PRINCIPLE VIII: Durable extractive contracts are underpinned by a fiscal system that provides for a fair sharing of economic rents benefits between the investor and the host government, taking into consideration the risks and potential rewards. A regime with automatic adjustments that have been agreed and which allows government to vary based on project profitability the government take to prevailing market conditions (whether from variable with variance in commodity price, production volume, or resource quality, or project profitability) reduces the incentives for either party to seek re-negotiations of terms. Due regard should be given to providing assurance of fiscal receipts to the host government for each year of commercial resource production.

COMMENTARY ON GUIDING PRINCIPLE VIII

43. Fiscal system refers to the combination of measures that determine how the host government earns revenues from extractive projects—these are the activities governed by the contract and includes instruments such as fees, contributions to training and development, royalties and taxes. In designing the fiscal regime factors such as the fiscal burden imposed during the early stages when there is little or no revenue (front-end loading), assurance of fiscal receipts to the state, avoidance of tax leakage, ease of understanding and effective administration should be taken into account. The fiscal systems can be embodied in:

- concession agreements: common to both mining and petroleum with the primary instruments being royalty and taxes
- production sharing contracts: characteristic of petroleum regimes which shares the production between state and investor. In some instances, there may also be royalty and taxes imposed
- Risk service agreements

Although there are different types of fiscal systems the real challenge for the government is to optimise revenue collection by striking a delicate balance between ensuring an adequate share of revenues for governments whilst maintaining the competitiveness of the fiscal regime under a range of outcomes to provide sufficient incentives for investors to pursue exploration, development and production for optimal resource recovery. Two key measures that provide useful information on the fiscal regime are: 1) the rate of return that the investor can earn and 2) “State Take”. State take refers to the percentage of the discounted net cash flow that accrues to the state over the life of the project. E.g. a project with 60% State take means 60% of the project’s profit goes to the State and 40% accrues to the investor. It should be noted that there is no one “right system” and the fiscal regime is ultimately dependent on the mix of instruments used and the strategic intent of the State.

44. Durable extractive contracts are underpinned by a progressive fiscal regime that provides enables the State Take to vary automatically in response to depending on project profitability, thereby providing a clear understanding of the equitable sharing of value between investor and government through all stages of, taking into account the project life cycle and across a range of outcomes and market conditions. The net effect of the fiscal instruments used should allow for automatic adjustments so that in instances of low profitability, state take is lowered to enable the investor to earn a fair rate of return and similarly in circumstances with high profitability, state take is increased so that the state can share in the upside. Having these pre-agreed self-adjusting fiscal terms which are agreed in advance that anticipate multiple profitability scenarios (whether influenced by from price, cost, volume etc) change and respond by equitably rebalancing the revenue sharing can contribute to the durability of the contract and lessen the need for renegotiations by balancing the interests of host governments and investors in times of both boom and bust and cope with fluctuations in market conditions (price, cost and volume). This structure can also help governments deal with political pressures to renegotiate or introduce unilateral changes while maintaining the competitiveness of the contract. In fact, in this arrangement “the government take tends to vary with project profitability so that the government may be less likely to adjust fiscal settings in response to major changes in market conditions”. The outcome is then mutually beneficial, with both the
government and investors sharing the rewards and enjoying a more sustainable long-term relationship. For example, some countries have introduced a progressive element in royalties by having them depend on the level of production or in some cases oil price. This is known as a sliding scale royalty, where the royalty rate is low when production or oil price is low and vice versa, thereby decreasing the possibility of negative cash flows when production or oil prices are low. There are various mechanisms available to governments to design progressive regimes, but it is also worth considering that it tends to increase the complexity burden of administration.

44. Fiscal instability is a risk factor that is under direct government control. It is one of the many items considered by investors, besides geologic, political, and development risks, which influence an investor's view of the overall investment climate and their assessment of the attractiveness of the opportunity. The key challenge for the government is to optimize revenue collection by striking a delicate balance between securing an adequate share of revenues for governments whilst maintaining the competitiveness of the fiscal regime under a range of outcomes to provide sufficient incentives for investors to pursue exploration, development, and production for optimal resource rents.

45. Without a progressive fiscal system, pressures for changes in fiscal terms may arise from governments and investors for different reasons. For example, without price responsive fiscal terms, governments often modify fiscal terms when commodity prices rise in an attempt to capture windfall. When prices are low two distinct approaches can be observed depending on the country's financial circumstances and its strategy for the extractives sector: (1) maximizing the capture of resource rents. Those governments who rely heavily on revenues from extractives for their budgets find themselves in a situation where they need to revise fiscal terms to receive more revenue to fund public spending; (2) Sustaining Investment. Those governments who wish to encourage continued investment in the extractives industry and increase production levels or sustain investment in risky exploration ventures take action to improve fiscal terms for the investor. Faced with sub-economic projects due to a fall in prices, investors often approach host governments to seek concessionary terms to enable continued activity and production. Chasing the price of commodities is neither efficient, (given that price volatility tends to be cyclical and is a structural characteristic of the market), nor is productive as experience shows that this resulted in strained relationships between host governments and investors, leading to renegotiation of agreements or unilateral imposition of new fiscal terms by governments. Host governments should aim to structure a credible fiscal system that does not distort production decisions, is responsive to price changes, and allows both governments and investors to reduce risk and adequately deal with imperfect information at the time of the signature of the contract.

46. Extractive projects are likely to operate through several economic cycles and they are likely to experience booms, but also periods of economic stress or even loss. Fiscal instability is therefore a key risk considered by investors, in addition to geologic, political, and technical risks, which influence an investor's view of the overall investment climate and their assessment of the attractiveness of the opportunity. If governments frequently change fiscal terms and structures when prices rise under the assumption that higher prices translate into unjustifiable higher returns to investors, this creates additional fiscal risk that investors will be either unwilling to accept or they will require expected higher project returns to compensate that risk, with a consequential reduction of the resource rent for host governments. In cases where governments reduce fiscal terms to incentivise activity, investors may perceive these as reversible and consequently adjudge the regime in the country as fluid or unpredictable, which may therefore not translate into increased investment. The same problem exists in a scenario of sharp decline in commodity prices where the driver may be less on maximizing the capture of resource rents than on sustaining investor commitments to existing projects and encouraging them to sustain investment in risky exploration ventures. In cases where investors perceive there to be high fiscal or political risk,
in either circumstance, investors require they will seek inclusion of fiscal stabilisation clauses in the extractive contract to reduce fiscal risk. Host governments may not need to offer or accept to include stabilisation clauses, if they could still attract the required investment. Where necessary to attract investment in high-risk environments and reduce investor risk premium, fiscal stabilisation clauses can be designed to minimise the general tax policy impact, by limiting their scope to specific key fiscal terms (not all fiscal terms) for a specific period of time (not indefinitely).

46. Chasing the price of commodities is neither efficient, given that price volatility tends to be cyclical and is a structural characteristic of the market, nor is productive as experience shows that this resulted in strained relationships between host governments and investors, leading to renegotiation of agreements or unilateral imposition of new fiscal terms by governments. Host governments should aim to structure a credible fiscal system that does not distort production decisions, is responsive to price changes, and allows both governments and investors to reduce risk and adequately deal with imperfect information at the time of the signature of the contract.

47. Depending on the context and regardless of the type of fiscal system adopted by a host government, it may be appropriate to ensure a minimum flow of revenues to the host government for each year of commercial production to ensure contract durability. Host governments face political and social pressures to demonstrate that resource extraction is beneficial to the nation. If there are sustained periods of production with little or no revenue flows, the sustainability of the contract may be brought into question. Early revenue is of particular importance to governments with newly developing extractive industries to bolster their budgets and whose population is expecting to realise some immediate benefits from its resource development. The rationale is that whatever the price of the commodity, the mere fact of extraction triggers a revenue payment, coupled with the variable component which is linked to profitability to help align interests of the government and investor. In a concessionary or tax-royalty system, early ensuring a minimum level of government revenue can be achieved through a production-based royalty payment while in a production sharing contract the same result can be achieved by imposing an annual recovery ceiling that is less than 100% of revenue in each year or alternatively via a modest royalty element. With these terms included, as long as there is production, the government will receive some benefit early in the project life cycle.

48. Early revenue is of particular importance to governments with newly developing extractive industries to bolster their budgets and whose population is expecting to realise some immediate benefits from its resource development. The rationale is that whatever the price of the commodity, the mere fact of extraction triggers a revenue payment. If the project was not economically justified, there will not be commercial production going on. If the project was attractive for investment and therefore there is commercial production, the government should benefit from it because the investor is doing it for a profitable reason. The proposed approach can be particularly useful for host governments with a large resource endowment, yet limited access to capital markets and a limited portfolio of projects. Under these circumstances, ensuring that the host government gets an early revenue stream as soon as production starts and whenever production occurs may be desirable—though revenue generation may start before production begins where signature and discovery bonuses are in place. It should be noted that flat rate royalties are regressive and may there could be circumstances where output-based royalties may not be desirable if the additional production cost imposed by the royalty makes the difference between acceptable and unacceptable profitability. Royalties may discourage incremental investments in mature high cost deposits for full recovery of the resources and lead to a premature abandonment of the field because they can cause operating income to become negative even when gross revenues exceed extraction costs. The level of royalty will be of critical importance to the investor and should be carefully considered when designing the fiscal regime.
49. Governments that have a wide portfolio of projects may not necessarily need nor desire to receive a payment in every year of production from every single project and may be able to withstand fluctuations through diversifying risk and optimizing revenue across the wide range of production through macro-economic management.

50. Governments need to decide what combination of fiscal elements will be appropriate for their individual circumstances – those circumstances not being just how much the government wants to raise and spend, but also how competitive the government wishes to be to attract investment. So, the optimal level of flexibility is likely to involve trading this off against the associated costs of risk-bearing. A risk-averse government may legitimately opt for greater certainty of the percentage of revenue flows it will receive and forego the prospect of exceptional revenues to reduce the risk of very poor outcomes, though the flip side of this may be a greater risk of reduced investment. A fiscal system where revenue is not responsive to changes in future market conditions reduces the risk of fiscal loss, but also does not adequately manage the risk of fiscal gain and participation in the upside when exceptional profits materialise. This scenario should be avoided to ease political economy pressures to renge on initial agreements, which leads to unilateral changes of fiscal terms or renegotiation that often prompt investors to require stabilisation clauses. Durable contracts should have some provisions that allow for the government’s revenue share to increase when resource profitability prices rise and also readjust downward when resource profitability prices fall.

51. Beyond attitudes towards risk, the government’s limited administrative capacity and performance in managing variable revenues, may point to heavier reliance on royalties than elsewhere.

52. A fiscal system that provides for combination of reasonable revenue certainty and is responsive to market conditions and outcomes will be perceived as more durable as it will reduce the likelihood that a change of fiscal terms would be imposed unilaterally, and consequently the perception of risk, which in turn can translate into higher level of investment or potentially a reduced investment hurdle rate and therefore an increase in the size of the total resource rent available for both host governments and investor.