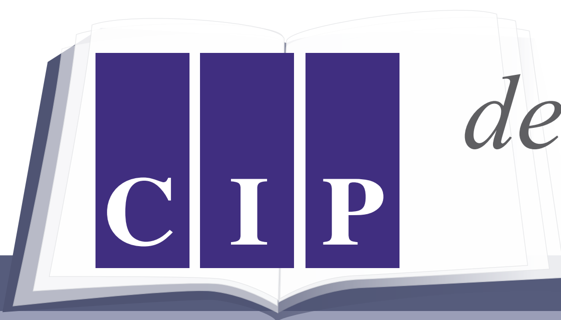

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Comments on Draft Fiscal Laws on Petroleum and Minerals

The Mozambique Government is revising the fiscal regime for petroleum and mining sector. Tax Authority undertook public consultations on the draft Fiscal Laws on Petroleum and Minerals. This is a CIP input to this process which concludes that by consolidating patchwork laws and decrees, placing core terms in legislation, closing some loopholes and adding a resource rent tax to the mineral sector, these laws provide a strong foundation for the next generation of extractive sector exploration in Mozambique. Good fiscal terms and clear laws improve the chances that the government will actually get a fair share of the revenues, though experience from other resource rich developing countries suggests that actually collecting the appropriate amount of revenue will be a serious challenge given company tax avoidance strategies.

Summary

1. Overall, the draft petroleum and mineral fiscal laws are very good. They represent an important step forward in promoting good governance in the extractive sector. The majority of the fiscal terms will now be in the publicly disclosed in legislation removing some discretion from contract negotiators.

2. Unfortunately, there is no provision in these laws for full contract transparency. Speculation therefore will continue that the 'real' terms in the contracts will be more generous than those set out in the publicly accessible laws. The solution is simple: the main laws on mining and petroleum should be amended to provide for the publication of scanned copies of the signed contracts, with annexes and without redaction, on a government website.

3. The draft fiscal laws represent more of a consolidation of existing terms than a substantial reorientation of the 'deal' being offered to companies. In the petroleum sector very little has changed with the core terms being almost identical to the model contract from the 2008 licensing round. Without seeing the model contract for the 5th licensing round however it is impossible to be sure. The model contract should be appended to the legislation and released as part of the public consultation process. One obvious shortcoming is the inability of the current fiscal terms to ensure an expanding share of revenues for the government for highly profitable projects.

4. There are more significant changes in the mining sector. First, there is the potential for a significant increase to the royalty rate (both the declared percentage and the way that it is calculated). Second, the law introduces a resource rent tax designed to capture super-profits. While the approach is consistent with current good practice, the rate being proposed is unusually high

compared to peer countries. The increase in the overall government take from the combination of increased royalties and a very high resource rent tax rate may well deter future investment in the mining sector.

5. The objective in fiscal laws is to find the appropriate balance between encouraging investment and securing a fair share of revenue for the government. Given that the government has yet to receive any significant revenue from the extractive sector nearly 10 years after the start of natural gas exports, there is good reason to believe that the balance between encouraging investment and securing a fair share of government revenue has been skewed too heavily towards securing investment. The current terms in the fiscal laws ensure too small a share of the revenue from the petroleum sector while asking too much from the mineral sector. Given the number of projects currently underway there is no substantial risk in testing whether companies are willing to pay more to access to Mozambique's natural heritage.
6. The improvements in legislation are welcome. It is important to be clear however that these laws will not change the generous terms provided to the existing projects (coal in Tete, gas in Rovuma) that will be responsible for the bulk of government revenue from the extractive sector over the next 10-15 years.

General Assessment

7. The bulk of the provisions in these two fiscal laws are drawn from existing laws and decrees including the three core laws from 2007 (No. 11, 12 and 13) and their associated Decrees of 2008, as well as substantial sections of the law on corporate income tax (IRPC). For the Petroleum Law, substantial portions of the model Exploration and Production Concession Contract have also been incorporated.
8. Consolidating existing laws and specifying terms in law that in the past were included only in confidential contracts is a substantial improvement in good governance in the extractive sector. It should significantly reduce the discretionary powers of those who negotiate the contracts.
9. There are three clear shortcomings that apply equally to the petroleum and mining fiscal laws: **a lack of clarity on provisions for accelerated depreciation of capital investments**; **a lack of specificity on the rate of the capital gains tax**; **and an over-reliance on sale price rather than international benchmarks for establishing value**.
10. The lack of transparency on provisions for accelerated depreciation – the pace at which capital investments can be written-off against taxable income – was identified three years ago in the first EITI report prepared for Mozambique. The draft fiscal laws make no progress in this area (See Article 24 on Petroleum and Article 36 on Mining). It is clear that the depreciation schedule (reportedly in place since the 1980s) is badly in need of updating. This need not be done in the law itself. But as the past contracts have contained generous tax incentives in this area, the new laws should explicitly specify the general terms for depreciation.
11. Capital gain taxes were introduced in the 2007 Corporate Income Tax code. The ways in which they have been imposed and assessed have been controversial. Both fiscal laws establish provisions for levying a tax on capital gains (Article 32 of the Petroleum Law and Article 44 of the Mining Law), but neither law specifies the rate that will be charged. If this is intended to be equivalent to the standard IRPC of 32%, it should be explicitly stated. There is also a lack of clarity on how the 'gain' is assessed, who will pay the tax (particularly when the seller divests its entire Mozambican assets and is therefore no longer 'present' in the country) and whether reductions based on

the length of ownership of the asset currently in place will be retained.

12. Good fiscal terms can be fundamentally undermined where the value of the resource is set artificially low. Mozambique has experienced this problem with the Sasol gas project in Inhambane where terms look reasonable (5% royalty and 15.5-32% income tax) but almost no revenue has been generated because of a highly unfavorable formula for establishing the sale price of gas. Valuation will become increasingly problematic as some companies seeking to purchase Mozambique's natural resources become involved in production within Mozambique resulting in non-third party transactions (in both the coal and gas sector potential purchasers from Asia are increasing ownership stakes in Mozambican production). Using a 'netback price' where value is determined by final sale price less shipping and processing costs is one option but it requires clarity on these 'arms length transactions'. A better alternative is to determine value based on internationally accepted benchmark prices.

The Petroleum Fiscal Law

13. The broad terms for the petroleum sector are unchanged from the new regime that was introduced with the 2007 laws and applied in the 2008 model contract and licensing round. However, it is impossible to understand the full ramifications of the new laws without also examining the new model contract that has been prepared for the 5th licensing round, previously scheduled for late 2012. In addition to clarifying the status of a series of past tax breaks; the model contract will also illustrate the biddable elements that the government intends to use to adjudicate the competitive process.

14. The main fiscal terms for the petroleum sector remain unchanged: the royalty rates remain at 6% for gas and 10% for oil. Consistent with the 2007 laws and with industry norms, royalty payments within the production sharing arrangement are not deductible expenses for calculating income tax. The IRPC for the petroleum sector is formally set at 32%.

15. The sector will continue to operate through a production-sharing scheme. The production tax is paid first, after which the company is allowed to recover costs to a limit of 60%. This is a lower limit than has been included in past EPC contracts and has the effect of increasing the effective royalty rate in the early years of production to 9.7% for gas and 13.6% for oil.

16. The split of profit oil/gas between company and government also mirrors past EPC contracts. The sliding scale is based on an r-factor with r<1 resulting in 10% to the government and 90% to the company. The r-factor scale, consistent with EPC contracts since the 3rd licensing round, ranges from 1-2.5. The full table is completed in the draft law with a government / company split at r+ 2.5 of 60%-40%. This is surprising as the relative split at higher r-levels is the most obvious element to be biddable in the competitive process for new concessions and should be left blank.

17. Equally important, the current r-factor formulation is not well suited to highly profitable projects, as the government seems willing to cap its share at 60%. The fiscal regime should be designed to function well at all potential levels of profitability. The compression of the r-factor scale of 1-4 to 1-2.5 (done between licensing rounds 2 and 3) with a de facto limit of 60% to the government makes much less sense than retaining the original 1-4 scale and setting a higher government percentage (70-80%) for highly profitable projects.

18. As in the past, a 'ring fence' is established for the calculation of production sharing (cost oil/gas and relevant r-factor) at the level of the Concession.

19. The petroleum fiscal law incorporates the valuation sections of past EPC contracts. There is far greater clarity on the valuation process for oil than for gas. This is somewhat surprising given that non-associated natural gas appears to be the main form of hydrocarbon discovered in Mozambique. Given this importance, greater specificity should be added to how the price of natural gas will be established.

Main Petroleum Issues

- The model contract should be published in order to understand the full nature of the fiscal regime and the elements that will be biddable.
- The combination of the established royalty rates and a 60% cost recovery limit pushes up the effective royalty rate to above average in comparison to peer countries.
- The percentage associated with all r-factor tiers except r<1 should remain empty and be the main biddable feature for future licensing rounds – the top percentage is completed and the others interpolated.
- The 1-2.5 r-factor scale should be replaced with the previous 1-4 scale – the expectations should be that the government percentage for r+4 should be 70% or greater.
- Terms for depreciation of capital investments should be incorporated into the law.
- The tax rate for capital gains should be explicitly specified in the law.
- Further clarity should be provided on the process for the valuation for natural gas.

Mining Fiscal Law

20. As with the petroleum fiscal law, the bulk of the mining fiscal law is consolidated from existing sources including the 2007 laws and 2008 decrees. As there is no publicly available ‘model contract’ for the mining sector, other elements are drawn from contracts that remain confidential. Unlike the petroleum sector there are substantial changes proposed in the mining sector including proposed increases to the Production Tax (royalty rate) and the imposition of a new Resource Rent Tax.

21. The laws suggest that the government intends to increase the effective rate of the production tax for precious and semi-precious metals. First, although specific royalty rates have not been proposed, a potential range has been provided in the draft law that implies an increase. The table below illustrates Mozambique current and proposed rates in comparison with other African countries.

	Botswana	Ghana	Tanzania	Mozambique (Existing)	Mozambique (Proposed)
Diamonds	10%	5%	5%	10%	7-12%
Precious Metals	5%	5%	4%	6%	6-10%
Semi Precious Metals	3%	5%	4%	5%	5-10%
Coal	3%	5%	3%	3%	5-10%

Second, although it is clear that there will be substantial transportation costs associated with mineral extraction (particularly coal) the draft laws will levy the royalty on the sale price without any deductions for the costs of production or transportation. Finally, in contrast to most other jurisdictions, Mozambique imposes a tax on all ore produced, rather than only on ore that is sold. Taxing all production can be problematic where, as will be the case for low-grade thermal coal in Tete, substantial volumes of ore will be mined for which there is no commercial market.

22. The effective royalty rate is further increased because revisions to the mining tax code in 2007 removed royalty payments as a deductible expense for IRPC calculations (a change that was and is appropriate for the petroleum sector but inappropriate for the mining sector). This has the effect of increasing the effective royalty rate over the lifetime of the project by almost 50%.

23. Increasing royalty rates is an attractive option for the government, given how little revenue is currently being generated by the extractive sector. And some increase may well be warranted to ensure that government generates greater revenue in the early years of mining operations. Significant increases in royalty rates however may also deter companies from investing in marginal projects.

24. The draft law explicitly applies the 32% corporate income tax (IRPC) rate to the mining sector. While the rate remains unchanged, there are important changes to the ways in which the IRPC will be applied including: mining projects are to be 'ring-fenced' at the level of the mining title, and investments in transportation infrastructure will no longer be deductible against mining income.

25. The provision on 'ring fencing' seeks to ensure that second and third generation investments by a company do not result in a long-term deferral of income tax payments. Even where a company operates multiple mining projects, income and expenses will be calculated, and income tax assessed, for each project individually. Ring fencing is unusual in the mining sector in Africa but there are signs that it may become more common. Introducing ring fencing in Mozambique will create an unleveled playing field, particularly in the coal sector. When applied only to new entrants, it will lock in the dominance of existing big companies who derive major tax benefits from being able to deduct second-generation capital investments against first-generation income.

26. The payment of corporate income tax in the coal sector will be deferred substantially due to high levels of investment in transportation infrastructure including railways and ports. The draft fiscal law proposes to sever this linkage. Future projects will be allowed to deduct only the costs of a transportation tariff (a set fee per ton of ore transported). They will not be allowed, as is currently the case, to deduct the capital costs of developing transportation infrastructure from mining income.

27. The most fundamental change to the fiscal regime for mining is the introduction of a resource rent tax (IRRM). This is a mechanism designed to ensure that the government share increases when a project becomes highly profitable. An IRRM is assessed where the company 'internal rate of return' (the ratio of the profit generated relative to the amount of money invested) exceeds a set percentage.

28. The draft mining law proposes the following: a direct tax on the net cash flow of a mining project where the rate of return before tax exceeds a yet to be determined percentage (somewhere between 12% -18%). In these circumstances, the tax rate proposed is 40-50%.

29. The combination of a modest royalty, a 30-35% income tax and a resource rent tax (RRT) is now widely seen as good practice in the mining sector. The internal rate of return (IRR) at which Mozambique's proposed resource rent tax would become effective (12-18%) compares well with peer countries. The proposed tax rate to be imposed where the IRR exceeds that

	Liberia	Malawi	Mozambique
IRR Threshold	22.5%	10%	12-18%
Tax Rate	20%	20%	40-50%

percentage is, as the table below shows, far higher than in peer countries.

30. The addition of a resource rent tax will create additional demands on the tax authority. Companies always have an interest in structuring their operations in order to minimize tax payments. Any effort by the government to capture a larger share when operations are highly profitable can be expected to result in even greater efforts by companies to ensure that their reported profits never exceed the threshold at which the IRRM becomes effective.

31. The draft mining law indicates that valuation for the Production Tax (Article 11) and IRPC (Article 27) are to be based on the sale price. The Tax Administration reserves the right to correct the taxable value where it is determined to be less than market value. The law contains references to sale price needing to be 'arms length' (Article 28) but in sectors, such as coal, there are many examples where even 'arms length' transactions are subject to routine underpricing. In response, other coal exporters including Indonesia, Mongolia and Colombia establish a price floor for different grades of coal based on indices from established trading centers.

Main Mining Issues

- Some increase in royalty rates may be appropriate, particularly given that early experiences have generated very little government revenue. But as higher royalty rates might also deter future investment, a balance needs to be struck.
- In keeping with industry standards, royalty payments should be deductible from taxable income (this should be changed in the mining law but *not* in the petroleum law where royalty payments in gas are not part of taxable income).
- The combination of ring fencing new projects and not allowing capital depreciation for transportation investment for new projects will ensure the continued dominance of the large existing coal mining companies.
- Terms for depreciation of capital investments should be incorporated into the law.
- The tax rate for capital gains should be explicitly specified in the law.
- Imposing a resource rent tax to capture a greater portion of highly profitable operations is appropriate, as are proposed rates at which the tax will come into effect.
- Greater attention should be paid to mineral / coal valuation including the possibility of establishing a price floor for the calculation or royalties based on international benchmark prices.

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