  - Taxation regimes in these countries are similar
  - They differ to Country 2’s taxation regimes on the Income tax

25% (Country 1 et 3)	⟺	45% (Country 2)
No tax holiday		3-5 years of tax holiday

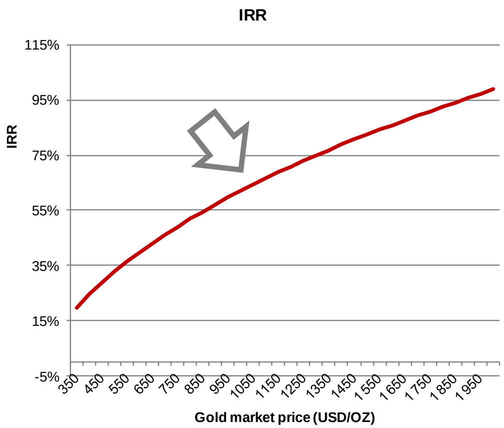


Adjustment of taxation regimes to market price volatility: case study

- Comparaison of the same project within two different taxation regimes



Country 2



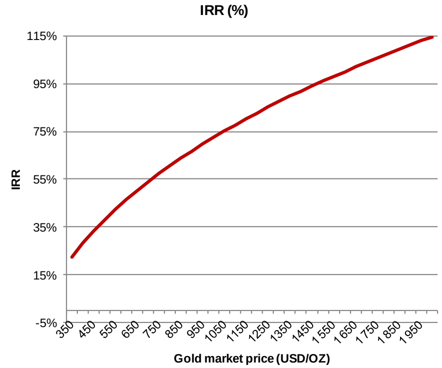
Country 1 and 3

- IRR is lower in countries 1 and 3
  - Similar IRR for a market price of 350 USD/oz
  - IRR of 96% vs. 111% for a market price of 2.000 USD/oz

Effective Extractive Industries
Taxation Regimes

Adjustment of taxation regimes to market price volatility: case study

- Raise of gold market prices or increased industrial performance?



- How to fairly adjust the division of the extractive rent
  - Replace the tax holiday for a loss carry-forward
  - Adopt a windfall profit tax

www.fair-links.com

SUMMARY

- Taxation Regimes for the Mining Sector
- Adjustment of taxation regimes to market price volatility: case study
- **Diagnosis and Recommendations**



- Diagnosis and Recommendations

  - **How can States maximize their taxation regimes?**
  - How can fiscal controls optimize States' revenues?
  - The positive impact of the EITI
  - Contract revisions vs. Fiscal adjustments

How can States maximize their fiscal regimes?

- **Diagnosis**
  - Limited understanding of the concept of the extractive rent
  - Standardized mining codes (good) … including royalty and income tax rates (non-sense)
  - Insufficient link between the project's economic model and taxation regimes
  - Weak tax administration: incomplete comprehension of the projects economics

How can States maximize their fiscal regimes?

- Recommendations
  - Understanding of the underlying of fiscal policies
    - Beyond the legal expertise
  - Follow-up of the current development plans
    - Sensitivity analysis
    - Monitoring of the realized budget
  - Benchmark of the other national taxation regimes

▪ Diagnosis and Recommendations

- How can States maximize their taxation regimes?
- **How can tax administration optimize States' revenues?**
- The positive impact of the EITI
- Contract revisions vs. Fiscal adjustments



How can tax administration optimize States' revenues ?

- Diagnosis
  - Limited capacities of civil servants on contractual frameworks
  - Lack of integrated information at the State level
    - Lack of communication between services
    - Lack of dialogue between administrations
  - Absence of distinction between the State's tasks: Sovereign State or State as partner?
  - Scarce available information on transfer pricing
    - States rarely request "at cost" reports from Companies

How can tax administration optimize States' revenues ?

- Recommendations
  - Nomination of a State control coordinator
    - High-level, respectable and reputable
    - Able to reach information a the highest levels of the administration
  - Reorganization of State controls and clear division of tasks
    - Between civil servants at the administrative level
    - Between the overlapping Sovereign and Partner roles of the State
  - A rigorous control procedure

Diagnosis and Recommendations

- How can States maximize their taxation regimes?
- How can fiscal controls optimize States’ revenues?
- **The positive impact of the EITI**
- Contract revisions vs. Fiscal adjustments

The positive impact of the EITI

- Diagnosis
  - The Extractive Industries Transparency Initiative (EITI) seeks to reinforce the governance and management of extractive public revenues
  - The EITI initiates
    - A clearer and more transparent State accountability
    - A formal link between mining revenues and development programs
- Recommendations
  - EITI implementation generates
    - An enhanced dialogue between the administrative bodies
    - An improved transparency in tax collection process



- Diagnosis and Recommendations
  - How can States maximize their taxation regimes?
  - How can fiscal controls optimize States’ revenues?
  - The positive impact of the EITI
  - **Contract revisions vs. Fiscal adjustments**

Contract revisions vs. Fiscal adjustments

- Diagnosis
  - Why change the contractual framework?
    - Mining revenues may not increase in correct relation with commodity prices
    - States rarely took into account the changing market prices when designing their taxation regimes
  - What does it involve?
    - Changing mining contracts into sophisticated contracts must go with the capacity to deal with more complex taxation regimes
- Recommendations
  - Revision of contracts raises a few concerns
    - Breaching contractual stability clauses may lead to costly arbitrations
    - Contract revision may damage the country's reputation and affect the future developments in the extractive sector
  - States should focus first on the full implementation of existing taxation regimes
  - Only then should States consider contract revision



Fair Links

42, avenue Montaigne
75008 Paris - FRANCE
Tel : +33 (0) 1 44 07 00 00
Fax : +33 (0) 1 44 07 00 10

1, Heddon Street
London W1B 1BD - UK
Tel : +44 (0) 203 075 0050
Fax : +44 (0) 203 075 0110

www.fair-links.com